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# Embezzlement

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*The author discusses the major forms of embezzlement and suggests steps that companies can take to detect embezzlement and to lower their risks of suffering such losses.*

A purchasing agent for a major corporation set up a vendor file in his wife's maiden name, then approved more than $1 million in company payments to her for "consulting services." A clerk in the purchasing department, suspicious of the agent's recent purchase of a new boat and car, discovered the scheme and turned him in.

Embezzlement, part of the broader category of "occupational fraud," is no respecter of persons or organizations. Occupational fraud covers a wide range of dishonest behavior against organizations by employees at every level, and victim organizations are found in every industry.

In a 2010 study by the Association of Certified Fraud Examiners ("ACFE") that analyzed almost 2,000 occupational fraud cases across the globe — half of them in the United States — there was a median loss of $160,000 per incident, and 25 percent of the incidents had losses over $1 million. Occupational fraud costs an organization about five percent of its annual revenue. The median duration — from when the fraud begins to when it is discovered — is about 18 months. Given the money and time involved, it is imperative to understand what occupational fraud is, how it

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occurs, how to detect it, and how to prevent it.

Occupational fraud can be divided into three main categories: corruption, fraudulent financial statements, and misappropriation of assets. Corruption includes conflicts of interest, bribery, illegal gifts, extortion, etc., and constitutes about one-third of occupational fraud cases, with a median loss of $250,000.

Financial statement fraud involves the intentional misstatement or omission of important information on an organization's financial reports. Although only about five percent of cases come from fraudulent financial statements, they cause median losses of over $4 million and account for 68 percent of the total reported losses. They also have the longest median duration — 27 months.

Asset misappropriation is the most common, though diverse, form of occupational fraud — almost 90 percent of the cases. However, it is the least costly, with a median loss of $135,000, and is the easiest to detect.

Asset misappropriation takes many forms, such as stealing property and cash, creating ghost employees or vendors, falsifying payroll records, altering checks, submitting fictitious expenses, etc. While the list is almost infinite, it can be divided into three major areas:

| **Type of Misappropriation** | **Frequency** | **Median Loss** |
|---|---|---|
| Fraudulent disbursements of cash | 73 percent | $387,000 |
| Theft of cash receipts or cash-on-hand | 37 percent | $183,000 |
| Theft of property or information | 16 percent | $90,000 |

(Percentages exceed 100 percent because cases had schemes from more than one category.)

The industries most commonly victimized are banking/financial services, manufacturing, and government/public administration.

## WHO ARE THE PERPETRATORS?

More than 80 percent of occupational fraud cases, and 95 percent of their resulting losses, come from six departments: accounting, operations, executive/upper management, sales, customer service, and purchasing, with 40 percent of cases coming from the first two departments, and 27 percent from the next two.

Two-thirds of perpetrators are male and cause twice as many losses as females. These trends are consistent even when controlling for differences in position. There is a strong relationship between a perpetrator's position of authority and the losses caused by fraud, with the greatest losses coming from those in upper management.

More than half of all cases are committed by people between the ages of 31 and 45. Median losses rise with the age of the perpetrator, and the greatest losses overwhelmingly come from people over 60.

The vast majority of perpetrators — 86 percent — were first-time offenders.

## WHY OCCUPATIONAL FRAUD OCCURS

Occupational fraud occurs when the fraud "triangle" is present — motive, opportunity, and rationalization, and effective fraud prevention controls are *not* in place — hotlines, management reviews, separation of duties, etc.

Another extremely importance control is the "tone" set by upper management. This is especially true in the $1 million+ fraud cases. Poor management tone includes unethical attitudes, overriding fraud safeguards, and setting unrealistic goals while excessively tying compensation to sales performance, among other things.

In addition, employees and executives who feel unfairly treated sometimes believe they can get "justice" through occupational fraud and abuse. Therefore, workplace conditions are a major component in predicting and preventing fraud.

## HOW OCCUPATIONAL FRAUD IS DETECTED

While there are many means by which fraud can be detected, tips are by far the most common and most effective method, catching nearly three times as many frauds as any other form of detection. Although employees are the most frequent source of fraud tips, customers, vendors, and competitors also provide fraud tips. Fraud reporting programs should be publicized not only to employees, but also to external entities, e.g., vendors.

Government agencies had the highest rate of detection by tips and by frauds caught through external audit. Publicly held companies tended to detect more frauds by management review and internal audit than their counterparts. Privately owned companies tended to have the fewest frauds detected by tips and the most frauds caught by accident.

| **Method of Detection** | **Frequency — U.S.** |
|---|---|
| Tips | 37.8 percent |
| Management review | 17.1 percent |
| Internal audit | 13.7 percent |
| By accident | 9.3 percent |
| Account reconciliation | 6.2 percent |
| Document examination | 6.2 percent |
| External audit | 4.2 percent |
| Notified by police | 1.9 percent |
| Surveillance | 1.7 percent |
| IT controls | 1.2 percent |
| Confession | .08 percent |

Management review and internal audits are the next most common forms of detection. There are also many “behavioral red flags” that fraudsters exhibit which can alert management to the fact that the company is being swindled. These include living beyond ones’ means, having financial difficulties, unwillingness to share duties or take vacations, addiction problems, and irritability or defensiveness.

## DETECTING FRAUD IN SMALL BUSINESSES

Small businesses suffer unusually high occupational fraud losses, with the median loss being $155,000. Small businesses are particularly good targets for occupational fraud because they tend to have far fewer anti-fraud controls, such as a separation of duties, than larger organizations.

While small companies may not have certain controls because of cost or lack of resources, even less expensive controls are often missing, such as management review of accounts, formal codes of conduct, and anti-fraud policies.

Check tampering schemes are much more common at small organizations, as are skimming and payroll frauds. The check writing, cash collection (control over incoming mail) and payroll functions are more likely to be performed by a single individual with little management oversight.

Small businesses catch a much lower proportion of schemes through tips or internal audits than larger organizations. Only 15 percent of small businesses had a hotline in place, compared to 64 percent of larger organizations. A relatively large percentage of frauds are caught by accident at small companies — nearly twice as many as at larger organizations.

Managers and owners of small businesses should focus their control investments on the most cost-effective mechanisms, such as separation of duties, hotlines and setting an ethical tone for their employees

## HOW TO PREVENT OCCUPATIONAL FRAUD

Prevention is the best “cure” for occupational fraud, and employee education is the foundation of prevention. Employees are an organization’s top fraud detection method. They must be trained in what constitutes fraud, how it hurts everyone in the company, and how to report any questionable activity.

Tips given via hotlines are the number one means by which fraud is detected. The median loss for frauds at companies with hotlines was 59 percent smaller than those without a hotline. Organizations should implement hotlines to receive tips from both internal and external sources. Tip hotlines should allow anonymity and confidentiality. In addition, employees should be trained to recognize the common behavioral signs that a fraud is occurring and be encouraged not to ignore these red flags.

Employee support programs are also associated with median loss reductions of more than 50 percent.

Unannounced audits are an effective tool in the fight against fraud, yet less than 30 percent of victim organizations in the study conducted surprise audits. Surprise audits' most important benefit is psychological: To cause potential perpetrators to believe that they will be caught and prosecuted, and thus has a strong deterrent effect on potential fraudsters.

Internal controls alone are insufficient to fully prevent occupational fraud. Though it is important for organizations to have strategic and effective anti-fraud controls in place, internal controls will not prevent all fraud from occurring, nor will they detect most fraud once it begins. Vigilance is essential.

External audits are the control mechanism most widely used by organizations, but they are relatively ineffective in detecting fraud and limiting losses. Audits are clearly important and can have a strong preventative effect on fraudulent behavior, but they should not be relied upon exclusively for fraud prevention.

Also, although a company should do background checks on potential employees, these checks do little to prevent occupational fraud, since the vast majority of perpetrators — 86 percent — have never been charged with or convicted of a prior offense.

Interestingly, regular financial statement audits — the most commonly implemented control — had one of the smallest results in reducing fraud. There are certain schemes that are more prevalent in one industry than in another. Organizations need to consider the specific fraud risks they face when deciding which controls to implement for fraud prevention and detection.[1]

**Effectiveness of Controls**

| Control | Percent Losses | Percent Duration |
|---|---|---|
| Hotline | 59 percent | 35 percent |
| Employee Support Programs | 59 percent | 17 percent |
| Surprise Audits | 52 percent | 37 percent |
| Fraud Training for Managers/Execs | 50 percent | 28 percent |
| Fraud Training for Employees | 50 percent | 28 percent |
| Job Rotation/Mandatory Vacation | 47 percent | 33 percent |
| Code of Conduct | 47 percent | 38 percent |
| Anti-Fraud Policy | 40 percent | 28 percent |
| Management Review | 40 percent | 50 percent |
| External Audit | 35 percent | 38 percent |
| Internal Audit/FE Department | 31 percent | 42 percent |
| Independent Audit Committee | 30 percent | 25 percent |
| Management Certification of F/S | 25 percent | 35 percent |
| External Audit of F/S | 25 percent | 33 percent |
| Rewards for Whistleblowers | 23 percent | 33 percent |

Lastly, the Internal Revenue Service requires that embezzlers include embezzled funds as income in their yearly income taxes. Upon returning the funds or paying restitution, the embezzler becomes eligible for a tax deduction. Failure to report embezzled funds as gross income can result in the bringing of tax evasion charges. Dealing with the IRS for the rest of their lives should be a well publicized factor to deter would-be perpetrators from defrauding their organizations.

**Early Warning Signs of Cash Misappropriation**

- Decreasing ratio of cash to credit card sales.
- Increasing accounts receivable compared with cash.
- Delayed posting of accounts receivable payments.
- Credits against individual accounts receivable.
- Unexplained cash discrepancies.
- Altered or forged deposit slips.
- Customer billing and payment complaints.
- Increasing "soft" expenses, such as consulting.
- Employee home address matches a vendor's address.
- Vendor address is a post office box or mail drop.
- Excessive voided, missing, or destroyed checks.

**When "Yes" is a Red Flag**

These are some of the characteristics that may influence employees to commit Financial Statement frauds and misappropriate asset.

**Financial Statement Frauds**

- Is management compensation tied closely to company value?
- Is management dominated by a single person or a small group?
- Does management display a significant disregard for regulations or controls?
- Has management restricted the auditor's access to documents or personnel?
- Has management set unrealistic financial goals?
- Does management have any past history of illegal conduct?

**Asset Misappropriations**

- Is an employee obviously dissatisfied?
- Does that employee have a past history of dishonesty or illegal conduct?
- Does that employee have known financial pressures, such as excessive debt, bad credit or tax liens?
- Has that employee's lifestyle or behavior changed significantly?

**Occupational Fraud Prevention Checklist**

The most cost-effective way to limit fraud losses is to prevent fraud from occurring. This checklist will help organizations test the effectiveness of their fraud prevention program.

1. Is ongoing anti-fraud training provided to all employees of the organization?
2. Is an effective fraud reporting mechanism in place?
3. Is the management climate/tone at the top one of honesty and integrity?
4. Are fraud risk assessments performed to proactively identify and mitigate the company's vulnerabilities to internal and external fraud?
5. Are strong anti-fraud controls in place and operating effectively?
6. Does the internal audit department have adequate resources and authority to operate effectively and without undue influence from senior management?
7. Does the hiring policy include thorough fraud prevention controls?
8. Are employee support programs in place to assist employees struggling with addictions, mental/emotional health, family or financial problems?
9. Is an open-door policy in place that allows employees to speak freely about pressures, providing management the opportunity to alleviate such pressures before they become acute?
10. Are anonymous surveys conducted to assess employee morale?

*See* 2010 ACFE "Report To The Nations" for complete lists.

## RESOURCES

2010 Association of Certified Fraud Examiners “Report To The Nations”

“Effective Solutions for Combating Employee Theft — Implementing and Managing a Fraud Hotline” by Donald L. Mullinax, ACFE 2004

http://topics.law.cornell.edu/wex/embezzlement

www.lawyershop.com

www.onlinelawyersource.com

www.diversifiedriskmanagement.com

## NOTE

[1] Highly recommend reading is the 2010 ACFE “Report to the Nations,” and “Effective Solutions for Combating Employee Theft — Implementing and Managing a Fraud Hotline” by Donald L. Mullinax, ACFE 2004.