

Internal control and human resource management: Closing the loop

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ABSTRACT

Internal control continues to be a major emphasis for most organizations. Under Sarbanes-Oxley, publicly traded companies must perform a fraud risk assessment and assess related controls. Smaller organizations and private companies are realizing improvements in effectiveness and efficiency of operations through implementation of internal control systems. Within the Committee of Sponsoring Organizations (COSO) internal control-integrated framework, control environments set the tone of the organization by influencing the control consciousness of employees. The control environment is the foundation of an effective system of internal control. Internal control is more than policy and procedure; it is a process effected by people throughout the organization. Within the COSO framework, every member of the organization is responsible for internal control. Organizations whose leaders are able to attract and retain good people will be more likely to implement a successful system of internal control. One of the best ways to maintain a good workforce is to have sound human resource management, which includes having employment policies and procedures that comply with the state and federal employment regulations.

Keywords: internal control, employment law, human resource management, Sarbanes-Oxley Act

BACKGROUND

Managers and those charged with corporate governance often look for ways to improve organizational performance as well as comply with applicable laws and regulations. Internal control, which serves many purposes, is one way to help organizations realize improved performance. Having in place an effective system of internal control is a well-recognized method of ensuring organizations chart and maintain a steady course. In fact, since the passage of the Foreign Corrupt Practices Act of 1977, organizations obligated to periodically document fiscal and managerial performance under the Securities Exchange Act of 1934 have been required to implement an adequate system of internal control (Arens, Elder, & Beasley, 2012). More recently, the Sarbanes-Oxley Act of 2002 (SOX) significantly increased the responsibilities of top-level management; both the chief operating officer and chief financial officer must certify corporate financial statements filed with the U.S. Securities and Exchange Commission (SEC). The independent auditors of these publicly traded entities must also provide an opinion on the effectiveness of internal control over financial reporting (SOX, 2002).

A generally accepted framework for internal control was provided by the Committee of Sponsoring Organizations of the Treadway Commission (COSO, 1992), a nonprofit organization with a board of directors that includes representatives of several of the top accounting institutes in the country. Established in 1985, the mission of the COSO (n.d.) is to provide thought leadership on three interrelated subjects: enterprise risk management, internal control, and fraud deterrence. Regulatory agencies observe and offer input to the activities of COSO; among these agencies are the Government Accountability Office, Federal Deposit Insurance Corporation, and SEC. Since 1992, COSO has periodically circulated guidance documents to provide reasonable assurance to business entities regarding the achievement of objectives in the following categories:

- effectiveness and efficiency of operations,
- reliability of financial reporting, and
- compliance with applicable laws and regulations.

Given the high-profile failures of effective human resource management (HRM) in recent months (e.g., the Penn State child abuse scandal which resulted in several leaders of the university being dismissed and accreditation of the university placed in jeopardy), compliance with applicable employment laws and regulations should be a top priority.

This purpose of this paper is to review some of the major employment law issues business face today and then provide a sample of review questions along with suggested answers (and resources) to help guide managers and ensure organizational compliance with applicable laws.

WHAT IS HUMAN RESOURCE MANAGEMENT (HRM)?

One of the most important functions of any modern organization is human resource management (HRM). HRM is responsible for issues ranging from recruiting and training personnel to compensation and performance appraisal. Labor relations, safety and security, and benefits management are also often administered by HRM. Many of these responsibilities have significant legal implications at both the state and federal level, and even inadvertent non-compliance can expose organizations to significant risk.

The performance of HRM can vary from organization to organization. In smaller entities one person may be responsible for HRM, while larger entities will employ a dedicated department of HRM professionals.

Areas in which HRM should strive to ensure compliance include unlawful discrimination, classification of independent contractors, minimum wage (and overtime) compliance, and background checks.

Unlawful Discrimination Employment Practices

Applicants to and employees of most private employers, state and local governments, educational institutions, employment agencies, and labor organizations are protected under federal laws. Some states have additional laws in place. HRM, as a component of internal controls, calls for companies to be familiar with the employment laws applicable in their state; see Table 1 (Appendix).

Classification of Independent Contractors

An independent contractor can be a person or a business organization that provides services to other business entities. Those who hire an independent contractor should provide Form 1099-MISC, Miscellaneous Income, to report to the contractor and Internal Revenue Service what has been paid to the contractor. An independent contractor is responsible for paying his/her own income tax and self-employment tax, in accordance with the Self-Employment Contributions Act of 1954). The Supreme Court has stated its opinion on a number of considerations that distinguish an independent contractor from an employee. For the four main characteristics of employment that can help an employer determine the classification of an individual as an independent contractor, see Table 2 (Appendix).

Minimum Wage and Overtime Compliance

The Fair Labor Standards Act requires that most employees in the United States be paid at least the federal minimum wage for all hours worked and overtime pay at time and one-half the regular rate of pay for all hours worked over 40 hours in a workweek. States may set minimum wage at a rate higher but not lower than that set by the federal government; see Table 3 (Appendix).

Background Checks

Employers face several state and federal laws that govern pre-employment background screening. Likewise, employers cannot require employees, except under certain circumstances, to provide their passwords to social networking sites. For details on related laws and similar issues, see Table 4 (Appendix).

TEST YOUR HRM KNOWLEDGE

Test your HRM knowledge using, as an example, a fictitious company, Allen Enterprises (AE), which operates retail outlets in several states. The audit committee for AE, aware that the

federal minimum wage rate increased to \$7.25 per hour beginning July 29, 2009, has asked AE internal auditor to ensure that AE was in compliance with minimum wages laws and any and all related payroll laws.

Questions

1. The internal auditor discovers the state minimum wage rate in Alaska (where AE has a retail outlet) increased to \$7.75 per hour effective January 1, 2010, but AE is still paying entry-level workers in Alaska \$7.25 per hour. When the internal auditor questions the manager of the Alaska outlet, the manager says federal law supersedes state law and AE is not obligated in to comply with the state (Alaska) minimum wage law. Which of the following statements is true?
 - a. The manager is correct, as long as AE pays \$7.25 per hour to its employees in Alaska, AE is in compliance.
 - b. The manager is incorrect; AE is required to pay \$7.75 per hour to its employees in Alaska, as required by state law.
2. While reviewing revised job descriptions, the internal auditor observes that AE is advertising to hire management trainees. The ad mentions the requirement to be available to work extended hours. The starting salary is \$20,000 per year plus benefits. When the internal auditor asks the vice president of operations about possible overtime implications, the vice president replies that management is exempt from overtime. The vice president is
 - a. Incorrect. Management trainees must be paid the prevailing minimum wage rate per hour, plus time and a-half for overtime.
 - b. Correct. Management is exempt from overtime regulations.
 - c. Correct, as long as certain conditions are met.
3. In the course of reviewing randomly selected personnel files, the internal auditor learns that an employee was denied a request to use paid time off to care for an ailing parent. The employee subsequently applied for leave under the Family Medical Leave Act ([FMLA] 1993), which was then granted. Which statement accurately describes how this situation was handled?
 - a. AE was within its rights to deny the request for paid time off because FMLA grants leave only for a serious health condition that makes the employee unable to perform his or her duties.
 - b. AE was within its rights to deny the paid time off because FMLA grants only unpaid leave.
 - c. AE probably should have allowed the employee to use any accumulated paid time off.
4. As the internal auditor is completing this assignment for the audit committee, she learns that an employee was recently terminated after a court-ordered wage garnishment. This termination of the employee because of wage garnishment was
 - a. Legal.
 - b. Legal if the garnishment was for more than one debt.
 - c. Illegal if the garnishment was for only one debt.
 - d. Illegal regardless of the circumstances.

5. Some of the IT technicians at AE are asked to be “on call” on a rotating basis in case of evening emergencies. When on call, the technicians are asked to carry a laptop to and from home each day. Some of the technicians ask to be paid for their commuting time when on call. Which statement is correct?
 - a. The technicians are correct. Having the laptop with them while commuting is compensable time.
 - b. The workers are incorrect.
6. When AE had a weekend supervisory position open, the store manager followed protocol by first posting the position on the company Intranet. Dan, a customer service representative at the local store was the only applicant for the position. The store manager then decided to temporarily suspend the search rather than promote Dan. Dan is considering bringing suit against AE, claiming he was not selected as retaliation for his earlier participation as a witness in a gender discrimination lawsuit two years ago. Which of the following statements is correct?
 - a. The closing of the position to avoid hiring Dan was unfair.
 - b. AE is not obligated to promote Dan.
7. Jane, an administrator at AE corporate headquarters, has discovered one of her colleagues uses illicit drugs. Jane notified her supervisor, and he is reviewing Department of Labor (DOL) regulations for guidance. Which of the following statements is true?
 - a. The U.S. DOL does not regulate the area of workplace drug testing.
 - b. Generally, employers have a fair amount of latitude in handling drug testing.
 - c. Use of some prescription medications may result in a positive drug test.
 - d. All of the above.
8. Brad, a delivery driver for AE, is questioning his classification as an independent contractor (which requires him to pay all of his Social Security taxes). The drivers follow agreed-upon delivery routes and are free to turn down assignments. While AE provides training and uniforms, the drivers have signed independent contractor agreements. Which statement is correct?
 - a. AE can classify Brad as an independent contractor because he signed an agreement to be classified as an independent contractor.
 - b. AE would likely lose if the drivers sue for unpaid wages (e.g., overtime).
9. Sarah, an accountant with AE, applied for a management position in the AE finance department. Based on her qualifications, Sarah was offered the finance position and resigned her position in the accounting department. However, the day she was to start her new position, AE withdrew the offer because of her credit history. Which of the following is correct?
 - a. AE can withdraw the job offer at its own discretion.
 - b. AE should not deny Sarah the position because she is well qualified for the job.
 - c. It depends.
10. AE offers a qualified 401-K benefit plan to all full-time employees. In reviewing recent 401-K statements for the company, employees noticed that AE is not depositing the employee contributions (and employer match) in a timely manner. For example, for the June 30 monthly payroll, the deposit was not credited to the employees until July 30. Which statement is true?
 - a. While employers are encouraged to make these deposits in a timely manner, there is no required time frame for 401-K contributions.

- b. AE is not in compliance with Employee Retirement Income Security Act ([ERISA 1974] requirements governing qualified 401-K plans.
11. Recently, a store manager refused to hire an applicant for a customer service position because of the extensive tattoos the manager observed during the interview. Was this hiring decision discriminatory in the legal sense?
- a. Yes.
 - b. No.

Answers

1. (b) The federal Fair Labor Standards Act of 1938 (FLSA), as amended in 2007, permits states to establish minimum wage rates higher than the federal minimum. AE is obligated to pay the higher rate in any of the 14 states (and the District of Columbia) with minimum wage rates higher than the federal minimum wage rate. For more information on minimum wage laws across the United States, see the U.S. Department of Labor (n.d.e) website.
2. (c) Three conditions must be satisfied for an employer to treat an employee as exempt from overtime. First, as of January 1, 2008, the employee must make at least \$468 per week. Second, job duties must be primarily within executive, administrative, professional, and outside sales, and computer employees' classifications. Third, the employee must receive a fixed, predetermined salary that does not vary due to quantity or quality of work performed. For more information, see Table 3 in Appendix.
3. (c) Employees may choose or the employer may require use of accrued paid leave while taking FMLA. However, to use paid leave for FMLA leave, employees must comply with the employer's normal paid leave policies. Also, employees must provide 30 days advance notice of the need to take FMLA leave when the need is foreseeable. When 30 days advanced notice is not possible, the employee must provide notice as soon as practicable. Caring for the employee's spouse, son, daughter, or parent who has a serious health condition is covered under FMLA. For more information on the FMLA see the U.S. DOL (n.d.a) website.
4. (b) A wage garnishment is any legal or equitable procedure through which a portion of a person's earnings is required to be withheld by an employer for the payment of a debt. Title III of the Consumer Credit Protection Act (CCPA) prohibits an employer from firing an employee whose earnings are subject to garnishment for any one debt, regardless of the number of levies made. The Act does not prohibit discharge because an employee's earnings are separately garnished for two or more debts. For more information on wage garnishment, see the U.S. DOL (n.d.c) website.
5. (b) The mere carrying of a laptop during a daily commute, without any other employment-related responsibilities, is not compensable work under the FLSA (2007). If AE required the technicians to perform a significant amount of work during the commute, the technicians would be entitled to compensation. An employee who is required to remain on call at home or is allowed to leave a message where he/she can be reached is not working while on call. For more information, see the U.S. DOL (n.d.f) website.
6. (b) AE has the right to avoid selecting from a pool of just one viable candidate. Additionally, there is no evidence pointing towards retaliation in this situation. Dan did not provide any reasonable justification to explain AE's motivation to deny him the

promotion. Moreover, there are strict time limits for filing charges of employment discrimination.

7. (d) The DOL does not regulate the area of workplace drug testing. However, it recognizes that workplace alcohol and drug usage creates significant safety and health hazards. Generally, employers have latitude in handling drug testing as they see fit, unless the organization is subject to certain federal laws such as transportation. Some prescription medications may result in a positive drug test. For more information, see the U.S. DOL (n.d.b) website.
8. AE does not provide strong evidence that the delivery truck drivers are independent contractors. Employers who misclassify an employee as an independent contractor and have no reasonable basis for doing so may be held liable for employment taxes for that worker. For more information, see Table 2 (Appendix) and the U.S. Department of Treasury, Internal Revenue Service (2012) website.
9. (c) It depends, but the Fair Credit Reporting Act ([FCRA] 1971) requires employers to secure consent from employees (and job applicants) before obtaining consumer reports. When consumer reports provide information that results in an adverse employment action, the employer must provide the individual with a copy of the report and the employee's or applicant's FCRA rights. AE has the burden of showing the business necessity and job relevancy for using the report in this manner. For more information, see the Federal Trade Commission (2012) website.
10. (b) AE is not complying with ERISA (1974). If a plan provides for salary reductions from employees' paychecks to the plan (such as in a 401(k) plan), then the employer must deposit the contributions in a timely manner, but not later than the 15th day of the month following the payday. If employers can reasonably make the deposits sooner, they need to do so. For more information, see the U.S. DOL (2010) website.
11. (b) American federal laws protect against race, color, and national origin discrimination; sex and gender discrimination; age discrimination; physical and mental disability discrimination; religious discrimination; and military status discrimination. Federal law does not provide protection to individuals with tattoos. For more information, see Table 4 and the U.S. Equal Employment Opportunity Commission (2009) website.

SUMMARY: A COMMITMENT TO INTERNAL CONTROL

An effective system of internal control requires an organization-wide commitment to implementing and maintaining effective policies and procedures to ensure compliance with applicable laws and regulations. Employment-related matters are no exception. Following best practices regarding employment helps develop a loyal workforce, the members of which will be more inclined to buy into the system of internal control, especially when workers see a commitment from the highest levels of the organization.

Many organizations have used COSO's (1992) treatise, *Internal Control—Integrated Framework*, to facilitate internal control processes and procedures to ensure compliance as well as promote effectiveness and efficiency of operations. Additional benefits of implementing and maintaining rigorous internal controls include ensuring reliable financial statements and minimizing risk.

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APPENDIX

Table 1: Unlawful Discrimination Employment Practices

Characteristic	Legislation
Race, color, religion, sex, national origin	Title VII of the Civil Rights Act of 1964 prohibits discrimination in hiring, promotion, discharge, pay, fringe benefits, job training and other aspects of employment on the basis of race, color, religion, sex or national origin.
Disability	The Americans with Disabilities Act of 1990 protects qualified applicants with disabilities from discrimination in hiring, promotion, discharge, pay, fringe benefits, job training and other aspects of employment on the basis of disability. The law also requires that employers provide qualified applicants and employees with disabilities with reasonable accommodations that do not impose undue hardship.
Age discrimination	The Age Discrimination in Employment Act of 1967 protects applicants and employees 40 years of age or older from discrimination on the basis of age in hiring, promotion, discharge, compensation, terms, conditions or privileges of employment.
Sex discrimination	In addition to sex discrimination prohibited by Title VII of the Civil Rights Act of 1964, the Equal Act of 1963 prohibits sex discrimination in payment of wages to women and men performing substantially equal work in the same establishment.
Retaliation	Retaliation against a person who files a charge of discrimination, participates in an investigation, or opposes an unlawful employment practice is prohibited by all of these Federal laws.

Note. Adapted from the U.S. Equal Employment Opportunity Commission (2009).

Table 2: Classification of Independent Contractors

Characteristic	Test
Behavioral control	<p>An independent contractor is a person who does not receive extensive instructions on how, when or where to perform the job tasks; what tools or equipment to use; what assistants to hire to help with the work and where to purchase supplies and services.</p> <p>An independent contract is a person who does not necessarily receive extensive training about required procedures and methods. This indicates that the hiring entity is the one specifying the procedures of conducting business in a certain way.</p>
Financial control	<p>Significant investment: If a person has a significant investment in his/her work, then he/she may be an independent contractor. While there is not a precise dollar test, the investment must have substance.</p> <p>Expenses: If the person is reimbursed for some or all business expenses, then he/she may be considered an independent contractor, especially if the unreimbursed business expenses are high.</p> <p>Opportunity for profit or loss: An independent contractor is a person who can realize a profit or incur a loss.</p>
Relationship with parties	<p>If a person does not receive benefits, such as insurance, pension, or paid leave, lack of receipt of benefits is an indication that he/she may be an independent contractor.</p>
Level of skills	<p>This test pertains to exertion of significantly high level of skills in performing the job in terms of the amount of initiative, judgment, or foresight in open market competition with others required for the success of the claimed independent person/entity.</p>

Note. Adapted from U.S. Department of Labor (n.d.d) and the U.S. Department of Treasury, Internal Revenue Service (n.d.).

Table 3: Minimum Wage and Overtime Compliance

Wage	Details
Federal minimum wage rate	Effective July 24, 2009, the federal minimum wage rate is \$7.25 per hour.
State minimum wage rate	18 states have a minimum wage rate higher than \$7.25 per hour. Where federal and state law have different minimum wage rates, the higher standard applies.
Overtime	Unless specifically exempted, employees covered by the Act must receive overtime pay for hours worked in excess of 40 hours in a workweek at a rate not less than time and one-half their regular rates of pay. A workweek is any consecutive 168 hours (seven consecutive 24-hour periods), and may begin on any day and at any hour of the day.
Exemptions	Executive, administrative and professional employees, outside sales employees, and certain skilled computer professionals are exempt from both the minimum wage and overtime pay requirements. However, to qualify for exemption, employees generally must meet certain tests regarding their job status and be paid on a salary basis at not less than \$455 per week. Job titles do not determine exempt status.
Notices and posters	Every employer of employees subject to the FLSA minimum wage provisions must post and keep posted a notice in a conspicuous place in all of its establishments explaining the Act.

Note. Adapted from the U.S. Department of Labor (n.d.e.). *Minimum wage* website.

Table 4: Background checks

Subject	Recommendation
Verification of education	Employers should ask job candidates to have a certified college transcript sent directly to the prospective employer to the school. To weed out degrees from diploma mills, refer to the Council for Higher Education (2012) to determine if the educational institution is legitimate.
Credit rating or economic status inquiries	Inquiry into an applicant's current or past assets, liabilities, or credit rating, including bankruptcy or garnishment, generally should be avoided because these factors tend to have a more adverse impact on minorities and females. Exceptions exist if the employer can show that such information is essential to the particular job in question. Requirements under the FCRA include obtaining the applicant's written authorization to obtain consumer credit reports.
Drug-testing programs	While the U.S. DOL does not regulate the area of workplace drug testing, the DOL does strongly recommend that before any drug-testing program is implemented, an employer have a written policy that is shared with all employees and clearly outlines why drug testing is being implemented, prohibited behaviors, and consequences of violating the policy. For more information, see the U.S. DOL (n.d.b) website.
Citizenship inquiries	Employers should not ask whether a job applicant is a U.S. citizen before making an offer of employment. Employment eligibility verification should be conducted after an offer to hire has been made. The following statement may be included on a job application: "In compliance with federal law, all persons hired will be required to verify identify and eligibility to work in the United States and to complete the required employment eligibility verification document upon hire." For more information, see U.S. Equal Employment Opportunity Commission (n.d.) website.
Arrest and conviction inquiries	There is no federal law that clearly prohibits an employer for asking about arrest and conviction records. However, using such records as an absolute measure to prevent an individual from being hired could limit the employment opportunities of some protected groups and thus cannot be used in this way. Several state laws limit the use of such records by prospective employers.

Note. Adapted from the U.S. Equal Employment Opportunity Commission (n.d.) website.