Fraud Risk Assessment
Payroll Cycle
part 3 of 3

Massachusetts Municipal Auditors' & Accountants' Association
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Agenda
Fraud Risk Assessment in Payroll

- Part 1 and 2 Review
- Fraud Tree – Payroll Cycle
- Fraud Triangle
- Common payroll fraud schemes, red flags and fraud prevention measures
- Municipalities' vulnerabilities
- Red Flags (in general)
- Incorporating Fraud Risk Assessment into Operations
- Key Detection Tools (in general)

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Part 1 & 2 Review – A Assessing Fraud Risk

- Fraud is generally perpetrated **internally** or **externally.**
- Fraudulent disbursements account for the largest dollar frauds in municipalities in the shortest time. Cash receipts and **payroll** are more **frequently** the subject of fraud, but generally take more time to become *material*.
- General culture within municipalities make it more susceptible to fraud risk
  - Segregation of duties
  - Budget constraints
  - Culture of trust
  - Political implications to exposing fraud

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Previous Informal Polls

- In the 2014 and 2015 Annual Meetings, we asked "How many in the room worked at an organization that was victimized by fraud?"
- Nearly 1/3 of the room raised their hands.
- Most indicated that they were victimized by theft of cash in departmental receipts, particularly from those "entrepreneurial" departments.

Fraud Statistics

In its 2016 Global Fraud Study, the Association of Certified Fraud Examiners (ACFE) reported:

- The median loss caused by fraud was $150,000 for all organizations; **$80,000** for municipalities.
- The medium duration of fraud (start to end) was 18 months.
- Asset misappropriation was the most common form of fraud
  - This is the most applicable to municipalities
- Banking and financial services, **governments** and manufacturers had the highest reported fraud incidents in this survey

Full study can be found at: www.acfe.com/rttn2016.aspx

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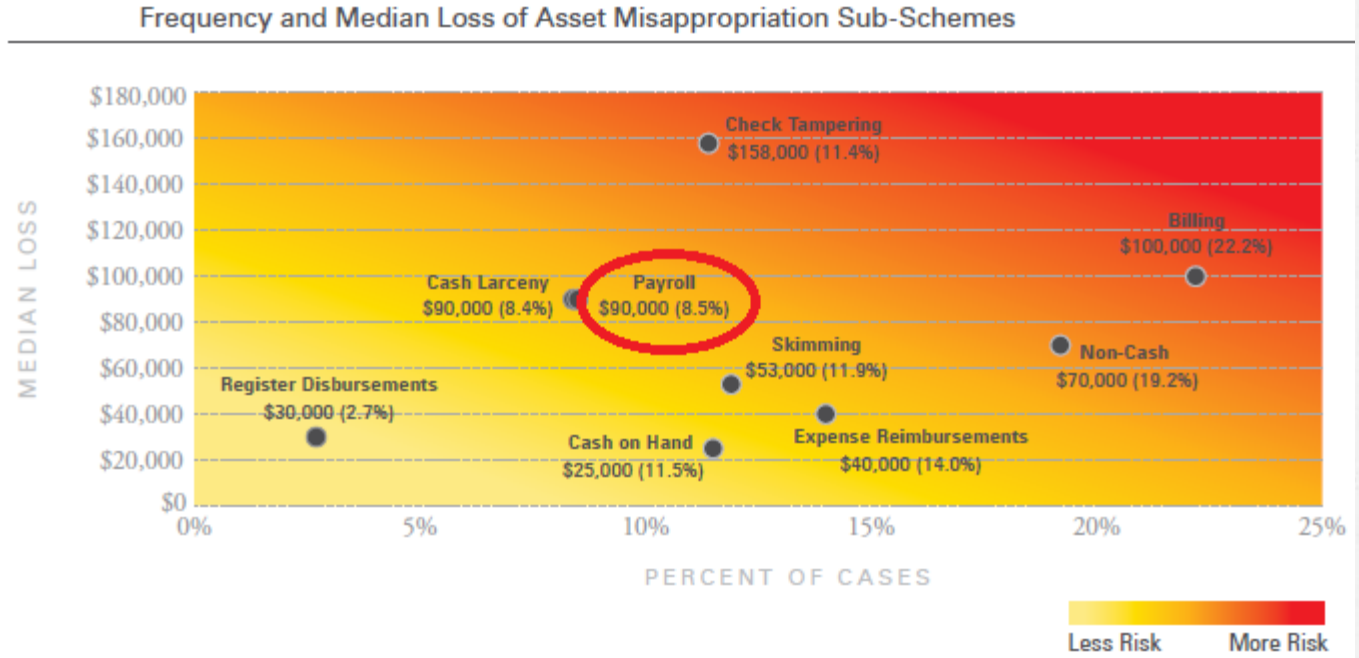
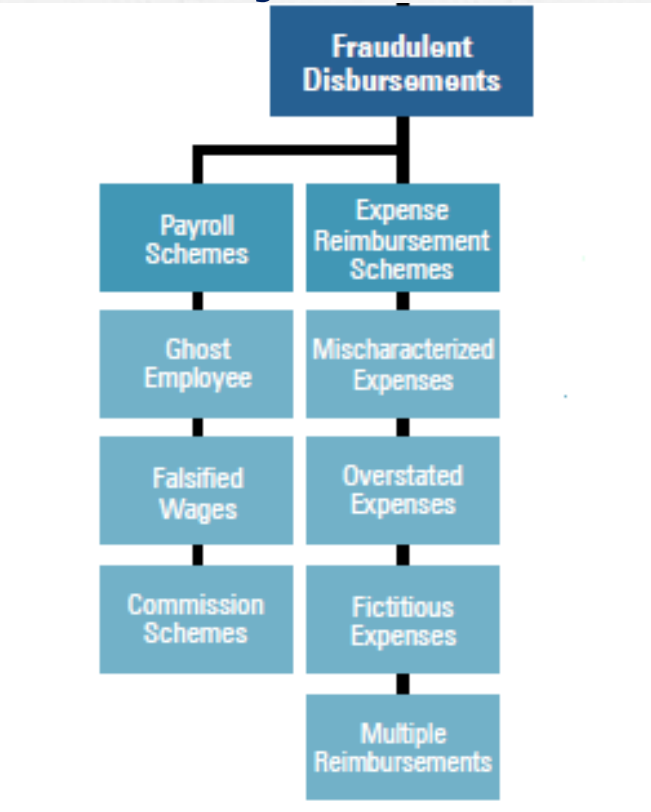
How Occupational Fraud Is Committed?



Source: Association of Certified Fraud Examiners
www.acfe.com

Uniform Occupational Fraud Classification System – Payroll



Source: Association of Certified Fraud Examiners
www.acfe.com

Fraud Triangle

3 key reasons why fraud occurs.

Developed by Dr. Donald Cressey, a criminologist, whose research focused on embezzlement.

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Fraud Triangle

- Financial Pressure
  - Money
  - Family issues
  - Gambling, drugs, alcohol
  - Dissatisfaction at work
- Rationalization
  - I'm owed this
  - I'll pay it back
  - Everyone does it
- Opportunity
  - System weaknesses
  - Environmental weaknesses

This is the area that you have control and can prevent payroll fraud!

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Common Payroll Fraud Schemes

- Ghost Employees
  - Issuing payroll to fictitious, nonexistent employee
  - Issue payroll to a real person who doesn't really work at the municipality

- Falsifying Wages
  - Hours worked (time clock / time sheet falsification)
  - Time off not reported
  - Manipulating wage rates
  - Compensated absence (sick and vacation) deception

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Ghost Employees

- Issuing payroll to ghost employees is pretty difficult (see below).
- 4 things must happen for ghost-employee scheme to work:
  1) Ghost must be added to payroll
  2) Timekeeping and wage rate information must be collected
  3) Paycheck/direct deposit must be issued to the ghost
  4) The paycheck/direct deposit must be delivered
- When the ghost is a real person, it's often a friend or relative of the perpetrator.

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Ghost Employees (continued)

- Ghost-employee schemes are performed in-house:
  - Accounting or treasury – access to payroll database and personnel records
  - Department head with hiring authority, timesheet review and approval and budget review/access
- The ghost employee may be a former employee with a change to direct deposit (this is how I would do it).
- A ghost employee with a similar name to another employee is surprisingly effective and rather easy.
  - Mary MacElroy is a real employee and Mary McElroy is ghost
  - Sr. and Jr. suffixes

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Ghost Employees (continued)

- This is best done for salaried employees and those who do not punch a clock or complete time sheets. This can be done by accounting/treasury or department head.
- Ghost employees with time sheets will likely be carried out by a department head.
- Lack of appropriate segregation of duties exposes municipalities in this area.
- More of a risk in large cities and towns.

Red Flags for Ghost Employees

- Unknown employee in payroll records.
- Overrides in time sheets.
- Someone continually blames the “system” for payroll errors.
- Lack of vacation or other time off for those in charge of payroll processing.
- Payroll processing performed off hours or in secret.
- IRS or SSA notices.

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Ghost Employees Fraud Prevention

- Segregate hiring functions from payroll processing.
- Rotate the duty of distributing payroll checks.
- Run audit report or other metrics to identify duplicate bank account numbers for direct deposit and SSN's.
- Periodically review the payroll database for terminated employees. Check for employees with no deductions!
- Consider requiring all employees to pick up checks one payroll cycle. Los Angeles did this years ago and hundreds of paid employees never showed up!

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Falsifying Wages

- Most common fraud scheme relative to payroll.
- For hourly employees:
  - Hours worked (time clock / time sheet falsification)
  - Change in rate (i.e., overtime, holiday, shift differential)
  - Unreported time off (compensated absence deception)
- For salaries employees, must falsify wage rate or add some kind of stipend.

Falsifying Wages (continued)

- Hourly employees may:
  - Add hours to their manual time cards
  - Report that they worked a particular day but was on vacation
  - Have someone punch in and out for them in a punch card system.
  - Report hours in incorrect time slots, which results in a change in rate (i.e., overtime, holiday, shift differential)
- For salaries employees, likely have access to payroll/personnel records and accounting system

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Red Flags for Falsifying Wages

- Small, remote office with little supervision.
- Good-ole-boy attitude within department/independent board.
- Public service isn't getting done timely or well.
- Department head is known to be a "rubber stamp" manager.
- Fuzzy support/details.

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Fraud Prevention for Falsifying Wages

- Upgrade time clocks/systems that have unique employee passcodes or fingerprint scanners.
- Authorized time sheets are sent directly to payroll.
- Budget to actual reviews.
- Mandatory vacation for those with payroll responsibilities.
- Periodically monitor payroll databases.

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Fraud Involving Expense Reports

- Topic of part 1 of 3.
- Most commonly used methods include:
  - Fictitious expenditures
  - Expenditures made for personal enrichment
- Due to nature of municipalities, relatively low amount of reimbursements.
- Higher degree of scrutiny should be placed on reimbursements. Inquire with an employee's board or direct supervisor about questionnable items.

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Municipal Vulnerabilities

- Why are municipalities vulnerable?
  - Inappropriate/incompatible segregation of duties
  - Culture of trust
  - Use of part-time employees
  - Over-reliance on key employees
  - Improper employee background checks
  - Budget constraints
  - Political implications to exposing fraud

Independent Auditors' Role in Fraud Detection

- Auditors are required to consider fraud in the planning and execution of an audit, but are not required to audit for fraud … this will be noted in your engagement letter.
- A clean audit opinion on your financial statements specifically disclaims an opinion on internal controls.
- The clean Yellow Book opinion also disclaims an opinion on internal controls.

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Red Flags for Insider Fraud

- Change in lifestyle
- **Not taking vacation, sick or other days off**
- Employee change in work habits/behavior:
  - Coming in early and staying late
  - Trying to do more work alone or unsupervised
  - Insists on doing work the they should not do or that they normally would have walked away from
- Employee is known to be having personal financial stress (health, college, marital, etc.)

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Red Flags for Insider Fraud (cont'd.)

- Unusual, close relationship with outside vendors
- Vendor/customer complaints about payment application
- Known or suspicion of gambling/drug/alcohol abuse
- Brags about recent gambling wins
- Recently demoted
- Has a "wheeler-dealer" personality

Incorporating Fraud Risk Assessment into your Operations

- Assess where you are most vulnerable
- Do not exclude anyone from your assessment ... this isn't personal…it's business
- Evaluate the controls you have in place for these vulnerabilities
- Identify gaps
- Incorporate controls
- Document controls
- Communicate controls

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Enhancements to Internal Controls May Include:

- Effective whistleblower system
- Fraud policy
  - Effectively communicated
  - Includes clear policy for punishment
- Enhanced training
- Background and credit checks
- Appropriate system authorizations
- Use of strong password(s) and periodic changes
- Periodic internal audits
- Cross training

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Key Fraud Detection Tools

- Periodic, unannounced internal audits
- Employee tips
  - Open door policy
  - Confidential whistleblower hotline
    - AG's hotline is (800) 322-1323
- **Timely** reconciliation of accounts
- Timely budget to actual analyses
  - Revenues as well as expenses
- Check logs with signoffs between Accountant and Treasurer… keep track of your check sequence(s)
- External audit

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Questions

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