

The Hidden Personnel Cost - Employee Fraud

The annual cost of workplace fraud has been estimated at over \$400 billion by the Association of Certified Fraud Examiners. This association estimates that the average organization loses more than \$9 a day per employee to fraud and abuse.

Surprisingly, it's the average worker for a small- to mid-sized company who often has his or her fingers in the cookie jar. Fraud is a big problem for small business. Research data shows that the median loss is \$120,000 for organizations with less than 100 employees. Amazing as it may seem, this dollar figure was virtually identical to the loss experienced by companies with over 10,000 employees. Unlike a large corporation, however, the impact of a six-figure embezzlement on a small business can be devastating.

A recent case handled by the forensic professionals at MKS&H involved the trusted controller of a small, local company. He came to the company with a strong resumé and good references. The owner was pleased to have this mature CPA help him run the three-person accounting department and assist with the financial end of the business. This individual began work in January, and by April had forged the owner's signature on over \$35,000 in checks written to himself.

Clearly trust and credentials are not a substitute for good internal controls. Another case involved a kind, elderly bookkeeper for a small construction company. This employee handled the books, acted as receptionist when needed and was of great assistance around the office. The two owners had so much trust in her that they allowed her to control the check-signing machine. Big mistake. She wrote checks to herself, her family and phony vendors she created. She routinely inflated her paycheck by adding numbers to it after the owner signed it. Over a period of seven years she took in excess of \$500,000 and ruined the business.

Sadly, these two cases are not unique. Fraud experts agree that most employee fraud goes undetected and that losses will continue to grow, especially with the expanding use of computers.

Most small businesses start with family members or partners controlling the key positions. In these situations, an internal control system is not usually considered necessary. As the business grows and becomes more complex, outsiders are generally added to the mix. The day the first outsider is given a key to the office, owners need to think about how they could be robbed and then design ways of doing business that protect their investment in the company.

Fortunately, most frauds are relatively simple schemes, and a basic set of internal controls can be very effective. Some of the most common frauds to guard against include:

- Theft of cash receipts
- Under-the-table payments for sales or performance of services
- Recording false discounts
- Theft of checks received through the mail
- Tampering with checks to be issued
- Creating fictitious vendors
- Creating phony expense vouchers
- Altering billing records
- Theft of inventory
- Altering purchasing, receiving or shipment records
- Creating "ghost" employees

A functioning internal control system is critical to preventing these types of fraud. Every business with even one outside employee should consider these basic controls:

- As much as possible, segregate duties and responsibilities. Whenever one person has the authority over an entire transaction, the risk is high that fraud can occur.
- Rotate assignments. Many schemes require constant attention to the fraud. Rotation will disrupt the fraud.
- Obtain fidelity bonding. Insurance will help limit the loss and may function as a deterrent.
- Control new vendor additions. Phony vendors are one of the most common fraud schemes.
- Control changes to the payroll. The common use of outside payroll services makes it easy to create "ghost" employees.
- Look into signs of affluence among employees. There are numerous cases of employees flaunting unexplained newfound wealth.
- Consider a fraud hotline.

Putting these procedures in place can be very effective deterrents. As much as possible, segregate duties and responsibilities. Whenever one person has the authority over an entire transaction, the risk is high that fraud can occur. Fraud will probably never be eliminated in the workplace, and it is especially challenging for small organizations that must balance the cost of controls with the risk of embezzlement. The organization must seek a balance between trusting its employees too much and too little.

If you suspect fraud or discover fraudulent activity, don't directly confront the employee. Mishandling the situation could create liability for the company and ruin the opportunity to uncover accomplices and discover the full extent of the scheme.

11311 McCormick Road, Suite 100
Hunt Valley, MD 21031
410-296-6200

70 Thomas Johnson Drive, Suite 100
Frederick, MD 21702
301-662-2400

www.mksh.com