SIGNS OF FRAUD

By Neil H. Fishman

IN CONTEMPORARY BUSINESSES, THE HIGH COST of maintaining strict separation of duties and the integration of automated systems has led to a relaxation in the strict separation of duties doctrine.

The theft of goods and services by employees is a growing area of concern for companies of every size. Commonly, such activities are hidden through various fraudulent documents, including falsified accounting records. Rarely does analysis of accounting records alone lead to the discovery of frauds. Usually, discovery occurs because someone asks an innocent question for an unrelated purpose that starts unraveling the fabric of the fraud. Subsequent analysis of the records by a trained accountant can provide the details of the amount stolen, the methods used, and the extent of the cover up. The following five cases illustrate common elements of employee theft and fraud:

Case No. 1: A young couple purchased a custom home in an exclusive area and applied for membership in a country club with an entrance fee of $100,000. On the application, the wife indicated that she worked as a clerk for a major bank. The country club called her manager to verify employment. The manager recognized the country club and knew it had a high entrance fee. He wondered how the employee and her spouse could afford such luxury. On a hunch, he initiated an internal investigation, which uncovered an embezzlement of $1.8 million.

Case No. 2: A small manufacturing business was the victim of a $20,000 embezzlement when its owner was convinced by her bookkeeper to switch from a handwritten ledger to a computerized system that he alone could run. The owner trusted the bookkeeper, a loyal employee since she began the business. Over several years, he diverted company funds into his own account and destroyed computer records to cover it up.

Case No. 3: A clerk in a retail store needed money to buy clothes. Her roommate needed money to make car payments. The pressure she felt became so intense that an error in handling a routine refund transaction revealed a way she could get needed cash. She started to steal by writing refund slips for more expensive items than customers actually returned and taking the difference.

Case No. 4: A government employee used a government credit card for a personal purchase in an emergency. When the charge was paid without question, the employee charged another $4,500 of personal items.

Case No. 5: The company's accountant "borrowed" bearer bonds from the company's safe to use as collateral for a loan whose proceeds he invested in a short-term, high-profit venture. He planned to be in and out of the market, reap his gains, repay the loan, and return the securities before anyone looked for them.

In each of the cases above, employee theft cost a business a significant sum of money, lost time, legal and investigation fees, and an employee. The thieves were eventually caught, lost their jobs in all cases; some were prosecuted, and some repaid the sums that had been stolen. The question every business owner should ask is how to avoid such incidents.

Elements of Theft

Understanding the elements that precipitate employee theft is the starting point for an effective preventive program:

- There must be the motivation to steal
- There must be the opportunity
- The thief must believe there is a way to hide the theft to avoid detection.

The design of a business' internal control system can effectively address the opportunity and cover-up elements. However, identifying motivational issues is far more subjective and depends on personal knowledge of an employee's mental state. Internal control systems are predicated on the belief that, if concealment is impossible, rational employees will not steal even if they have the motivation and the opportunity for fear of discovery and dismissal from their job. Unfortunately, it is virtually impossible to design foolproof systems that eliminate the ability to conceal evidence of a theft by every employee. Consequently, businesses, especially small businesses in which a single employee may have several responsibilities that provide both the opportunity and the means to conceal theft, must be vigilant in addressing all three elements.

The traditional approach to internal control system design relies on separating the duties of individuals responsible for decision-making, asset custody, and accounting. A decision-maker authorizes transactions but neither has custody of assets nor accounts for their use. A custodian cannot authorize transactions or account for them, but is held responsible for the assets' safekeeping. The accountant neither authorizes transactions nor has custodial responsibilities, but does maintain a record of transactions and assets. For a theft of assets in this environment to go undetected would require collusion among the three parties.

However, in contemporary businesses, the high cost of maintaining strict separation of duties and the integration of automated computer accounting systems has led to a relaxation in the strict separation of duties doctrine. For many small businesses, it is unfeasible to have three different individuals for the sake of internal control. In these cases, employee motivations and opportunities should be carefully considered.

Motivation. Most people are honest and trustworthy—to a point—but will also resort to theft under some specific pressure. That point may differ from individual to individual, but very few people are incorruptible. In cases 1 and 3, employees were motivated to steal from their employers because they needed money to support a lifestyle, a very common reason. Other people might be motivated to steal because of medical or other emergencies in their families. Another common motivation for employee theft is

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the belief that the employer owes them more, usually because a friend in a similar position earns more or because the employee believes that management is taking too much.

The single most important factor that affects employee motivation is the tone at the top. Respect for internal control and adherence to the requirements of a reasonable system will be seen as an invitation to compliance by all. If employees observe top management taking advantages of the business for their personal benefit, they will see this as an invitation to do likewise.

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Opportunity. In cases 2, 3, 4, and 5, the employee had an opportunity to steal because of a convergence of at least two of the incompatible duties: authorization, custody, and accounting. In cases 3 and 4, typical of thefts by lower-level employees, a properly functioning accounting system should identify the theft, if management reviews the documentation and relates it properly to reality. On the other hand, no knowledgeable review of an accounting system would detect the thefts in cases 2 and 5, representative of those by higher-level employees. In case 2, the records do not exist, and, in case 5, if the controller is successful and replaces the bonds, there is no record-keeping effect. In order to deal with such situations effectively, the opportunities must be removed.

Concealment. In all cases, the thief believed that concealment of the theft would thwart detection. In case 5, the concealment involved the unauthorized use of an asset for personal advantage without any alteration of the record-keeping system. In case 2, destruction of electronic records concealed the theft. In cases 3 and 4, record falsification was the concealment method. In record falsification cases, detection is possible from analysis of the accounting records. However, in the other cases, detection depends on external information, as in case 1. In many situations, it is possible to find evidence only if the object of the search is known.

Effective Control Measures

Periodic rotation of job duties among employees can be an effective means of limiting the opportunity for and concealment of theft. Likewise, mandatory vacations provide the opportunity for another person to become involved in seeing whether an employee has been following policies and procedures. Management awareness of employees' motivations, opportunities, and ability to conceal acts of theft will also identify points of risk and guide the design and implementation of an appropriate control system. ❑

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