



Padding the Payroll: How to Detect and Prevent

FRAUD

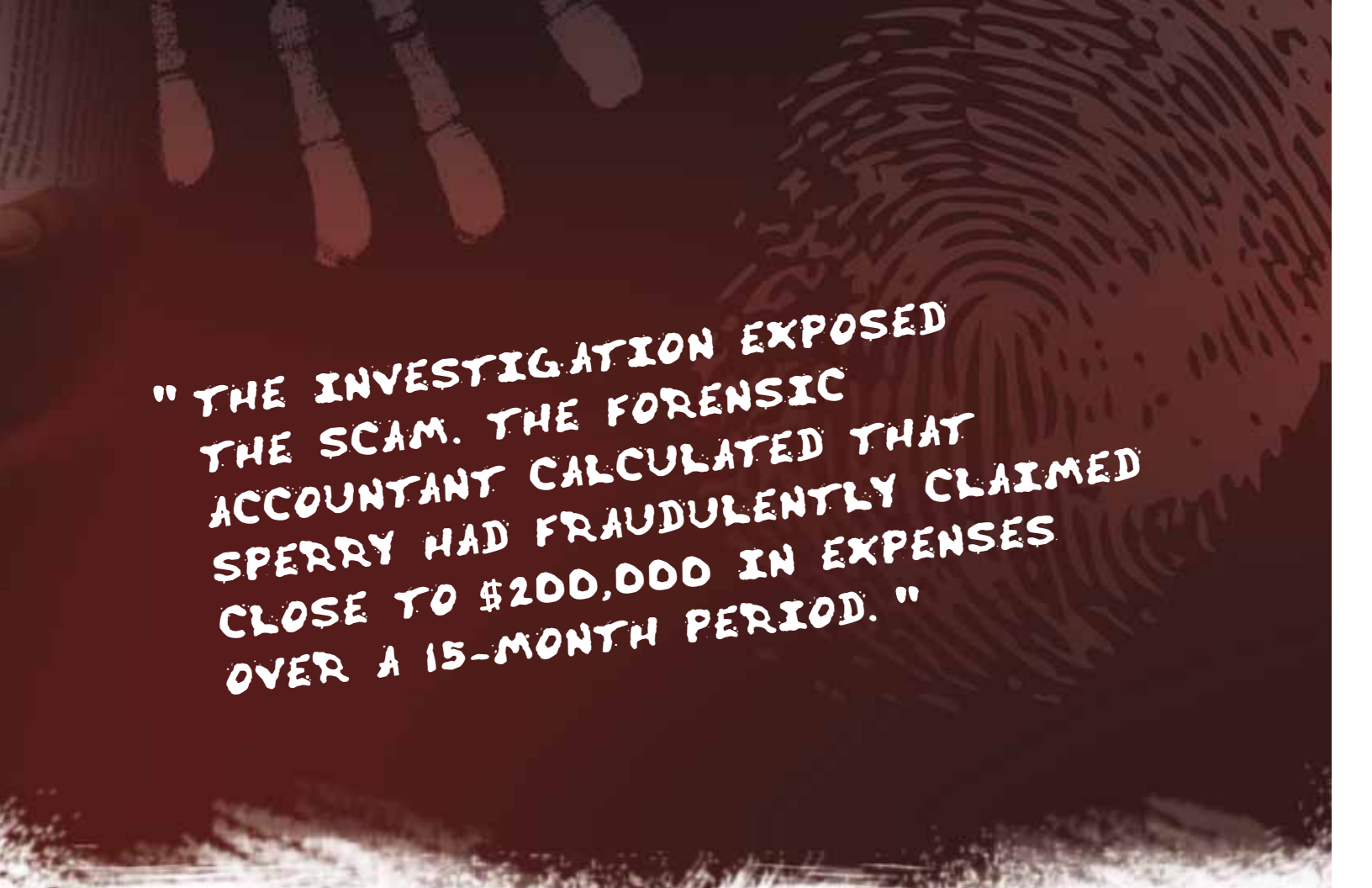
By Edward Nagel, CA, IFA, CBV

Sam Sperry* had been dreaming about building his dream cottage for as long as he could remember. The successful Vice-President of Business Development at a large privately held manufacturing business had used his 2007 bonus payment to begin work on an expensive renovation to his existing summer home. His plan was to use his 2008 bonus to pay for the final half of the project, which was due to be completed by late fall of that year.

When the recession hit in 2008, however, Sperry's company cancelled all bonuses. A spendthrift whose credit lines were maxed out, Sperry had been counting on the bonus to take care of the money due on the cottage project. In a panic, Sperry concocted a survival plan: a clever payroll fraud.

Sperry's work required him to do extensive entertaining and business-class traveling, both within North America and overseas. As a result, his expense account was always significant and virtually unrestricted.

A trusted employee, Sperry was also a known workaholic who was often in the office late at night, when everyone else had gone home. He was also a respected member of his church, and had initiated a program at work whereby he collected airline frequent flyer points and used them to help families in need in his community afford trips for various purposes, including traveling back home to visit relatives.



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As the manager of this charitable work, Sperry regularly booked and paid for tickets on behalf of other senior executives at the firm, so that their points went to his account. As a thank-you to his colleagues, he processed their ticket expense claims to save them the trouble.

Desperate for money, Sperry realized it would be relatively easy to manipulate the expense system to his advantage. In his mind he wasn't doing anything wrong; he was simply awarding himself the bonus he felt he rightfully deserved for all his paid and unpaid hard work.

Sperry typically obtained large advances to pay for his travel and expenses. This required him to requisition the advances, which were approved by the CFO and paid for by cheques through the accounts payable department. Once he had completed a trip, which sometimes involved several different locations, he claimed his expenses (as well as those for entertainment outside of the trips) against the advances. It was not unusual for this reconciliation to occur months after the initial advance had been issued. The payroll department processed the expense reports and, if money was owing to Sperry, it was directly deposited into his bank account with his salary.

Sperry was quite certain the payroll department didn't keep track of, or pay any attention to, his advances (particularly as they were processed by accounts payable). It took as a given that

whatever he submitted was accurate.

Following an extended trip to Asia, Sperry submitted, as usual, all his boarding passes, as required by company policy, and a claim for the airfare and related expenses. This time, however, he failed to deduct his considerable advance. He decided that if anyone noticed what had happened, he would claim forgetfulness. If no one noticed, he planned to continue, and expand, his scheme.

To his relief and delight, his plan worked.

Buoyed by his initial success, Sperry did the same for several of the tickets he had purchased on behalf of fellow executives who had also received advances (which they had passed on to him to pay for their tickets). At first he tried this with just a few, but when this aspect of his scheme also worked without a hitch, he expanded it to include all the claims he made on behalf of his colleagues.

Following his next trip, Sperry added to his deceptions by doctoring his expenses. He increased the amounts on receipts and submitted personal expenses coded as the entertainment of clients. This ruse also passed by payroll without any questions asked.

Although his company audited expenses and advances, Sperry knew it was done on a quarterly basis. To avoid detection, he timed the submission of his falsified expense claims so they never arrived at payroll in the same quarter as when he had obtained the advance.

In early 2010, about 15 months after Sperry had begun the fraud, a payroll administrator noticed by happenstance that one of Sperry's expense receipts was for a restaurant she frequented. Curious as to what he had ordered, she looked at it closely, which she normally would never have done. She was shocked at the total for the meal, which far exceeded what she had ever paid to eat there. When she scrutinized the itemized bill she saw the total was far greater than the list of items ordered. A quick calculation revealed that someone had doctored the bill by changing a "1" to a "7". As a result, a \$190 bill had become \$790.

Her first reaction was that someone at the restaurant had scammed Sperry, and he had blindly signed a bill for far more than he should have. She took the bill to him but not before photocopying it first, as a precaution. When she showed him the bill he responded nervously at first and then aggressively, grabbing it from her and saying he would check it out. She found his demeanor concerning and decided to take a closer look at some of his other expenses. That brief exercise revealed similar doctored expenses. The administrator took her findings to the firm's CFO.

The CFO was disturbed by her findings and had Sperry's expenses pulled for the past year. That undertaking exposed the ticket scam. In shock, the CFO met with Sperry and asked for an explanation. Sperry was unable to provide one, other than to suggest he must have made an innocent mistake or two along the way. Unsatisfied with the response, the CFO suspended Sperry and retained a forensic accountant to review all of Sperry's expenses.

The investigation exposed the scam. The forensic accountant calculated that Sperry had fraudulently claimed close to \$200,000 in expenses over a 15-month period. Sperry was subsequently terminated with cause and litigation was commenced to pursue recovery.

Payroll & Fraud

The payroll function is particularly vulnerable to fraud. Although there are numerous payroll scams, there are three primary methods:

- The creation of fictitious employees
- False wages/benefits fraud
- False expense reimbursement frauds (as was the case with Sperry)

Fictitious Employees

A fictitious, or "ghost," employee is a person who is on the books but does not actually work for an organization. In some instances, the fictitious employee worked there previously but either left or became deceased; more commonly, however, the

individual never worked there at all.

The fraudster, normally a payroll employee, uses the former employee's social insurance number or creates a fake one for a fictitious employee. He or she then arranges to have cheques or direct deposits sent to the ghost at an address or account the fraudster controls.

There are several red flags related to this scam: unusual employee addresses, especially post office boxes; addresses and phone numbers that are the same as those of genuine employees (this can be done by cross-referencing contact information for everyone on the payroll); employees with dates of birth that make them too old or too young to be on the payroll; manual adjustments to reverse entries in the payroll register; and any evidence of the payroll register being "physically" split in any way (which could indicate someone is removing pages that include the fictitious employee).

It is also worth noting whether any payroll employees work excessive overtime, especially at night, and/or do not take vacations. Fraudsters often enact their schemes when no one else is around, and as they fear being detected, they may be reluctant to take time off for holidays.

Measures to detect and prevent fictitious employees

- Ensure there is a paper trail for all payroll transactions, such as receipts, cheques, stubs or invoices, to facilitate the tracing and recovery of the misappropriated funds.
- Have someone in a trusted position—preferably at arm's length from payroll—review the exception reports generated internally or provided by the third-party payroll provider. This role should be rotated.
- Segregate duties within payroll, as many frauds involve, and require, collusion.
- Ensure employees use up their vacation time.
- Have department heads regularly review and sign off on their headcount and employees paid through payroll.

False Wages/Benefits Fraud

False wages/benefits fraud is another common payroll scam that is particularly prevalent in companies with significant numbers of hourly employees, where timesheets and timecards are common practice. These employees are paid based on a formula of hours and dollars per hour.

This scheme often involves collusion between an hourly employee and a payroll employee. The hourly employee increases the number of hours worked, thus triggering time-and-a-half pay-

ments, which are processed by the payroll employee. If done with enough employees, the loss to a company can add up quickly.

In other cases, it's the employer who initiates this type of fraud to save money. For example, thanks to an anonymous tip, a franchisor discovered that one of her franchisee had forbidden his employees, most of whom were immigrants who feared losing their jobs, from claiming more than the standard number of work hours per week to avoid paying them overtime.

In another case, to earn sales bonuses, a sales department had side agreement with certain customers to provide them with a full refund on some large orders after the auditors had completed their onsite fieldwork as part of the year-end audit. The sale was completed in one fiscal year and the commission sales staff received the appropriate bonuses, which were contingent upon the sale closing. Then those customers were fully reimbursed in the following fiscal year, and the customers' representatives were given a payment as a reward.

Measures to detect and prevent wages/benefits fraud

- Segregate duties between the various functions, particularly the individual(s) responsible for the submission and approval of timecards and the person(s) who analyze(s) the period-over-period fluctuations in payroll expense.
- Limit physical access to supporting documentation. Ideally, they should not be accessible to anyone who creates or approves those documents.
- Initiate random spot checks. Take a period of time and compare production levels to the timecards—do certain employees stand out in terms of hours worked or overtime claims?
- Make sure there are strong controls over timecard entry that make it difficult, if not impossible, for employees to punch cards on behalf of colleagues.

False Expense Reimbursement Fraud

The third most common method of committing payroll fraud involves falsified expense reports. This can involve a variety of manipulations, including personal expenses claimed as business; inflated, false and duplicate expenses; and advances being made, and then expenses subsequently claimed, without reconciliation between the two.

Although prevalent, this type of fraud is certainly preventable. One reason it's so widespread is that companies do not tend to implement controls, especially when they relate to trusted and/

or senior personnel. Eliminating that complacency is the single most effective way of controlling this fraud. If all personnel know their expenses will be checked closely, a great deal of expense fraud will not even be attempted. And if it is attempted, the chances of detecting it are high.

Measures to detect and prevent expense reimbursement fraud

- Accept only original receipts when employees submit expenses.
- Always verify that the claimed expense falls under the company's policy of acceptable expenses.
- Inform all personnel that random expense audits will occur throughout the year.
- Conduct reconciliations between advances paid and expenses claimed.
- If the information supporting the expense claim is not 100% clear, request and require additional documentation before it is processed.

Prevention is Key

Prevention—rather than detection—is the best deterrence against payroll and other financial frauds.

Although payroll fraud will never be completely eliminated, it can be reduced significantly by having effective checks and controls in place and, more importantly, by regularly testing their effectiveness. No one should be exempt from any of the controls, no matter how senior, and organizations should provide periodic fraud awareness training for employees, especially those in positions of authority or trust.

Even where there is a cost involved in establishing the controls or upgrading existing ones, organizations should not hesitate to pay it. It is invariably a lot less costly to prevent a large fraud in the first place than to fix the damages that it could wreak later.

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