Chapter 35

Payroll Auditing

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A *payroll audit* is primarily an examination of a contributing employer's records to determine whether the employer has submitted payments to a benefit plan as required by the collective bargaining agreement (CBA). The auditor looks for under- and overpayments from intentional or unintentional reporting errors regarding workers' hours worked or paid. If the employer paid less than what was required, there is a *deficiency.* Sometimes, an employer does not submit the required reports and/or payments. This is a *delinquency.*

Payroll auditing, done properly, can be a source of revenue for a multiemployer benefit plan. The plan should constantly monitor the revenue generated by payroll audits and compare it to the expenses of conducting the audits. If the revenue increases from year to year, then the plan should probably conduct more audits. If the cost of audits increases faster than the revenue generated from year to year, then fewer audits should be performed. Constant monitoring by trustees is essential.

Is There a Difference Between Payroll and Compliance Audits?

The simple answer is "no." Some multiemployer benefit plans refer to *payroll audits* as *compliance audits.* Why? Two reasons are usually given. First, payroll audit suggests an auditor is looking only at payroll records. To be thorough, an auditor must also look at an employer's cash receipt and disbursement records, the general ledger and personnel records. The auditor might also look at an employer's financial statements and income tax returns. Access to more than payroll records is essential to an auditor who is trying to judge whether the *remittance* (payment) reports accurately represent the hours worked by or wages paid to employees covered by the CBA.

A second reason for using *compliance audit* is that employers seem to be less offended by it. A payroll audit has a negative connotation to some—like an IRS audit! Compliance, on the other hand, suggests adherence to plan rules. Is this just smoke and mirrors? Perhaps. In the future, "compliance audit" may replace "payroll audit." For now, let's just use the term *payroll audit.*

What Employer Records Are Produced for a Payroll Audit?

The agreement and declaration of trust should be as inclusive as possible in stating the records that the contributing employer should produce for a payroll auditor. Employer records that should be required as part of the payroll audit process are:

- Payroll records including detail on hours worked and paid (weekly or monthly)
- Individual employee earnings records (quarterly or yearly)
- Federal 941 Quarterly Payroll Tax Returns
- Annual employee earnings reports (Forms W-2, W-3, 1099 and 1096)

Tip for Trustees

Check that your plan has a written agreement, declaration of trust or other document that allows a plan auditor to access the employer records needed to complete a payroll audit.

- Copies of monthly remittance reports to all fringe benefit funds to which the employer contributes
- Cash disbursements records
- All pertinent personnel information, such as a hire and termination list
- General ledger
- Records of payments made for leased employees
- Corporate or personal income tax returns.

Why Are Payroll Audits Needed?

One of the fiduciary duties of a trustee is to collect delinquent contributions. In the case of *Central States Pension Fund v. Central Transport, Inc.*, 472 U.S. 559 (1985), the court rejected the argument that the responsibility for collecting contributions was that of the union, the Department of Labor (DOL) or the beneficiaries. The Employee Retirement Income Security Act of 1974 (ERISA) gives this responsibility to trustees, and if trustees do not make what is considered a reasonable effort to collect contributions, they can be held personally liable. Payroll audits provide assurance that all employer contributions have been submitted to a plan.

Another reason for payroll audits concerns a plan's audited financial statements. Auditors of employee benefit plans must follow rules established by the accounting profession including the generally accepted auditing standards (GAAS). An auditor who does not follow GAAS when conducting an audit could have civil and criminal liability. The auditor could also lose his or her license and/or be sanctioned by the American Institute of Certified Public Accountants (AICPA). One of the ten GAAS requires certified public accountants (CPAs) who examine benefit plan financial statements to gather sufficient information to support the opinion given on the statements. As part of the process, an auditor must verify plan income including employer contributions. In a multiemployer plan audit it is difficult, if not impossible, to gather enough information regarding the completeness of employer contributions without doing payroll audits.

AICPA has published *Audits of Employee Benefit Plans*—a guide that interprets GAAS and should be adhered to by CPAs. The guide states that auditors should compare employer contribution reports with participant payroll records to gather participant data. The guide does not use the term *payroll audit,* but the requirement is clear. The guide suggests several alternatives to payroll audits, but all of these alternatives have complications and risks.

What happens if an auditor is not able to gather the necessary participant data? The result is that the auditor will not be able to give an unqualified opinion on the plan's financial statements. Instead, the auditor will have to give a qualified opinion or disclaimer of opinion. This can have disastrous consequences for a plan.

DOL and the Internal Revenue Service require plans with more than 100 participants to attach an independent auditor's report of plan financial statements to the Form 5500. DOL will not accept the auditor's report with a qualified opinion that indicates there is no payroll audit program. When a Form 5500 filing is rejected, DOL treats the filing as if it were a nonfiling. DOL can assess penalties of up to $1,100 per day for failing to file timely and complete reports.[1]

In addition to meeting trustees' fiduciary duty, here are five more reasons for conducting payroll audits:

1. **Checking suspicious contributions.** Local union officials may complain to trustees that an employer is not properly reporting all employees covered by the CBA. Perhaps after annual statements are sent to participants, the plan administrator receives complaints from participants about the information in the statements. A payroll audit will help the plan determine whether employers are fulfilling the terms of the CBA—more specifically, whether there are any unreported employees or other reporting issues. Do keep in mind, however, that a payroll audit may not be successful in finding problems if the employer hides employees or wages by paying cash.
2. **Keeping employers honest.** We want to believe that all employers pay their contributions to employee trust funds because they are genuinely concerned about the welfare of their workers. For most employers, this is true. For others, the only factor that keeps them honest is fear they will be caught and penalized. A payroll audit program puts the less-than-honorable

Tip for Trustees

Make sure the plan you represent has a detailed written collection policy. This policy should include the policies and procedures for auditing contributions made by contributing employers. Chapter 52 on Collection Litigation identifies items that should be in a written policy.

It is common for trustees to have questions for auditors concerning payroll audits. Here are answers to some of the questions frequently asked:

1. **Why does an audit take so much time?**
A proper payroll audit takes time. The time doing the fieldwork at the employer's office may be only a day or even half a day. Once the payroll auditor leaves the field, he or she spends a great deal of time investigating the records. The auditor must determine whether all employees were reported and their employment information is correct. If there are unreported hours, these hours must be summarized and totaled by type of error. In addition, the audit report must be written.
There are many reasons why fieldwork takes longer than usual. The employer was in a remote location. The employer was not prepared and kept the auditor waiting. The employer's records were not in good order or organized in a way that makes auditing difficult. Many audit findings require the auditor to look at 100% of the records.

2. **How much should a payroll audit cost the plan?**
The cost of the payroll audit depends on the answers to many questions. Just a few of these questions are:
   - *Who is performing the audit? Is it an internal audit staff or a CPA firm?*
   - *Will the auditors examine all hours paid or will they use a sampling approach?*
   - *How large is the employer being audited?*
   - *Do the employer's covered employees represent a small or a large percentage of the workforce?*
   - *Will the auditor find a small or large number of errors?*
   - *Will the employer have all records available and displayed in a logical sequence when the audit starts?*
   - *Does the auditor have to measure hours paid, hours worked or some other unit of measurement?*
   - *Are hours paid weekly summarized by the month, by the quarter or annually?*

3. **Why don't we audit every employer every three years?**
A plan should annually measure the amount of funds collected as a result of payroll audits relative to the cost of the audits. The goal is to collect more money performing payroll audits than the payroll audit program costs. Many successful payroll audit programs identify deficiencies that represent a multiple of the cost of the program. The amount of the multiple depends on such factors as the employer's industry and how rapidly delinquencies can be identified and collected.
The ideal time to audit the average employer may be every three years—or it could be four, five or six years. Each plan is different. How often a plan audits an employer depends on plan policy and the plan's history with the employer.

4. **Should we have payroll auditors perform a 100% examination or should we instruct the auditor to sample the employer's payroll, isolate errors by type and then do 100% examination on those error types?**
Some plans prefer the 100% audit. The major advantage of the 100% examination is that almost (if not) all errors will be identified. The major disadvantage of this method is the cost. A 100% examination is extremely time-consuming. It works best when a plan has an internal payroll audit staff. Experience suggests that the majority of plans that do payroll audits do not perform a 100% examination.

5. **Why can't the employer send us all the records to do a payroll audit in the auditor's office?**
Most payroll audits have to be done in the employer's office. The sheer volume of records reviewed compels the auditor to visit the employer.
One other reason for doing the audit on site is that the payroll auditor can observe how the employer operates. The auditor quickly discovers how cooperative the employer will be, and almost as quickly determines whether deficiencies are likely to be found in the audit.

employer on notice that trustees are serious about collection. If Employer X is audited and penalized for nonreporting, Employer Y may pay what he owes to avoid the same penalties. Payroll auditing is preventive medicine.

3. **Helping new employers.** New employers often do not understand the reporting requirements set forth by the CBA. Many funds audit new employers after six or nine months of reporting. The audit provides an opportunity to help the employer properly report.
4. **Determining liability upon termination.** Employers that cease to be covered by a CBA also present a problem. Employers may stop their contributions before the CBA expires. A payroll audit on terminating employers ensures that remittances are sent through the termination date of the CBA.
5. **Documenting for collection.** When an employer experiences financial difficulty, benefit payments often slow or stop completely. If an employer fails to make contributions, the matter may have to be referred to legal counsel. A payroll audit supports the legal action the plan's attorney will take to enforce payment.

What Kinds of Problems Do Payroll Audits Identify?

Some problems are common and easily found:

- Clerical errors
- Failure to report:
  - New and/or terminated employees
  - Paid overtime hours
  - Paid sick pay and bonus hours
  - Apprentices
  - Covered nonunion employees
  - Subcontracted or leased employees
  - The fifth week of a month.
- Employees whose work changes from noncovered to covered status
- Capping reported hours incorrectly.

Other deficiencies are unusual and difficult to identify:

- Disguising hours paid as materials or other expenses
- Using an alter ego company
- Failure to report a covered group
- A double set of books
- Payments off the books
- Payments for owners, relatives and other noncovered employees.

For a full description of these deficiencies, see the separate article posted at www.ifebp.org/Handbook7.

Employer Questions

Payroll audits generate many questions. The following are questions (and *answers*) often asked by employers.

1. **I only want to give you payroll records for collectively bargained employees. I don't want to give you records for office staff or officers of the company. Why is this a problem?**
   The Supreme Court has ruled that an employer must produce payroll records of all employees for the payroll auditor.[2] The payroll auditor does not have an interest in the payroll records of noncollectively bargained employees. However, the auditor must look at all records to judge who the collectively bargained employees are.
   On occasion, an employer asks an auditor to sign a statement that the wages of noncollectively bargained employees will not be revealed to the benefit plan. Under normal circumstances, the auditor will agree to this. If an employer objects to showing individual salaries for officers and office employees, the payroll auditor may give the employer permission to blank out individual salaries and leave the total so overall payroll can be verified.

2. **Why should I have to pay on nonunion employees? They cannot get benefits.**
   A nonunion employee can receive benefits. A plan cannot discriminate in favor of a participant just because that participant is a union member. If a person's job is covered by a collective bargaining agreement (CBA), the employer must pay on that individual. Once the individual earns enough credits, he or she gets the benefits.

3. **Our state is a right-to-work state. Why should I pay on those who choose not to join the union?**
   Employees in a right-to-work state have the right to decide whether to join the union. Whether they join the union or not has nothing to do with their benefits. If they are performing work covered by the CBA, contributions must be made on their behalf.

4. **Why should I pay on temporary employees or summer help? They will never receive a pension.**
   Defined benefit plans recognize that not all employees will receive enough credit to earn a pension. In determining the pension benefits for participants, the actuary considers contributions for these workers even though they (the workers) will never be paid benefits.

5. **Why should I let you see my cash disbursements journal? That is a private record.**
   The agreement and declaration of trust—signed by the employer—state the plan may conduct a payroll audit and identify the records the payroll auditor is entitled to examine during the audit. Normally this includes reference to payroll records and cash disbursement journals. Some plans even include the general ledger and the income tax returns.

6. **Why did the union select me for an audit?**
   The union has nothing to do with who is selected for a payroll audit. The plan determines who is audited. There are many different reasons an employer is chosen for a payroll audit. The employer may have been chosen at random—participating employers had an equal chance of being selected for audit. The decision to audit may also be the result of complaints filed by a participant or something a plan employee noticed while processing reports submitted with contributions. Some plans audit all employers on a four-year cycle and the employer's number just came up. Typically, the auditor has nothing to do with the selection process and can honestly respond that he or she does not know why the employer was selected.

7. **Why are you auditing me? I'm sure you don't audit the employer trustees.**
   For most plans, the answer to this question is that the plan has a payroll audit program that requires all employers—including companies owned by employer trustees—to be audited every three or four years. Employer trustees often insist their companies be audited first to avoid any hint of favoritism or special treatment.

   The purpose of a payroll audit is not to harass an employer. It is performed to ensure the employer is reporting correctly and to determine that all covered employees receive the benefits to which they are entitled.

8. **Why have you written down the hours paid for that employee? It says on his payroll record that he is a shop employee, and shop employees are not covered.**
   It is usually easy to identify shop employees (and other noncovered employees) because their hourly pay rate is lower and/or different from the wage rates of covered employees. When the rate of the shop worker is near the wage rates of covered workers, the auditor writes down the hours paid and does further research to make sure the individual is not a covered employee.

9. **Even though I own this business, I spend a majority of my time working with the tools of the trade. Can't I be a covered employee?**
   There are certain circumstances where owner/employees can be treated as covered employees. Plans have specific rules that must be followed to allow owners to participate. The owner/employee normally must sign an agreement to be placed in this category.

10. **Why should I pay for coverage on my son?**
    Unless the son has an ownership interest in the company, he must be treated the same as any other covered employee.

11. **I have been overpaying for years. Why can't I get a refund for the entire overpayment?**
    Many employee benefit plans specify that when an employer has overpaid contributions, the employer can receive a refund of no more than one year's overpayment to the plan. ERISA states that the plan can limit credit for overpayments to one year.

12. **Why do I have to pay on probationary employees?**
    Probation to join the union or for seniority may differ from the probationary period before a person becomes a plan participant.

    The CBA or participation agreement normally indicates whether contributions are due from the first day of employment or there is a probationary period (e.g., 30 days or 60 days) before contributions are required. The CBA determines the hours reported for probationary employees.

13. **How long will the audit take?**
    The payroll auditor should tell the employer whether the audit is budgeted for a half day, a full day or multiple days. The auditor should also explain that the actual time depends on factors such as the volume and auditability of records examined. As the audit progresses, the auditor may provide a status update with a revised estimated completion time.

14. **The local union's plan audited us last year. Why is the national plan auditing us this year?**
In an ideal world, all of an employer's payroll audits would be at the same time. Often it is difficult to coordinate audits. The hours examined by each plan may also be different; this means the plans are looking at different records. When an employer has workers in more than one local, the local that audited last year may not be affiliated with the national benefit plan.

15. **I am too busy to sit with the auditor all day. Do I have to?**
No. If the records are set aside for the audit, the employer (or his representative) often needs to spend very little time with the auditor. The employer usually spends time only at the very beginning to explain the records. The employer should then be available to answer questions as the job progresses and at the conclusion for an exit interview. The actual time spent with a payroll auditor is usually less than one hour.

16. **The local union could not provide any people when I needed them. Why should I contribute for persons I hired without the local's help?**
The employer's reporting obligation is for all persons covered by the CBA regardless of how they were hired. The employer may have a legitimate complaint for the union to address, but it does not affect the plan's reporting requirements.

17. **Why do I have to pay for vacation hours when an employee terminates?**
The CBA normally requires the employer to report all hours "paid" to covered employees. Vacation hours are reported regardless of when they were paid.

18. **I am a construction contractor. Why do I have to report on an employee if the person worked only two weeks?**
In the construction industry, employees change jobs frequently. An employee may work only two weeks for a particular employer but may have worked for other employers on a full-time basis. Proper reporting by each employer ensures the worker gets the credit necessary to earn plan benefits.

Endnotes

1. ERISA §502(c)(2).
2. *Central States Southeast and Southwest Area Pension Fund v. Central Transport, Inc.*, 472 U.S. 559 (1985).