

# Guide to Electronic Disbursement Controls for Payroll Purposes



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## Guide to Electronic Disbursement Controls for Payroll Purposes

### Introduction

This handbook will assist local unit officials to comply with Local Finance Board rules concerning using payroll vendors to make payroll agency deposits on behalf of the local unit. Compliance is required when local units or their vendors engage in the any of the following practices:

- They use servicers to prepare the payment documentation and execute disbursements from the local unit's bank account;
- They use servicers to prepare payment documentation, take possession of local unit funds, and make such disbursements on behalf of a local unit.
- Servicers use their own customized programming process to execute disbursements for the local unit;
- Servicers use a third party processor to execute disbursement for the local unit.

The rules apply to any local unit under the jurisdiction of the Local Finance Board: municipalities, counties, local authorities, and fire districts, and boards of education (N.J.S.A. 52:27D-20.1). Local unit officials that engage in the covered practices should carefully review the contents of this handbook.

In doing so, some local officials may be surprised by the responsibility the rules place on governing bodies and local employees. The practice of contracting out "paying services" to a third party is not to be taken lightly. Security of public funds is at higher of risk when administration is contracted to a third party. The rules make it clear that governing bodies must take their fiscal oversight responsibilities very seriously. Similarly, the local official administering the day-to-day activities must act to minimize risks to loss of funds by obtaining confidence in the integrity and internal controls of a servicer.

The rules cover four major areas:

- General Authority (N.J.A.C. 5:30-17.3)
- Authorization Process (N.J.A.C. 5:30-17.4)
- Servicer Control Activities and Operations (N.J.A.C. 5:30-17.5)
- Contracts Terms and Conditions (N.J.A.C. 5:30-17.6)

Each area is covered in the summary section, and detailed in the rule. The general requirement is that in order to have a payroll servicer provide disbursement services, the local unit governing body must formally approve the principle of a third party having access to local unit funds, formally assigning responsibility to an official to oversee the process by enacting an ordinance or resolution (depending on type of government), and approving all contracts or extensions.

Once the authority to contract is established, the designated approval officer must be sure the contract meets a series of requirements, focused on internal controls of the local unit and of the contractor. Finally, there are contract administration rules that must be followed.

Local units are encouraged to share documents such as enabling ordinance or resolutions and standard contract language. Participating officials are urged to take advantage of the Discussion Forum and Document Library features of GovConnect as a way of exchanging information and practices. The Division will also support exchange of documents through its website.

Questions concerning these rules can be addressed to the Division's Bureau of Financial Regulation and Assistance via e-mail at [dlgs@dca.state.nj.us](mailto:dlgs@dca.state.nj.us).

## General Authority

### N.J.A.C. 5:30-17.3

N.J.A.C. 5:30-17.3 outlines the authority created by the rule. The rule requires the local unit to pass an enabling action that authorizes the local unit to use a servicer to process payroll disbursements. The enabling action is either an ordinance (municipalities) or resolution (all other units). For those units with an administrative code, the enabling action should create the authority in that document.

The enabling action must specify the tasks that may be performed by a disbursing organization. This can include the authority:

- To prepare the necessary payment documentation and execute disbursements from the local unit's bank account on behalf of the local unit;
- To prepare payment documentation, take possession of local unit funds, and make such disbursements itself on behalf of a local unit; or
- Any combination of the two.

This includes practices of servicers that use their own customized programming process to execute disbursements and those who use a third party processor to execute disbursements. The key is that regardless of the contractual relationships of preparing payroll, if a third party gains any control over the local unit's funds, the governing body must authorize the practice.

No enabling action or compliance with the rule is required for:

- Payroll servicers that perform payroll calculations and do not control the disbursement of payroll funds; and
- Tax pay and file service payroll service providers that are certified users of the various electronic filing programs of the federal and state government, and where the servicer does not release, transfer or otherwise execute disbursements of the local unit.

## Authorization Process

### N.J.A.C. 5:30-17.4

N.J.A.C. 5:30-17.4 describes the requirements of the enabling action. The rule requires the governing body to approve the use of servicers for the payment of payroll agency claims by describing the tasks the servicer is authorized to perform. Permissible tasks can include, but are not limited to:

- Data collection;
- Servicer report preparation;
- Calculation of withholding;
- Direct deposit of payroll disbursements; and,
- Local unit transfer of funds to disbursing organization's account for subsequent payment.

Further, the governing body must:

- Approve any renewal or extension of a contract
- Designate an **approval officer** responsible for authorizing and supervising the activities of the servicer. This would normally be the Chief Financial Officer in a municipality or county, the School Business Administrator in a school district, or, in the case of an authority, another appropriate individual.
- Supplement the duties of the approval officer to include the reconciliation and analysis of all general ledger accounts affected by the activities of the servicer.
- Act to specifically approve the authority for the servicer to hold local unit money.
- Require that the governing body be notified by the servicer if it detects irregularities that may indicate potential fraud, noncompliance with appropriate laws, dishonesty, or gross incompetence on the part of the approval officer; or experiences circumstances that could jeopardize its ability to continue operations or otherwise interrupt services.

The rule makes it clear that any transfer of funds to servicer is a disbursement under the accounting rules of the local unit.

After the governing body approves the authority to enter into contracts, the approval officer can then solicit proposals. As part of the contracting process, the approval officer must certify that they have reviewed and approve of the terms of the contract, and that the contract satisfies the rules. The governing body can then approve a contract. Prior to the extension or renewal of a contract, the approval officer shall review the services rendered under the contract and provide an analysis of them to the governing body. The local unit's contracting law guides the length of the contract.

*In cases where a local unit has an existing contract, the local unit may continue it and apply these procedures when the contract is up for renewal. If renewal dates are not established, the next anniversary of implementation of the contract is considered the renewal date and the requirements must be applied accordingly.*

## **Servicer Control Activities and Operations**

### **N.J.A.C. 5:30-17.5**

N.J.A.C. 5:30-17.5 implements requirements that the approval officer be assured that the servicer has its own internal controls to ensure that calculations are performed correctly and that they appropriately guard against theft and other adverse conditions. Several industry standards are listed that can be used demonstrate the adequacy of a servicer's controls to clients. They include:

- SAS 70 Report: The disbursing organization's Report on Policies and Procedures Placed in Operation and Tests of Operating Effectiveness, performed pursuant to American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards No. 70.
- SysTrust™ examination with an unqualified report on Availability, Security, Integrity and Maintainability completed in accordance with the AICPA/CICA (Canadian Institute of Certified Accountants) SysTrust™ Principles and Criteria for Systems Reliability.

If a servicer does not have either of these (small businesses may not, as these examinations are costly), the approval officer can require evidence of compliance with a mutually agreed upon external standard of internal controls.

A final requirement provides that all servicers have an office within a distance acceptable to the approval officer to ensure that physical delivery of documents can occur to assure the delivery of paychecks for regularly scheduled paydays and timely delivery all other payroll materials. Use of overnight delivery services can be used to fulfill a geographically remote servicer.

## Contracts Terms and Conditions

### N.J.A.C. 5:30-17.6

The final section of the rule at N.J.A.C. 5:30-17.6 is a series of contractual requirements that all contracts between servicer and local units must contain. Contracts must:

1. Indemnify the local unit against any losses incurred because of the actions or inactions of the servicer;
2. Require the servicer to be responsible for the errors and omissions of its employees, particularly where errors and omissions prevent timely disbursements on behalf of the local unit from being made, including penalties, fines, interest, and damages;
3. When a servicer takes local unit funds, they must have adequate insurance to cover losses in amounts at least equal to the highest level of exposure to the local unit for 30 days;
4. Require that the servicer have a written complaint procedure with, at a minimum, a complaint log;
5. Upon reasonable notice, the servicer shall allow an independent auditor compensated by the local unit to examine its internal controls;
6. All disputes between the parties and disputes concerning the contract or its operation shall be in writing and forwarded to the other party via registered mail; and,
7. Specify the information required by the local unit to enable it to reconcile its books and records.

In addition, all contracts shall have appropriate provisions for:

- Dispute resolution between the parties, service of process to the servicer in New Jersey, and application of New Jersey law in resolving disputes.
- Within five working days of each disbursement, the servicer shall provide to the approval officer reports and documentation supporting the disbursements.
- Corrections and adjustments to be completed and provided to the local unit promptly.
- Copies of notices, memoranda, complaints or other correspondence received by the disbursing organization regarding local unit accounts to be forwarded to the local unit within 48 hours of receipt.
- Provisions for termination of the contract.
- The contract must require that no disbursement is made unless the demand for payment meets the local unit's requirements for paying claims (net paychecks and agency payments); that is the use of vouchers and other documentation must comply with local procedures. If there are no local procedures they must meet the requirement of the rules and N.J.S.A. 18A:19-2 for school districts, and N.J.S.A. 40A:5-16 for all other local units.

The rule also provides that contracts for these services are not data processing service contracts under N.J.S.A. 40A:11-15(5) and 18A:18A-42(d). This limits the length of the contract to two years, subject to a two-year extension.

Finally, the rule requires that all contracts shall be in writing and executed by all parties, **including intermediaries, such as banks providing payroll services as part of a compensating balance agreement**. This means that any relationship where a bank provides the service through compensating balance agreements **requires that the bank be a party to the contract**.

**CHAPTER 5:30 – LOCAL FINANCE BOARD**  
**SUBCHAPTER 17. ELECTRONIC DISBURSEMENT CONTROLS**  
**FOR PAYROLL PURPOSES**

**5:30-17.1 Purpose**

This subchapter sets forth standards for local governments to follow when contracting with an organization to make disbursements on the local unit's behalf, as permitted by N.J.S.A. 52:27D-20.1. The subchapter is intended to ensure that local units understand the risks associated with electronic disbursements and implement sound fiscal and control practices governing such disbursements. This subchapter is limited in application to third-party preparations and calculations for and the disbursement of salaries and wages, all withholdings, and additional related liabilities.

**5:30-17.2 Definitions**

The following words and terms, as used in this subchapter, shall have the following meanings, unless the context clearly indicates otherwise:

“Chief financial officer” or “CFO” means the individual statutorily responsible for supervising the accounts and finances of a local unit and shall include any certifying and approval officer appointed pursuant to N.J.S.A. 40A:5-17(a), any individual appointed in accordance with N.J.S.A. 18A:19-4.1, or such individual in similar capacity legally appointed by the governing body of a local unit.

“Contract” means any written agreement entered into by a local unit and a disbursing organization for the purposes authorized in these rules.

“Dedicated cash account” means a demand deposit bank account owned by the local unit and funded solely for use by a disbursing organization in performing its duties and responsibilities in accordance with the contract.

“Disbursement” means any payment of moneys, including any transfer of funds, by any means, to the dedicated cash account established for use by a disbursing organization.

“Governing body” means the board, commission, council or other body having control of the finances of the local unit. In those local units in which a chief executive officer is authorized by law to participate in such control through powers of recommendation, approval or veto, the term includes such chief executive officer to the extent of such participation.

“Local unit” means a municipality, county, school district, authority subject to the “Local Authorities Fiscal Control Law,” P.L. 1983, c. 313 (N.J.S.A. 40A:5A-1 et seq.), or a school district as defined in N.J.S.A. 18A:18A-2(d).

“Payment documentation” includes transmittals, remittance forms, tax returns, releases, filings, reports, and tapes supporting the disbursement of funds.

“Payroll” means the object and result of all preparations and calculations for, and the disbursement of salaries and wages, all withholdings therefrom, and additional liabilities related thereto.

“Third-party disbursement service organization or disbursing organization” means an organization engaged either directly or indirectly to perform any of the services indicated in these rules.

“Third-party disbursement service” means such service or services of the type described in these rules. Such service or services may include the processing and disbursing of payroll and payroll agency obligations.

“Transaction” means any activity that, in accordance with sound fiscal practices, affects the general books of entry, ledgers, records, or logs of a local unit.

### **5:30-17.3 Authorization to use a third-party disbursement service organization for payroll**

(a) The governing body of a local unit may enact policies for contracting with a disbursing organization to process payroll disbursements on its behalf. Such policies shall be formally authorized by ordinance or resolution of the governing body, as appropriate to the form of government and shall specify the tasks that may be performed by a disbursing organization. Such policies may involve the use of a disbursing organization:

1. To prepare the necessary payment documentation and execute disbursements from the local unit’s bank account on behalf of the local unit;
2. To prepare payment documentation, take possession of local unit funds, and make such disbursements itself on behalf of a local unit; or
3. Any combination of (a)1 and 2 above.

(b) This subchapter applies to disbursing organizations and local units who contract with one another for the determination and disbursement of payroll and related services.

1. The following service providers are not required to comply with these rules:

- i. Payroll service providers that perform payroll calculations and do not control the disbursement of payroll funds; and
- ii. Tax pay and file service payroll service providers that are certified users of the Electronic Federal Tax Payment System (EFTPS) batch filer program and the State of New Jersey EFTPS batch filer program, that do not release, transfer or otherwise execute disbursements of the local unit.

2. The following service providers are required to comply with these rules.

- i. Payroll service providers who use their own customized programming process to execute disbursements for the local unit; and
- ii. Payroll service providers who use a third party processor to execute disbursement for the local unit.

#### **5:30-17.4 Local unit requirements**

(a) Local units shall meet the following terms and conditions prior to executing contracts with disbursing organizations:

1. Prior to the execution of a contract with a disbursing organization, the governing body shall approve the use of disbursing organizations for the payment of claims pursuant to N.J.A.C. 5:30-17.3(a). Such approval shall describe those tasks to be performed by a disbursing organization to meet the governing body's objectives, including specific authorization to use electronic means for the disbursing of funds. Permissible tasks can include and are not limited to data collection, agency report preparation, calculation of withholding, direct deposit of payroll disbursements, or local unit transfer of funds to disbursing organization's account for subsequent payment.

i. The governing body shall, by resolution, approve any renewal or extension of a contract under this subchapter.

2. Pursuant to N.J.S.A. 40A:5-17(a)(1) or 18A:19-4.1, the governing body shall designate an approval officer to be responsible for authorizing and supervising the activities of the disbursing organization. For authorities operating under N.J.A.C. 5:31-4.1, the governing body shall designate an approval officer to authorize and oversee the activities of disbursing organizations.

i. The governing body shall supplement the duties of the approval officer established in accordance with N.J.S.A. 40A:5-17(a)(2) and 18A:19-4.1 to include the reconciliation and analysis of all general ledger accounts affected by the activities of the disbursing organization.

ii. If the terms of the contract between the disbursing organization and the local unit provide that the disbursing organization will hold funds of the local unit pending transmittal of those funds to a payee, the governing body must specifically authorize the disbursing organization to hold the funds pending transmittal.

iii. The governing body shall require the disbursing organization to provide the governing body with notification in the event:

- (1) The disbursing organization detects irregularities that may indicate potential fraud, noncompliance with appropriate laws, dishonesty, or gross incompetence on the part of the approval officer; or

(2). The disbursing organization experiences circumstances that could jeopardize its ability to continue operations or otherwise interrupt the services provided to the local unit.

iv. A transfer of local unit funds between local unit accounts, to a dedicated cash account or to an account owned or controlled by a disbursing organization shall be deemed a disbursement subject to the Local Fiscal Affairs Law, N.J.S.A. 40A:5-1 et seq., and is to be treated as in compliance with N.J.S.A. 18A:19-9 for school payrolls.

3. After the governing body has initially approved the use of disbursing organizations pursuant to N.J.A.C. 5:30-17.3 and (a) above, the CFO shall qualify disbursing organizations pursuant to the requirements of N.J.A.C. 5:30-17.5.

i. Prior to the execution of any contract for the provision of third-party disbursement services, the contract shall be reviewed and approved by the CFO of the local unit as to terms, including satisfaction of the requirements of N.J.A.C. 5:30-17.5, 17.6 and 17.7.

ii. Prior to the extension or renewal of a contract, the CFO shall complete a review of the services rendered under the contract. Such review shall be conducted in compliance with N.J.A.C. 5:30-17.5.

#### **5:30-17.5 Eligibility requirements for disbursing organizations**

(a) Disbursing organizations shall meet the following conditions and/or requirements:

1. The disbursing organization shall provide evidence of satisfactory internal control, evidence of which shall be required by the CFO. Such evidence may be:

i. The disbursing organization's Report on Policies and Procedures Placed in Operation and Tests of Operating Effectiveness, performed pursuant to American Institute of Certified Public Accountants (AICPA) Statement on Auditing Standards No. 70;

ii. A completed SysTrust™ examination with an unqualified report on Availability, Security, Integrity and Maintainability completed in accordance with the AICPA/CICA (Canadian Institute of Certified Accountants) SysTrust™ Principles and Criteria for Systems Reliability; or

iii. Evidence of compliance with a mutually agreed upon external standard for determination of the sufficiency of a system of internal controls that support the work to be performed in accordance with the policies established by the local unit.

2. All disbursing organizations shall have offices within a distance acceptable to the CFO of the local unit such that the physical delivery and receipt of documents and records can occur in a manner that assures the delivery of paychecks on regularly scheduled paydays.

**5:30-17.6 Contract terms and conditions**

(a) All contracts between a local unit and disbursing organization shall:

1. Contain adequate provisions to indemnify the local unit against any losses incurred as a result of the actions or inactions of the disbursing organization;
2. Require the disbursing organization to be responsible for the errors and omissions of its employees or agents, particularly where those errors and omissions prevent timely disbursements on behalf of the local unit from being made, including penalties, fines, interest, and damages; and
3. In those cases where the disbursing organization takes possession of local unit funds, require adequate insurance to cover such losses as may arise as a result of errors, omissions, failure to perform or dishonesty in amounts at least equal to the highest level of exposure to the local unit for 30 days. Such exposure as regards cash shall be based on at least the amount of money accessible by the disbursing organization during said 30-day period and shall not include moneys that the disbursing organization cannot divert to its own benefit.

(b) All disbursing organizations shall have a written complaint procedure in existence. At a minimum, the complaint procedure shall require that a complaint log be maintained, which shall be available to the local unit for inspection.

(c) Upon reasonable notice, the disbursing organization shall allow an independent auditor compensated by the local unit to examine its internal controls applying SAS 70 standards, SysTrust™ standards or other standards and procedures mutually agreed upon to ensure accurate, complete and timely work product. Upon completion, the independent auditor's report shall be provided to the CFO and governing body and shall be for internal use only.

(d) All disputes between the parties and disputes concerning the contract or its operation shall be in writing and forwarded to the other party via registered mail. All contracts shall have appropriate provisions for:

1. Dispute resolution between the parties;
2. The service of process to the disbursing organization in New Jersey; and
3. Application of New Jersey law.

(e) Within five working days of each disbursement on behalf of a local unit, the disbursing organization shall provide to the CFO, reports and documentation supporting the disbursements. The contract shall also specify the information required by the local unit to enable it to reconcile its books and records.

(f) All corrections and adjustments must be completed and provided to the local unit promptly. All adjustments and reports of adjustments resulting in disbursements must be reported consistent with the provisions of (e) above.

(g) Copies of notices, memoranda, complaints or other correspondence received by the disbursing organization regarding local unit accounts shall be forwarded to the local unit within 48 hours of receipt.

(h) Contracts for third-party disbursement services are not data processing service contracts under N.J.S.A. 40A:11-15(5) and 18A:18A-42(d).

(i) All contracts for third-party disbursement services shall have appropriate provisions for termination of the contract, including, but not limited to, termination for failure to perform on the part of the disbursing organization.

(j) All contracts entered into between local units and disbursing organizations for the provision of third-party disbursement services shall be in writing and executed by all parties, including intermediaries, such as banks providing payroll services as part of a compensating balance agreement.

(k) The contract for third-party disbursement services must require that no disbursement is made unless the demand for payment meets the requirements of N.J.S.A. 40A:5-16, N.J.S.A. 18A:19-2 and this subchapter.