The Legal Risks of Not Establishing Internal Controls over Payroll



The owners of a small bracelet business hired a personnel agency to find them an administrative assistant. The assistant the agency placed there defrauded the company of $263,000. The company later discovered that the personnel agency didn't do a background check on the assistant. Even though the contract didn't mention background checks, the attached fee schedule assured the company that the agency would provide the "highest caliber of professional screening, evaluating and reference checking of all candidates." The company sued the agency for breach of contract and negligence. The agency denied responsibility and blamed the fraud on the company's negligence. If the company had implemented better internal financial controls over the assistant, it wouldn't have wound up in this predicament, the agency contended. The court agreed, finding that the company's lack of supervision was partly to blame for its losses; so it cut the company's damage award by 50% [*Treaty Group Inc. (c.o.b. Leather Treaty) v. Drake International Inc.*, [2005] O.J. No. 5232, December 5, 2005, affirmed [2007] O.J. No. 2468, June 25, 207].

THE PROBLEM

Although doing background checks is a must for all positions, it's especially imperative for payroll and other sensitive financial positions. One of the nice things about using a personnel agency is that you can count on it to conduct a thorough background check. The knowledge that the employee has passed the agency's rigorous screening means that you can entrust the person to conduct payroll operations for your organization. Or at least that's what many companies assume. But, as the employer in Drake case found, out, that assumption can prove disastrously wrong.

THE EXPLANATION

Personnel agencies have expertise in background checking. But some personnel agencies overstate their expertise; others cut corners; and even top agencies can make mistakes. Many personnel agencies give warranties or accept legal responsibility for the integrity of the employees they place. Although that can help if the employee later commits fraud or malfeasance, relying on contractual guarantees from a placement agency isn't an effective way to manage risks. There may be disputes about the meaning of the language in the contract.

More importantly, as the *Drake* case plainly shows, even if the placement agency is

contractually liable for a placed employee's wrongdoing, companies may also be assigned a share of the blame for failing to exercise controls over the employee. Result: The company will be able to recover only pennies on the dollars it loses.

THE SOLUTION

Don't have blind faith in the integrity and competence of payroll staff because they come from personnel agencies. Establish effective controls over internal financial operations and the people who perform them—no matter where those people come from and how honest you think they are. What kinds of controls do you need? Take a lesson from the *Drake* case:

- Instead of requiring only one signature on a cheque, the owner should have signed all the cheques himself or at least required two signatures on each cheque which would have required the bookkeeper to explain each cheque to the owner.
- The company shouldn't have let the same person who prepared the cheques and paid the invoices also review cancelled cheques and bank reconciliations. A better solution would have been to have an outside bookkeeper prepare the financial statements and bank reconciliations if the owner couldn't do so himself.
- The company shouldn't have given the assistant signed blank cheques. Even if the signor will be away when payment is required, the signed cheque should always be made out to the payee so that only the amount is left blank. The company should also require that the resulting invoice verifying the amount is stapled to the accounting copy of the payment.
- The company should have provided more direct supervision over the assistant even if it had to use an outside bookkeeping or accounting firm to do so.