FAIRFIELD COUNTY BUSINESS JOURNAL
September 29, 2008

It Can Happen to You: Protecting Your Company from Employee Fraud

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Marilyn had worked as Sam's store manager for eight years, responsible for approving all customer returns and refunds, reconciling the daily sales drawers, and preparing the deposits. She was also charged with coordinating remodeling projects, determining pricing and payment terms, and collecting customer payments.

One day a store employee completed a cash sale to a customer just before closing time. There were no further sales that day. The next morning the employee noticed the previous day's drawer reconciliation completed by Marilyn. There was no cash included for the day's activity, which puzzled the employee, since the last sale recorded was paid in cash.

Without alerting Marilyn, Sam began reviewing daily activity and trends with the help of Alice, the company's business manager. Before long a pattern was identified within the credit card sales activity.

The store's returns and refunds policy required customers and Marilyn to complete and sing a form. Alice found processed returns and refunds but none of the required forms could be located.

Upon further analysis, the unexplained refunds — oddly always processed to one of three credit card numbers — occurred on days with cash sales (most of the store's sales were via customer credit or debit cards). The refunded cards ended up belonging to Marilyn, and she had posted more than $25,000 to them. Added to this was the $25,000 in cash sales Marilyn stole and poorly concealed as customer refunds.

Fortunately for Sam, he identified fraudulent activity taking place in his company. Unfortunately, his discovery came $50,000 too late.

The impact of employee fraud and embezzlement is greatest to owners of small, closely held businesses. In some instances the theft can lead directly to a business' demise, as was almost the case for Sam.

There is no industry or size or type of organization immune from this threat, and when combined with outsider frauds, such as counterfeit checks and vendor kickbacks, the losses to a business attributable to fraud and abuse can exceed 6 percent of annual revenues.

Virtually every business collects payments, processes credit cards, writes checks, and pays employees. These four areas comprise a vast source of opportunities for employees to divert funds away from their employers. While it may not be feasible for a business to eliminate risk in any one of these areas, employers can institute several critical controls to minimize their risk. Every business owner should consider a three-pronged approach to address the potential for employee theft and embezzlement.

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First, employers should apply preventive controls to every financial process in the company. Requiring approvals, ensuring regular reviews of cash receipts and bank deposits, counting cash drawers mid-shift, requiring second signatures on checks, and performing unannounced reconciliations are steps that should be taken regularly to deter fraud.

Owners need to know, however, that even with the best of prevention controls, thefts can still occur. Sam had controls within his business. Unfortunately, all too often owners like Sam become complacent and begin to simply trust that their employees are ethical.

Second, every organization needs to implement detection measures to identify fraudulent behavior as early as possible. Steps could include independent receipt of bank statements, independent reconciliations of deposit activity, random reviews for compliance, spot audits, rotation of employee duties, and comparing employee information to vendor information for address matches.

The goal is to detect the schemes that weren't prevented. Had Sam required a separate review of the daily activity, including cash sales, returns, and refunds, Marilyn's theft likely would have still occurred but may have been discovered sooner, limiting Sam's loss.

Still, even with expertly designed preventive controls and detection measures in place, employee theft and embezzlement will remain a risk. Dishonest people seem to have an unlimited capacity for creativity when it comes to "beating the system."

The third prong requires every employer to maintain employee dishonesty insurance coverage. Often when a substantial amount of money is stolen and identified only late in the scheme, the funds are unrecoverable. Employee dishonesty insurance, however, will typically enable companies to recover funds stolen by an employee.

Every business owner should estimate the minimum amount of insurance coverage needed to ensure the financial health of the company, keeping in mind that $100,000 is usually the recommended minimum for any size entity.

Business owners need to talk to their insurance agent about this as soon as possible, since coverage typically covers losses only after the date of insurance. Unfortunately for Sam, his agent never talked with him about coverage. Consequently, his commercial and general liability policies did not include any provisions for employee crime or theft. A few hundred dollars in annual premiums could have afforded Sam a full recovery of Marilyn's theft, less a minimal deductible amount.

The lesson for employers, when it comes to employee fraud and embezzlement is to remain vigilant. To quote former President Ronald Reagan, "trust with verification" should be the policy.

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