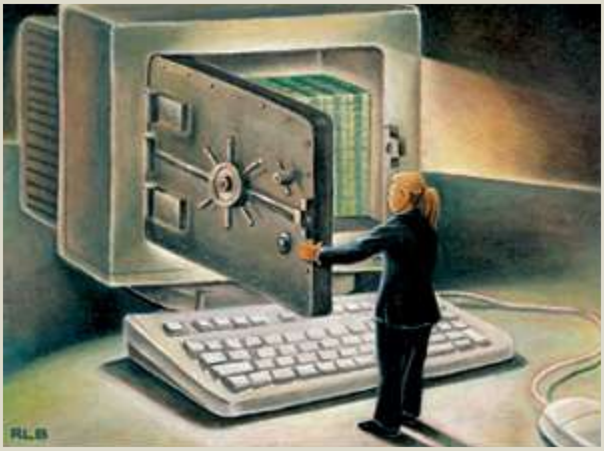
By Edward Nagel

The payroll payoff

Beware of your vulnerability to fraud by lax controls over your payroll systems



RANDY BUTTERFIELD

Adele Sharpe was a compulsive gambler, and she hid it well. Her problem began innocently at work when one day a casino website popped up on her computer as she surfed the Internet during lunch. She placed a few bets using the free credits offered by the site to entice first-time players. She won, and that gave her a thrilling feeling, she would later explain to fraud investigators.

Two years later, as the payroll manager of a medium-sized manufacturing firm near Winnipeg, Sharpe found herself accused of defrauding her employer of $750,000.

Why did she do it? To pay off her gambling losses, an average of $7,000 a week. How did she do it? By taking advantage of a lack of proper controls in her company's payroll department.

There was nothing cunning about Sharpe's scheme. She simply exploited a system that functioned on the assumption that, like most payroll managers, she was trustworthy. Until she developed a taste for gambling, that had been true.

Sharpe had worked at the company for a decade. Her performance reviews described her as hardworking, reliable and loyal but did not mention she felt underpaid. Her annual salary was slightly more than $35,000, and had barely risen in recent years despite an increase in her responsibilities. As a result, Sharpe was bitter, thinking her employer didn't treat her fairly. Her bitterness grew as she saw others get annual increases and bonuses. When her gambling began to spiral out of control, she used the lack of oversight in the payroll department to cover her debts. "As far as I was concerned, they owed me," she told the forensic accountants.

Sharpe's primary deception was two factitious employees she set up on the company's hourly payroll system as a new and separate cost centre. As she processed and received the records sent to and from an external payroll provider (EPP) without effective oversight, she was able to control the scheme without detection. The phantom employees' cheques were drawn up manually by EPP, sent to Sharpe and deposited into an account she had in a bank near her home.

In theory, the company's human resources manager and comptroller were supposed to review Sharpe's work. In reality, the manager was focused on providing her with the correct input for employees' wages and ben-

PREVENTING AND DETECTING PAYROLL FRAUD

A combination of the following steps will help prevent and detect payroll fraud:

- Segregation of duties at all times — separate payroll preparation, authorization and distribution functions.
- Monitoring payroll records for unusual "accounting" adjustments, such as excessive payments without deductions, large payroll reversals near year-end, etc.
- Minimal use of cheque payments and increased use of payments by direct deposit.
- Monitoring payroll records for duplicate names/addresses or postal codes, incorrect or invalid SIN numbers and other anomalies.
- Separate segregation and oversight of amendments made to payroll master files, such as direct deposit details, to prevent unauthorized changes.
- Conducting surprise audits to ensure, for example, that all employees on a payroll exist and have an employee file.
- Reconciliation and independent reporting of variations in payroll expense month to month, quarter to quarter with supporting documents as well as comparing current payroll levels to prior years.
- Conducting thorough pre-employment reference checks for all payroll administrators to identify previous fraudsters.
- Reconciling payroll expense and the actual amounts paid to the authorized payroll on a regular basis, and conducting immediate follow-up whenever discrepancies are identified.

efits. The comptroller appeared not to have exercised control over payroll in any meaningful fashion, a trait Sharpe was well aware of. In particular, the payroll paid was never reconciled with the authorized payroll.

When EPP returned the voluminous payroll registers, Sharpe destroyed the pages relating to the phantom employees. Near year-end, she also had EPP make adjustments to the payroll register to eliminate the amounts paid to the phantom employees, thus avoiding any undue T4 slips. When she went on vacation, she deactivated the two names from the payroll — it was not uncommon for hourly workers to come and go — and reactivated them upon her return. Sharpe could design the payroll system so that only active employees would appear on the payroll register generated by EPP. During her absences, the phantom employees were excluded from the payroll package.

To conceal the additional costs of her scheme, Sharpe would spread them over the company's legitimate cost centres when she provided the payroll journals to the comptroller.

Sharpe also expanded her scheme. She started paying herself for unauthorized overtime. Although this plan proved to be a great success — she paid herself for 1,500 hours overtime over two years as opposed to the actually 50 she did work — it proved to be her downfall.

Sharpe falsified records, carelessly changing numbers with whiteout. She used already approved overtime forms and altered dates and hours to paper her overtime file. One day, the human resources manager noticed one of the clumsily altered documents — the excessive overtime claimed had itself gone unnoticed — and contacted the company's external auditors. After a preliminary review, a full-scale investigation was done by independent forensic accountants.

Although Sharpe managed to shred critical documents before her dismissal, it didn't take the forensic accountants long to uncover her schemes. When she was confronted with the evidence, it was confirmed that she had spent all the money on gambling.

While Sharpe exploited the company's almost nonexistent controls over a long period, Sonia Arpao's company had more than adequate oversight. Her opportunistic plan was described as a smash-and-grab operation.

During a 20-year career, Arpao moved up through the ranks at a large retail company until she became its payroll administrator. She was respected for her work ethic and her tendency to mind her own business. However, a change in her life circumstances led her to defraud her employer and, ultimately, to her undoing.

While on a trip to Brazil, Arpao fell in love and allowed herself to be talked into a plan her lover said would allow them to retire together, forever.

Arpao and he concocted a way to steal $1 million when her immediate supervisors would be away in early November.

As part of the retailer's control system, most payroll functions were set up on a computer only Arpao and her two supervisors — both of whom implicitly trusted her — had access to. Arpao knew the retailer didn't have a separate bank clearing account for payroll (an unwise decision), which made it possible for an artificially created payroll run to be charged against the firm's main bank account.

Arpao was also aware the firm would be paying generous bonuses to senior managers after the year-end in October.

Consequently, in early November she directed EPP to make an unauthorized payroll run that sent bonus payments of $1 million to her account at a local bank. On the payroll the payments were made under the executives' names, but the direct deposit information was changed to ensure she got the funds. She counted on the false run being perceived by EPP as legitimate bonus payments. At the same time, she purchased a one-way ticket to Brazil.

She later tried to wire transfer the funds to Brazil. However, an alert bank employee noticed the infusion of company funds into her account and contacted the employer for verification. The transaction was cancelled and the accounts were frozen. If not for the alert bank employee, a temporary weakness in the firm's controls would have allowed her plan to succeed.

A common failing in many business systems is that they are too focused on the prevention and detection of fraud by employees. However, payroll fraud is not just perpetrated by workers and middle-level employees, it can also involve senior executives.

Michelle Rivers was a long-term, trusted executive who had full responsibility over the executive payroll function at a large investment dealer. She longed to live the high life and, early on during her tenure at the company, began to award herself unauthorized salary increases. At first she made small annual adjustments to payroll, but these gradually increased over time, as greed got the better of her. Over a 10-year period, Rivers paid herself $5 million she had not earned.

Rivers' exclusive control over executive payroll allowed her to appropriate some of the firm's profits. Her scheme was effective until an internal auditor stumbled over the excessive payments.

Each of these cases involved a trusted employee who had access to the payroll system without controls or oversight.

In the first case, the employee took advantage of her employer's trust and used her extensive knowledge of the EPP functions to cover up fraudulent activity. A periodic review of the payroll registers by the human resources manager or comptroller, closer scrutiny of labour costs or reconciliation between the payroll expense and the funds disbursed for payroll would have revealed the fraud.

In the second case, the employee took advantage of a temporary absence of effective oversight and the availability of funds as the company had no separate payroll clearing accounts. While not an uncommon practice, particularly in smaller firms, this was an easy and tempting target for a greedy employee.

The third case was an opportunity waiting to happen. Rivers created an exclusive role for herself by ingratiating herself to key executives. The payroll function lacked any segregation of duties such that this role went completely unsupervised. And there was a strong, healthy cash flow from operations. Again, a blatant weakness in internal controls led to this simple yet effective fraud.

Given the autonomy enjoyed by payroll administrators, the frequency and volume of activity going through payroll throughout the year, and the fact that payroll often represents by far the most significant expense a company incurs, it would follow that the payroll function is highly susceptible to fraud. In light of this, it is critical companies do whatever they can to prevent opportunities for payroll fraud, including careful oversight of personnel at all times.

Although most employees are trustworthy, there are enough cases of that trust being exploited for all companies to ensure they always look over the shoulder of the people who look over their payroll.

All the cases have been disguised.

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