ARIZONA Auditor General
Making a Positive Difference

FRAUD PREVENTION ALERT
Payroll Disbursement Frauds
December 2021

Why are we issuing this alert?

Payroll disbursement frauds are related to falsified wages, ghost employees, or commission schemes and generally involve employees making false claims that cause their employers to issue them compensation or benefits they are not entitled to. Payroll disbursement frauds account for only 13 percent of all occupational fraud in the U.S. and Canada; however, they are some of the longest-lasting schemes, averaging about 2 years in duration before detection.[1] Over the last 9 years, we have identified public money losses in Arizona governments totaling $0.5 million due to payroll-disbursement-related fraud schemes. This alert outlines how some of those payroll disbursement frauds occurred and what actions management can take to deter and detect them.

Falsified wage schemes involve an employee manipulating compensation-related factors to increase their pay or otherwise benefit in some way. Common examples of falsified wages include an employee fraudulently recording inflated work hours, forging a supervisor's signature for time sheet approval, colluding with a supervisor to approve a fraudulent time sheet, or exploiting an opportunity created from inadequate oversight. For example, in the falsified wage schemes outlined below, 4 of the 5 involved inadequate oversight of employees who manipulated payroll software data:

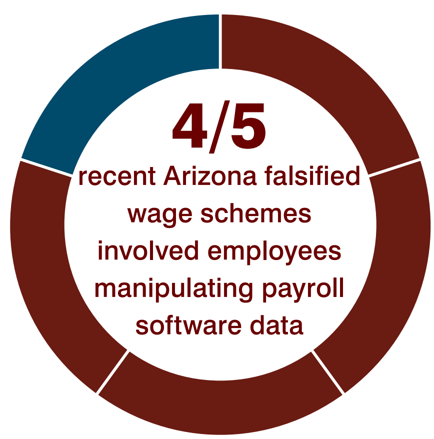
- For at least 5 years, a county sheriff and captain directed 77 employees to record unworked overtime on their time sheets, resulting in 7,220 hours of unauthorized compensation totaling $196,842. Specifically, under the sheriff's and captain's direction, Sheriff's Office supervisors and command staff instructed employees to claim 1 hour of overtime each day they performed duties beyond their pay grade.[2]

- For over 2 years, an elementary school district payroll clerk unlawfully paid herself unauthorized overtime totaling $23,504. The payroll clerk abused her position and entered in the district's payroll software 807 overtime hours for herself that her supervisors did not approve.[3]

- For 4 years, a high school district controller fraudulently altered data in the district's payroll software to reduce taxable wages and increase tax-sheltered annuity contributions reported on her and her sister's (also a district employee) W-2 forms. Her actions resulted in their combined unpaid federal and State income taxes estimated at $19,716. Additionally, she and her sister received a combined $8,400 they were not entitled to for refunds of their alleged overpayments to the tax-sheltered annuities.[4]

- For almost 2 years, an elementary school district payroll specialist altered the district's payroll software data to stop her payroll deductions for health insurance premiums totaling $7,791 while still maintaining the benefits of district-provided health insurance.[5]

- For 1 year, a career and technical education district business manager unlawfully increased her salary and employer-related benefits by $5,956 when she entered in the district's payroll software an unauthorized salary amount for herself.[6]



1 See Association of Certified Fraud Examiners, Inc., *Report to the Nations on Occupational Fraud and Abuse*, 2020.

2 See Office of the Auditor General, *Santa Cruz County Sheriff's Office—Alleged Misuse of Public Monies and Solicitation of Forgery*, April 2021, Report 21-401.

3 See Office of the Auditor General, *Eloy Elementary School District—Theft and Misuse of Public Monies*, January 2017, Report 17-401.

4 See Office of the Auditor General, *Phoenix Union High School District—Fraudulent Schemes and Theft*, August 2017, Report 17-402.

5 See Office of the Auditor General, *Gadsden Elementary School District—Criminal Indictment—Theft, Misuse of Public Monies, Fraudulent Schemes, and Computer Tampering*, August 2021, Report 21-403.

6 See Office of the Auditor General, *Western Arizona Vocational Education District—Criminal Indictment—Theft and Misuse of Public Monies*, August 2018, Report 18-402.

Ghost employee schemes may involve a fictitious or real-life individual who is on the payroll and receives a paycheck but does not actually work for the victim entity. Fraudsters falsify personnel or payroll information to generate a paycheck for the ghost, often pocketing the amount or splitting it with an accomplice. A ghost employee scheme requires 4 elements: (1) the ghost is added to payroll, (2) time sheet and wage information is collected, (3) a paycheck is generated, and (4) the paycheck is delivered to the ghost or an accomplice. Although not all 4 elements are present in the situation outlined below, inadequate oversight by State officials allowed a fraudster utilizing ghost-employee tactics to receive $250,000 in State grant monies:

- In September 2011, the president/CEO of a California company fraudulently obtained $250,000 in Arizona grant monies from the Governor's Office of Economic Recovery (GOER) Job Creation Fund, which were intended to help relocate the fraudster's company headquarters from California to Arizona. The perpetrator falsely represented that he had more than 300 employees when he had none and attempted to conceal his lie by creating 34 fictitious personnel files and submitting them to the GOER, falsely representing the files were a sample of his employees.[7]

Commission schemes are applicable to employees whose compensation is not based on hours worked or a set yearly salary but rather on completing a task, meeting an established performance criterion, or achieving a certain sales volume. Perpetrators may falsify task completion, fabricate meeting a performance criterion, or inflate their sales amount and/or commission rate. As of this alert date, we have not identified commission schemes in Arizona governments that have caused public money losses.

Recommendations

Public officials should exercise their fiduciary responsibilities to protect public monies by establishing and enforcing sound payroll disbursement fraud deterrence and detection measures, such as:

- **Policies and procedures—**Create and implement written payroll policies and procedures that clearly communicate only documented and approved compensation practices are allowed and other practices, such as payments for unworked or unapproved overtime hours, are not permitted. Further, entities should regularly train employees on these policies and procedures and require employees to document their understanding in writing.
- **Separation of duties—**Separate responsibilities of preparing payroll, approving payroll, and distributing warrants, ideally among 3 different employees. If this is not possible due to limited staff size, adequate review procedures by management should be in place. Also, separate human resource and payroll responsibilities so that payroll personnel cannot add new employees or assign pay rates and ensure that employees cannot change their own information in payroll systems. An employee without payroll responsibilities should regularly reconcile payroll records to related disbursements such as insurance premiums, income tax withholdings, and tax-sheltered annuity contributions.
- **Independent verification of payroll—**Conduct periodic unannounced reviews of payroll records to ensure policies and procedures are followed, payments are made to actual employees, and employees are paid only authorized compensation, including those employees paid on commission. The verifier, ideally someone who does not have permissions to make changes in the payroll system, should review the payroll software's audit or change log for unauthorized payroll changes and be able to recognize employee names, confirm any commission plans or rates of pay, validate hours worked including overtime, and determine payroll deductions are appropriate.

[7] See Office of the Auditor General, *Arizona Governor's Office of Economic Recovery—Theft and Fraudulent Schemes*, October 2012.