OTHER PEOPLE'S MONEY:
THE BASICS OF ASSET MISAPPROPRIATION



Association of Certified Fraud Examiners

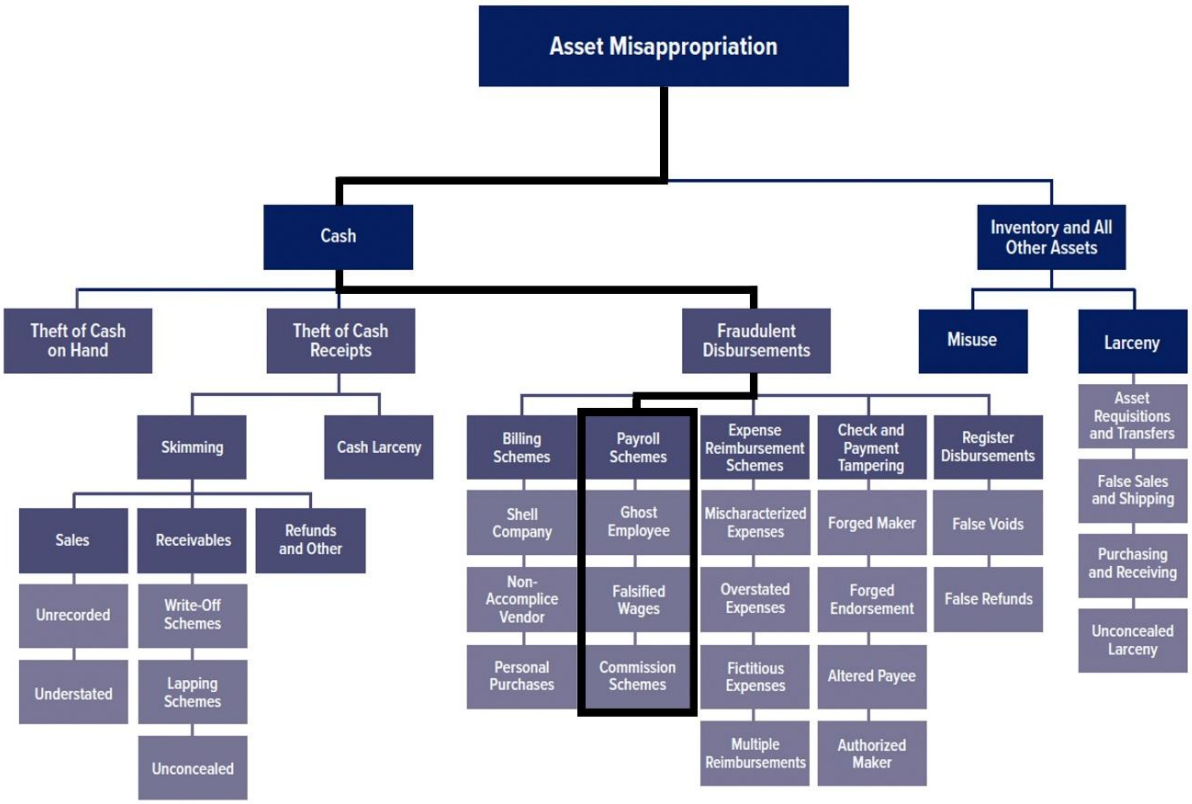
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IV. PAYROLL SCHEMES

Overview

Payroll schemes occur when an employee fraudulently generates overcompensation on their behalf. These schemes are similar to billing schemes, in that the perpetrator generally produces some false document or otherwise makes a false claim for a distribution of funds by their employer. In billing schemes, the false claim typically comes in the form of a fraudulent invoice. In payroll schemes, the false claim generally occurs when the fraudster falsifies payroll records, timekeeping records, or some other document concerned with the payroll function. The most common forms of payroll fraud are:

- Ghost employee schemes
- Falsified hours and salary
- Commission schemes



Ghost Employees

A *ghost employee* is a person on an organization's payroll, either real or fictitious, who does not actually work for that organization. When the ghost is a real person, it is often a friend or relative of the perpetrator. To succeed at a ghost employee scheme, an employee falsifies personnel or payroll records, which causes paychecks to be generated to a ghost. The fraudster or an accomplice then converts these

paychecks. An employee who runs a successful ghost employee scheme essentially adds an additional income to their household.

For a ghost employee scheme to work, four things must happen: (1) the ghost must be added to the payroll, (2) timekeeping and wage rate information must be collected, (3) a payment must be issued to the ghost, and (4) the payment must be delivered to the perpetrator or an accomplice.

Placing the Ghost on the Payroll

Authority to Add Employees

The first step in a ghost employee scheme is including the ghost on the payroll. Ghost employee schemes are generally perpetrated by employees who have hiring authority or who have access to payroll records. These persons are in the best position to fraudulently add personnel to an organization's rolls.

In some businesses, all hiring is done through a centralized personnel department, while in others the personnel function is spread over the managerial responsibilities of various departments. In still other organizations, the hiring function is concentrated in a single individual. Regardless of how hiring of new employees is handled within a business, those with authority to add new employees are in the best position to place ghosts on the payroll.

EXAMPLE

A high-ranking school administrator added several fictitious employees to the school district's payroll. The scheme succeeded principally because of a lack of separation of duties. The perpetrator had the authority to hire new employees and approve payroll expenditures. The bookkeepers for the school district relied on the perpetrator's authority in processing and recording payroll transactions. Payroll checks were distributed through the perpetrator's office, under their supervision. The perpetrator always took direct responsibility for distributing the paychecks to the fictitious employees.

Questions about the ghost employees were initially raised by the Social Security Administration. The Social Security numbers that were submitted with the District's Form W-3 were not in the SSA's database. Once this came to light, inquiries were made by other school district employees. It was discovered that no one could recall ever having met the individuals in question. A formal investigation was launched and the perpetrator eventually resigned.

Ghosts are frequently added to the payroll by employees who work in payroll accounting. Ideally, every name listed on the payroll should be verified against personnel records to make sure people who receive paychecks actually work for the company; but in practice this does not always happen. As a result, a person with the authority to make changes to payroll records can sometimes add a fictitious employee, and generate a check to that fictitious employee, even if no other record of that individual exists with the victim organization.

Access to payroll records is usually restricted to managers or high-level employees, and they are often the most likely suspects in a ghost employee scheme. On the other hand, lower-level employees sometimes gain access to payroll records, either through poor observance of controls or by surreptitious means.

EXAMPLE

An employee in the payroll department was given the authority to enter new employees into the payroll system, make corrections to payroll information, and distribute paychecks. This employee's manager gave a quick approval to the employee's actions because of a trusting relationship between the two. The lack of separation of duties and the absence of review made it simple for the culprit to add a ghost employee into the payroll system.

Ghosts with Familiar Names

One way to help conceal the presence of a ghost on the payroll is to create a fictitious employee with a name very similar to that of a real employee. The name on the fraudulent paycheck appears legitimate to anyone who glances at it. This is not a very sophisticated method for concealing a ghost, but it is fairly common and surprisingly effective in a number of cases.

Using Former Employees as Ghosts

Some ghost employee schemes involve former employees, usually without the knowledge of those former employees. The scheme is simple: An employee leaves an organization, but the person who manages the payroll does not remove the ex-employee from the payroll. Thus, the company continues to issue paychecks to the ex-employee. The perpetrator collects and converts the ex-employee's paychecks.

EXAMPLE

An accountant delayed the submission of resignation notices for certain employees, then falsified time sheets for these employees to make it appear that they still worked for the victim company. The accountant was in charge of distributing paychecks to all employees of the company; so when the fraudulent checks were generated, she simply removed them from the stack of legitimate checks and kept them for herself.

Video



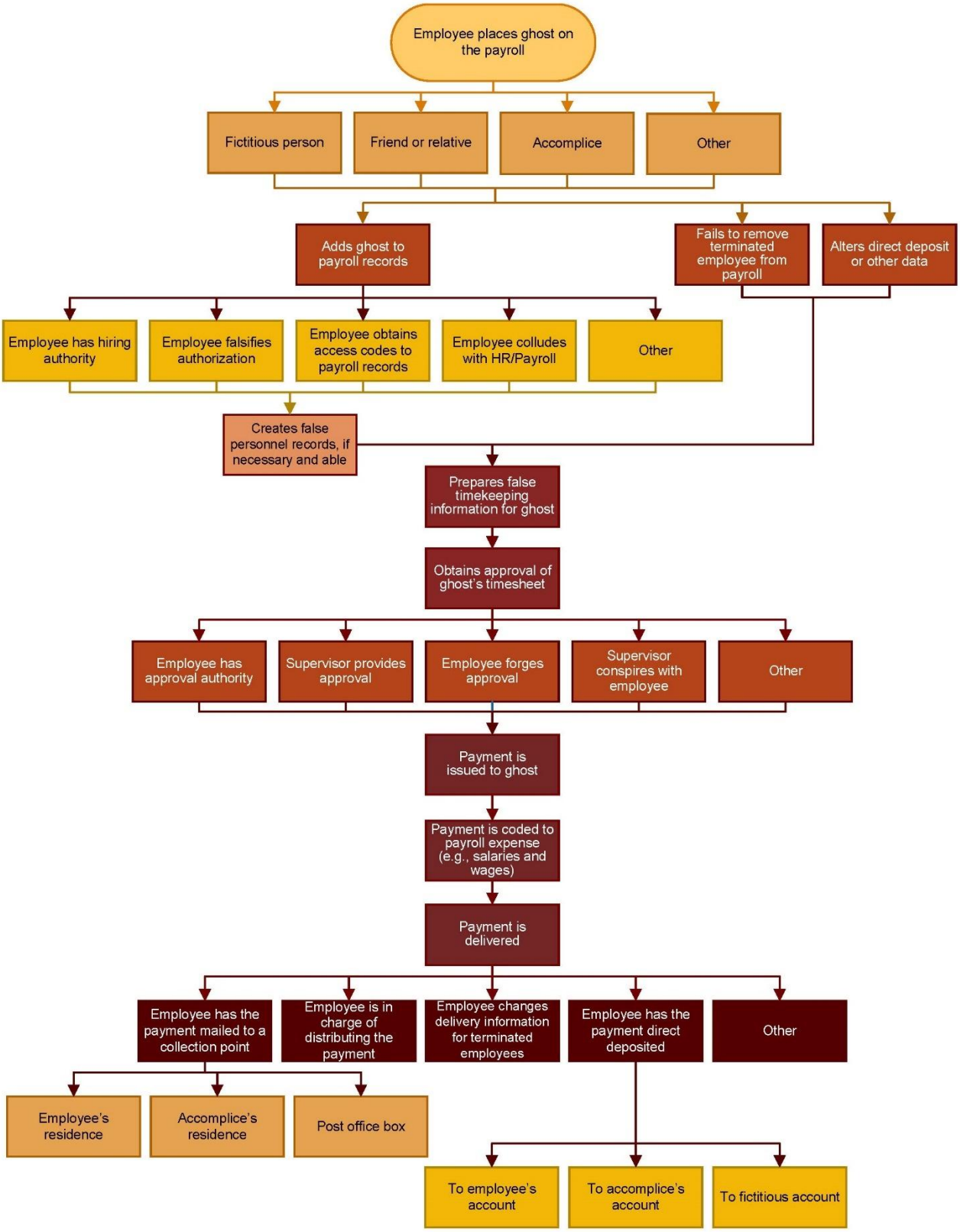
In the video titled "Ghost Employee Scheme," convicted fraudster Walt Pavlo shares his story of how he committed a payroll fraud scheme. Pavlo describes how he used his position as a manager to create a ghost employee with his wife's identification information. (Go to [redacted] to view the video.)

Collecting Timekeeping Information

Timekeeping information must be collected for all hourly employees before paychecks are issued. When a fraudster creates a ghost employee who works on an hourly basis, the perpetrator must therefore create a record of the hours worked by the ghost. In most situations, the perpetrator must produce a time card for the fictitious employee. The time card, along with the wage rate information contained in personnel or payroll files, is used to compute the amount of the fraudulent paycheck.

Timekeeping records can be maintained in a variety of ways. In many organizations, computer systems are used to track employees' hours. Alternatively, employees might manually record their hours on time cards or punch time clocks that record start and finish times.

Regardless of how employee hours are monitored, someone must create documentation for the ghost's hours. This essentially amounts to preparing a fake time card showing when the ghost was allegedly at work. Depending upon the normal procedure for recording hours, a fraudster might write up a fake time card and sign it in the ghost's name, punch the time clock for the ghost, or otherwise record false time worked. Preparing a fraudulent time card is not generally difficult. The hard part of a ghost employee scheme is getting someone to approve the issuance of a paycheck to a person who does not actually work for the organization.



Ghost Employees

Time cards of hourly employees should be approved by a supervisor and verified by a timekeeper. This assures the payroll department that the employee actually worked the hours claimed on the card. A ghost employee, by definition, does not work for the victim organization, so approval will have to be fraudulently obtained. Generally, it is a supervisor who creates ghost employees, and this supervisor approves the hours claimed on the ghost's time cards. Thus, authorization for the fraudulent time card is self-obtained. When a non-supervisor commits a ghost employee scheme, the most common method for authorizing the fraudulent time card is to forge the necessary approval and then forward the bogus time card directly to the timekeeper or payroll accounting, bypassing the immediate supervisor.

If a fraudster creates ghost employees who are salaried, rather than hourly employees, it is not necessary to collect timekeeping information. Salaried employees are paid a fixed amount each pay period regardless of how many hours they work. Because the timekeeping function can be avoided, it might be easier in some cases for a fraudster to create a ghost employee who works on salary.

Issuing the Ghost's Paycheck

Once a ghost is entered on the payroll and the time card has been approved, the third step in the scheme is the issuance of the paycheck. The center of a ghost employee scheme is in the falsification of payroll records and timekeeping information. Payroll will generally issue a paycheck so long as a time card has been approved by a supervisor and verified by the timekeeper. Once these challenges have been overcome, the payroll department prints the check—based on the bogus information provided by the fraudster—as it would any other paycheck.

Delivery of the Paycheck

The final step in a ghost employee scheme is the distribution of the fraudulent paycheck to the perpetrator. Depending on the system in place, paychecks might be hand delivered to employees while at work, mailed to employees at their home addresses, or deposited directly into employees' bank accounts.

Ideally, those in charge of payroll distribution should not be involved in any of the other functions of the payroll cycle. For example, supervisors who are authorized to hire employees and approve time cards should not be allowed to distribute paychecks because they could easily create a false employee, approve a fraudulent time card on behalf of that fictitious person, and then collect the fictitious employee's paycheck. Obviously, when the perpetrator of a ghost employee scheme is allowed to mail checks to employees or distribute them at work, they are in the best position to collect and convert the ghost's checks.

EXAMPLE

A high-ranking official of a midsize corporation added several ghosts to their company's payroll. This individual used fictitious Social Security numbers and the names of deceased individuals to create their

ghost employees. Over a five-year period, the perpetrator created more than 30 fictitious employees and embezzled more than $1 million.

The perpetrator created the internal paperwork necessary to place the ghosts on the payroll and prepared the timekeeping information needed to generate paychecks. This individual had sole control over payroll checks once they were issued. They would remove the fraudulent paychecks prior to general distribution, and then have outside accomplices' cash the fraudulent checks.

The fraud was discovered when an accounting clerk noticed that a Social Security number was missing from one employee's file. This employee asked the perpetrator to verify the Social Security number, but the perpetrator stalled. After several unsuccessful attempts to get the number, the clerk brought the discrepancy to the attention of others in the organization, and an investigation commenced. The fraudster was terminated and signed a restitution agreement.

What happens when paychecks are deposited directly into employee accounts or are mailed to employees instead of being distributed on-site? Methods for collecting payments to a ghost in these situations generally vary depending on whether the ghost is a fictitious person, an accomplice, or a former employee who is unaware of the scheme.

Distribution to Fictitious Persons

If a fictitious employee was added to the payroll by the fraudster, the problem of distribution is usually a minor one. When the ghost's employment information is prepared, the perpetrator lists a bank account or a mailing address to which the payments can be sent. In the case of purely fictitious ghost employees, the account number is often the perpetrator's personal account. In other cases, the fraudster might set up a bank account in the name of the fictitious employee to collect the payments, in much the same way a false account might be set up on behalf of a shell company in a billing scheme. This strategy can be useful for two reasons. First, the organization might periodically run tests on account numbers or mailing addresses to ensure that extra payments are not being sent to the same destination. An independent destination for the ghost's paycheck would not be flagged by such a test. Second, if the ghost employee scheme were discovered, the perpetrator would not be obvious because payments have not gone directly to them.

EXAMPLE

An accounting employee was responsible for handling company payroll for a professional services firm. Payroll at this company was distributed through a national payment center. Regional offices would transmit payroll information to the national center via commercial software, which the perpetrator had installed. Money would be wired from the company's accounts to the payroll center and then distributed to employees.

The perpetrator was in charge of sending payroll information to the national distribution center. They would code additional payments to themselves, wait until the payment was transferred, and then delete the unauthorized account activity from the system. The perpetrator's regular paychecks were delivered directly to them. The fraudulent payments were sent via direct deposit to bank accounts they had set up for the scheme.

Distribution to Accomplices

Remember that ghost employees are not always fictitious persons. They might, instead, be real individuals who are conspiring with the perpetrator to defraud the victim organization. When an existing individual is falsely added to payroll, the fraudulent paychecks generally go directly to that person's bank account or mailing address. In this way, the fraudster avoids the problem of duplicating account numbers or addresses on the payroll.

Distribution to Non-Accomplice Ghosts

Distribution is a more difficult problem when the ghost is a former employee whom the perpetrator did not remove from the payroll. The existing employee already has an established bank account in the payroll system; if the information is not changed, the fraudulent paychecks will continue to go to the terminated employee. To divert future paychecks issued in the terminated employee's name, the fraudster must change the terminated employee's information in payroll or personnel records.

Suggestions for Preventing and Detecting Ghost Employee Schemes

- Separate the hiring function from other duties associated with payroll. If all hiring is done through a centralized human resources department, an organization can substantially limit its exposure to ghost employee schemes. Most ghost employee schemes succeed when the perpetrator has the authority to add employees to the payroll and approve the time cards of those employees.
- Make sure personnel records are maintained independently of payroll and timekeeping functions. Require that any changes to payroll be verified by the personnel department.
- Require that payroll checks be secured until distribution, and ensure that the person who distributes paychecks works independently of those who hire employees, authorize time cards, and issue paychecks.
- Rotate the duty of distributing paychecks.
- Periodically check for duplicate bank account numbers where paychecks are deposited.
- Verify the existence of any employees whose checks are mailed.
- Be alert to employees who lack government identification numbers or to multiple employees with the same identification number. Also look for multiple employees with the same address. Ghost employees also frequently lack withholding taxes, insurance, or other deductions from their paychecks. Run listings of any employees who lack this information and verify the existence of these persons.

- Review the backs of canceled payroll checks for similar signatures or account numbers. Be particularly wary of any payroll check with a dual endorsement. Employees who commit ghost employee schemes frequently deposit the fraudulent checks in their own banking accounts.
- Check the payroll periodically against personnel records for terminated employees, fictitious employees, unauthorized wage, or deduction adjustments, etc. Pay specific attention to employees who were on the payroll for only a short time before being terminated.
- Verify that any changes made to payroll information and direct deposit accounts are authentic and connected to an active employee.
- Compare payroll expenses to production schedules. The distribution of hours to activity or departments should be reviewed by supervisors in those departments.

Falsified Hours and Salary

The most common method of misappropriating funds from the payroll is the overpayment of wages. For hourly employees, the size of a paycheck is based on two factors: the number of hours worked and the rate of pay. For an hourly employee to fraudulently increase the size of their paycheck, they must either falsify the number of hours worked or change the wage rate. Because salaried employees do not receive compensation based on their time at work, these employees usually generate fraudulent wages by increasing their rates of pay.

Timekeeping is generally done by one of three methods. Time clocks might be used to mark the time when an employee begins and finishes work. The employee inserts a card into the clock at the beginning and end of work, and the time is imprinted on that card. Digital punches can also track the time employees spend on the job based on log-in codes or other indicators. Finally, time cards showing the number of hours an employee worked on a particular day are prepared manually by the employee and approved by their manager.

Manually Prepared Time Cards

When hours are recorded manually, an employee typically completes their time card to reflect the number of hours worked and then presents the time card to a supervisor for approval. The supervisor verifies the accuracy of the time card, signs or initials the card to indicate that it has been approved, and forwards it to the timekeeper or to the payroll department so that a paycheck can be issued. In some organizations the time card must also be reconciled to job-time tickets before a paycheck is cut.

If an employee manually prepares their own time card, it might be easy to falsify the number of hours that were worked. The employee writes down the wrong times on the card to overstate their hours. The difficulty lies not in falsifying the time card, but in getting the fraudulent card approved by the employee's supervisor.

EXAMPLE

An individual who worked for a government agency committed fraud by falsely claiming overtime. The perpetrator was employed at a remote location and was the only individual in their office, so no one was overseeing their activities. This person would fill out false time cards, crediting themselves with an average of 10 hours of overtime per week. Rather than submit their time cards to a supervisor (because there was no supervisor in the office), the perpetrator signed and forwarded them to headquarters.

The scheme was discovered during a routine review of overtime records. The perpetrator had claimed extra hours during a period when the victim agency was not authorizing any overtime. By the time the fraud was detected, the perpetrator had received more than $20,000 in fraudulent pay. The lack of supervisory approval on the perpetrator's time and attendance records contributed directly to the success of the scheme.

Forging a Supervisor's Signature

If an employee has overstated their hours on a time card, one way to obtain approval is to forge the supervisor's signature on the card. At the end of the pay period, when time cards are collected for approval by a supervisor, the fraudster withholds the fraudulent time card. The fraudster forges the supervisor's signature on the time card and then adds it to the batch of authorized cards that are sent to the payroll department. The fraudulent time card arrives at the payroll department with what appears to be a supervisor's approval, and a paycheck is subsequently issued.

EXAMPLE

The victim company in this case contracted with a temporary agency for help in its housekeeping department. The temporary workers were issued assignment sheets that were to be filled out by the workers and signed by their supervisors at the end of their shift. These sheets were the basis for the invoices submitted by the temporary service.

Several of the temporary workers inflated their hours and forged the signatures of their supervisors. This resulted in excess billings of more than $15,000. The victim company did not maintain copies of the workers' assignment sheets and had no way to compare the invoices from the temporary agency with the actual hours worked by the temporary workers. Eventually the fraud was revealed when it was discovered that expenses related to housekeeping services were significantly out of line.

Collusion with a Supervisor

The second way to obtain approval of a fraudulent time card is to collude with a supervisor who authorizes time cards. In these schemes, the supervisor knowingly approves false time cards and usually takes a portion of the fraudulent wages. In some cases, the supervisor might take the entire amount of the overpayment. It can be particularly difficult to detect payroll fraud when a supervisor colludes with an employee because managers are relied upon as a control to assure proper timekeeping.

EXAMPLE

A supervisor assigned employees to better work areas or better jobs, but demanded payment in return. The payment was arranged by the falsification of the employees' time cards, which the supervisor authorized. The employees were compensated for fictitious overtime, which was kicked back to the supervisor.

EXAMPLE

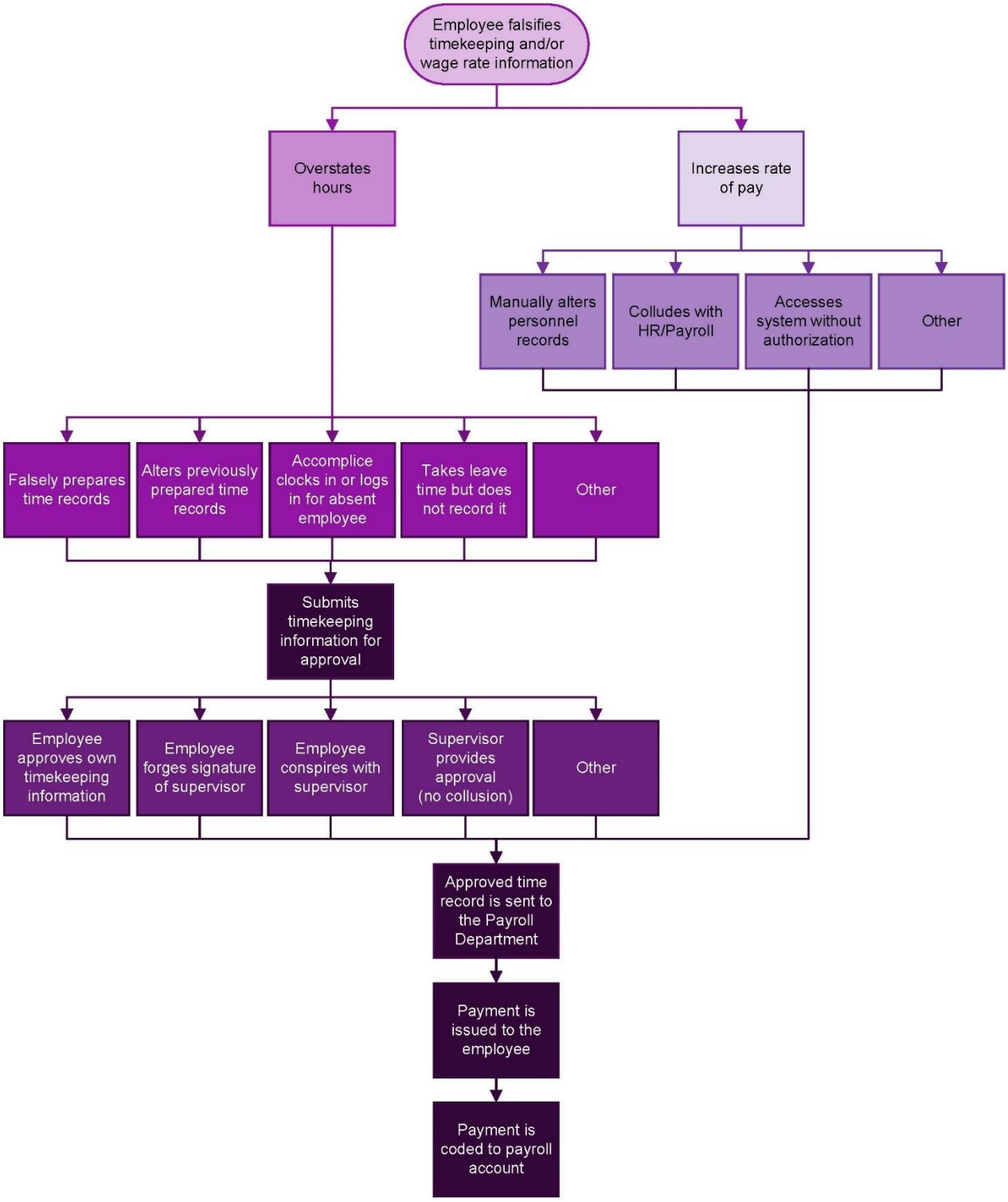
A temporary employee added fictitious hours to their time sheet. The employee obtained approval from an administrator at another site, rather than from their direct supervisor. The employee was related to the off-site administrator, who authorized their overpayment without receiving any compensation.

Negligent or Busy Supervisors

The third way to obtain approval of fraudulent time cards is to rely on a supervisor to approve them without reviewing their accuracy. The perpetrator knowingly submits a fraudulent time card to a supervisor and hopes that the supervisor will not notice that the information on the time card has been falsified. The "lazy manager" method seems risky—so much so that one would think that it would be uncommon—but it frequently occurs. A recurring theme in occupational fraud cases is the reliance of fraudsters on the inattentiveness of others. When a dishonest employee sees that a supervisor tends to easily or quickly approve time cards or even ignore them, this can be a factor in an employee's decision to begin stealing from their employer.

EXAMPLE

A temporary employee noticed that their manager did not reconcile the expense journal every month. Thus, the manager did not know how much was being paid to the temporary agency. The fraudster completed fictitious time reports that were sent to the temporary agency, causing the victim company to pay more than $30,000 in fraudulent wages. Because the fraudster controlled the mail and the manager did not review the expense journal, this extremely simple scheme went undetected for some time.



Falsified Hours and Salary