

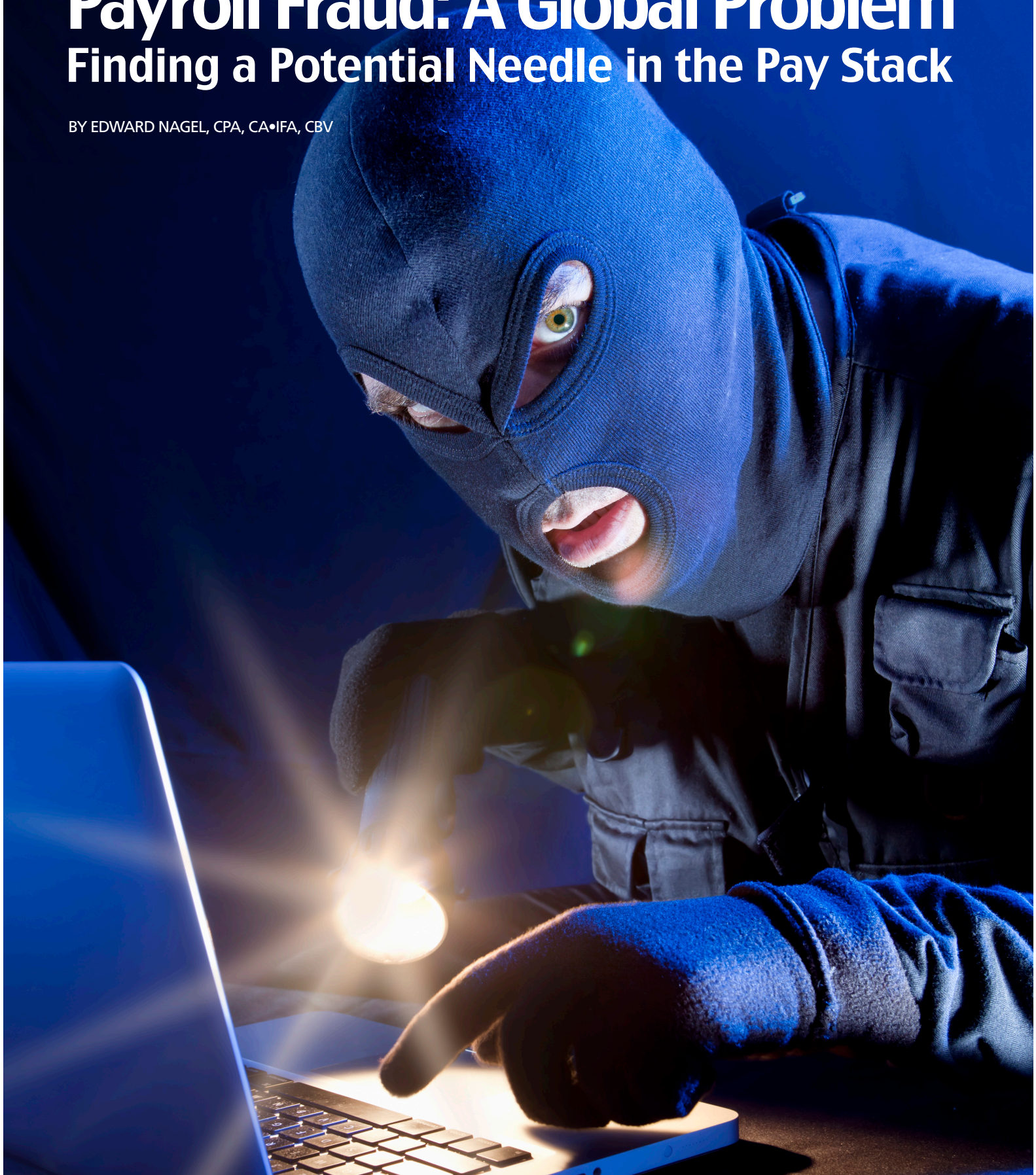
Reprinted From

July 2015

# PAYTECH

## Payroll Fraud: A Global Problem Finding a Potential Needle in the Pay Stack

BY EDWARD NAGEL, CPA, CA•IFA, CBV



When it comes to fraud, the recurring headlines undoubtedly draw our attention to this much-covered topic. However, the staggering statistics tell the real story here, as suggested by the following:

- The Royal Canadian Mounted Police (RCMP) Commercial Crime Branch indicated that fraud-related offenses in Canada are thought to be as profitable as drug-related offenses, estimated at between \$10 billion and \$30 billion annually.
- The Certified General Accountants Association of Canada (CGA Canada) estimates that Canadian businesses lose \$3.2 billion annually from occupational fraud alone.
- The Association of Certified Fraud Examiners (ACFE) found that the typical organization loses 5% of revenues each year to fraud. If applied to the 2013 estimated Gross World Product, this translates to a potential projected global fraud loss of nearly \$3.7 trillion or \$3,700,000,000,000!

Regardless which of the above statistics is considered to be more accurate, what is fair to say is that fraud is a significant and growing problem globally.

Historically, organizations' approach to dealing with fraud has largely been reactionary and event-driven. That is, many organizations tend to wait for allegations to surface before addressing potential weaknesses in internal controls or recognizing the absence of strong corporate governance; both of which are designed to prevent and detect fraud from occurring.

In recent years, it appears that this philosophy is shifting, with more organizations starting to take a proactive rather than reactive approach to dealing with fraud.

One process within the accounting cycle that tends to draw significant attention from management and boards alike is payroll. This comes as no surprise because of the frequency

of payments and the fact that payroll can often represent more than 50% of an organization's annual expenditures.

Invariably, these factors also contribute to fraudsters frequently targeting payroll. Let's examine one case study to see just how easy it is for payroll fraud to occur.

### Events Giving Rise to 'Ghost Employee' Scheme

In one organization, a seasoned Payroll Administrator handled payroll and implemented numerous checks and balances to prevent errors while mitigating the risk of fraud. This proved to be effective, as the payroll administrator's track record was impeccable. Errors were virtually non-existent, and not a single occurrence of fraud surfaced during her 15-year tenure managing the company's payroll for more than 500 employees.

The Payroll Administrator reported to the company's Controller, whose review was normally limited to a cursory examination of the payroll register.

The Payroll Administrator was celebrating a milestone anniversary and decided to take a three-week vacation to Europe. During this absence, responsibility for the company's weekly payroll was delineated to "Sonia," a senior, trusted employee and team player by all accounts. After all, Sonia was the company's Controller and had overall responsibility for the company's accounting.

### Crime of Opportunity

Over the years, Sonia had been progressing well in terms of promotions. During a recent performance review meeting, Sonia's

---

*Edward Nagel, CPA, CA•IFA, CBV, is a seasoned forensic accountant who, since 1998, has focused exclusively on providing forensic and investigative accounting services to corporations, individuals, public sector, and not-for-profit organizations and their legal advisors/boards, primarily in the area of corporate fraud. Nagel is the Principal and founder of nagel + associates inc. (nagel-forensics.com), a Toronto-based boutique forensic accounting firm that specializes exclusively in conducting forensic investigations, providing anti-fraud consulting, and developing and delivering customized anti-fraud training courses. He can be reached at edward@nagel-forensics.com.*

boss alluded to the fact that there was a “serious” promotion in the making for her. Sonia knew that could only mean a VP role. Recognizing that this would result in a higher salary, bonus, and car allowance, she decided with her spouse to purchase their dream home in advance of being officially promoted.

When it came to promotion time, Sonia was stunned to find out that her long-deserved promotion was being deferred indefinitely as the result of a new VP Finance person being parachuted into the company.

Deflated and demoralized, Sonia returned to her office to start processing the weekly payroll. It occurred to Sonia that with the Payroll Administrator out of town for a few weeks and the new VP Finance getting up to speed, there would be limited controls—particularly segregation of duties—involving the processing of payroll.



## The Ghost Employee

Sonia proceeded to add a new fictitious, or “ghost,” employee to the payroll. A 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 died; more commonly, however, the individual never worked there at all.

The ghost employee Sonia added was a relatively junior hire within an existing department that had several recently vacated positions—as this would diminish the likelihood of detection. She used an alias name and her own legitimate bank account to set up the new employee. She also set up an HR file and put in a few “usual” forms (but certainly not the complete file normally found for legitimate employees). In short, Sonia believed that uncovering one ghost employee among 500 was going to be like finding a needle in haystack—or in this case, pay stack!

After the payroll was processed later that week, Sonia walked the payroll register to the VP Finance to be reviewed, a responsibility that was normally assigned to her. The VP Finance took a cursory look through the payroll register and signed off on it, trusting her employee.

What the new VP Finance apparently failed to consider is that trust is *not* an internal control.

Within weeks of her return from vacation, the Payroll Administrator’s keen eye for details and strong checks and balances uncovered the Controller’s payroll fraud scheme. Sonia was terminated with cause, and the company was able to recover the misappropriated funds through their fidelity insurance (i.e., insurance against employee malfeasance).

## The Fraud Triangle

Sonia’s ability—albeit temporary—to carry out this fraud scheme can be explained by the “fraud triangle,” which is the generally accepted model for managing fraud risk. It asserts that there are elements of rationalization, opportunity, and motive in every fraudulent act.

In the example case, the **rationalization** was clear. Sonia believed that she deserved the promotion to VP Finance that was wrongfully taken from her by someone who was parachuted into the company.

Sonia’s **opportunity** was the fact that she was a long-term, trusted employee reporting to a new boss. Sonia took advantage of the temporary absence of the seasoned Payroll Administrator, coupled with the lack of segregation of duties

relating to the processing/review of payroll. However, Sonia failed to consider the Payroll Administrator's keen attention to detail and ability to identify potential anomalies in the payroll upon her return from vacation.

Finally, Sonia's **motive** was to support her lifestyle. Sonia put herself into an adverse financial position by purchasing a larger, more expensive home, but justified it on the basis that she was going to be promoted and therefore was going to earn the additional money she would need to support her mortgage.

### 'Red Flags' of Payroll Fraud

Regardless of the country in which payroll is processed, many potential indicators, or "red flags," may help uncover errors in payroll or potential fraud schemes (such as that committed by the Controller), including the following:

- Employees with duplicate addresses and/or bank account information
- Invalid social security or social insurance numbers
- Employees without source deductions and/or employee files
- Fluctuations in payroll expense as compared to prior periods, including inconsistencies between the level of payroll as compared to department productivity
- Timesheets with notations in different handwriting or color
- Extra pay stubs left over after distribution to employees
- Changes to payroll from one pay period to the next that are unsupported or unauthorized
- Expense reports with photocopied/altered receipts, calculation errors, and supporting documentation lacking details of expenses incurred.

Arguably, even those companies with the most robust corporate governance models, detailed policies, and procedures governing every process performed on a day-to-day basis can be victimized by fraud.

This can often be explained simply as complacency.

Employees need to be reminded that fraud is a real and ongoing risk and that they should be on the lookout for any suspicious transactions or potential discrepancies. Employees also need a mechanism, such as a whistleblower hotline, to report such issues, particularly if they are not comfortable coming forward to their supervisors.

### Other Common Fraud Schemes

In addition to "ghost" employee schemes, payroll practitioners should be aware of other common fraud schemes so that they can help to minimize the likelihood of fraud in their own organizations. These fraud schemes can victimize organizations, regardless of their location, and can include the following:

- *Falsified wage schemes*—include any scheme whereby employees make a claim for compensation for hours not worked or by falsifying their timesheets/timecards
- *Fraudulent commission schemes*—such schemes are typically carried out by salespeople and normally involve the manipulation of commission policies and structures as well as the use of side agreements to record sales or revenue prematurely or without basis
- *Workers' compensation schemes*—include schemes whereby employees fake injuries, such as neck, back, bone, or joint problems, for the purpose of bilking their employer and insurance company (also injuries sustained out of the workplace but represented to have occurred in connection with the person's employment)
- *False expense claims*—include schemes whereby employees claim personal expenses and represent them to be business-related, overstated expense claims, claims involving altered or fictitious receipts, and expenses claimed on behalf of other employees in duplicate
- *Failure to remit schemes*—include schemes whereby individuals responsible for withholding taxes and other deductions withhold the funds from employee pay but fail to remit such funds to the applicable government authority

### Prevention the Best Deterrent

With the passage of time, it is human nature for complacency to kick in, which may include processing transactions without considering how such transactions may be fraudulent. By providing employees with regular anti-fraud training, you not only increase the chances of catching errors and fraud sooner, you also deter would-be fraudsters from engaging in illicit activity in the first place, as they know that everyone around the payroll is now trained in fraud prevention.

With technology playing a greater role in our day-to-day lives, we have seen the advent of automating the review of payroll registers. The purpose of such reviews is to identify potential changes to payroll or anomalies that may be errors or, worse, could indicate an ongoing fraud scheme.

Although the risk of fraud can never be completely eliminated, having effective payroll checks and balances and internal controls can certainly reduce it significantly. Regular testing of the effectiveness of such controls is required.

In short, no one, no matter how senior, should ever be exempt from any of the organization's internal controls. Moreover, the messaging or "tone from the top" must be clear: There is simply no room for fraud and other illicit activity in your organization.

Fraud awareness needs to be top of mind in order to keep the crooks off the books! ■