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EMPLOYEE DISHONESTY AND THE SMALL BUSINESS: THE COSTS OF OCCUPATIONAL FRAUD AND HOW TO PREVENT IT

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The Heavy Costs of Occupational Fraud

Business organizations in the United States lose approximately 5% of their annual revenue to fraud.[1] Applied to the United States' expected 2006 Gross Domestic Product, this translates to approximately $652 billion in fraud losses in a single year. The Association of Certified Fraud Examiners (ACFE) study reported that the median loss caused by occupational fraud was $159,000. Organizations with fewer than 100 employees suffer disproportionate losses from occupational fraud; the median loss such organizations suffer from a single fraudulent scheme is $190,000. This is due not only to the frequent lack of internal controls and other anti-fraud measures, but the nature of the small business structure and concentrated authority typically associated with small businesses.

Small businesses generally can do a much better job in actively detecting fraud. Less than 10% of small businesses surveyed had an anonymous fraud reporting system and less than 20% had an internal audit department or conducted fraud training for their employees and managers. In fact, more small business frauds are detected by accident than by any other means.

Typical Occupational Fraud Schemes

In order to help small businesses identify employee dishonesty and prevent loss caused by occupational fraud, the following describes examples of typical employee theft or other fraudulent schemes of which employers and managers should be aware.

- *Skimming* occurs when cash is stolen from a business before it is entered into the books and records of an organization. An example would be an employee accepting payment from a customer without recording the transaction.
- *Larceny* occurs when cash is stolen after it has been entered in the company books and records. For example, an employee steals checks or cash, after receipt, but before they can be deposited in the bank.
- *Billing* or *expense reimbursement* schemes often involve a business issuing payment on fraudulent invoices submitted by a person within the organization. An employee may submit an invoice for goods or services that were not provided; inflated invoices; or invoices for personal purchases.

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[1] Unless otherwise indicated, the statistics reported in this article can be found in the Report to the Nation on Occupational Fraud and Abuse, 2006 ASSOCIATION OF CERTIFIED FRAUD EXAMINERS. This study, conducted by the Association of Certified Fraud Examiners (the "ACFE study") was based on data compiled from 1,134 cases of occupational fraud investigated between January 2004 and January 2006.

- *Check tampering* schemes involve stealing an employer's funds by forging or altering a check on one of the organization's bank accounts, or stealing a check the organization has legitimately issued to another payee. Check tampering is the most common fraudulent scheme affecting small businesses, representing nearly 30% of the cases examined in the ACFE study.
- *Payroll* schemes involve a person causing his or her employer to issue an improper payment by making a false claim for compensation. Examples include claiming overtime for unworked hours and adding "ghost" employees to the payroll.

Anti-Fraud Strategies and Controls

The following is a list of activities and strategies that can help prevent and/or limit loss caused by occupational fraud with particular emphasis on fraud-related risks facing small businesses.

- *External audits* can be an effective anti-fraud measure for small businesses. External audits are the most common anti-fraud measure utilized by small businesses and account for nearly half of the cases of fraud detection.
- *Internal audits* or controls or even internal fraud examination departments are highly recommended for small businesses. The ACFE study found that only 19.2% of small businesses had internal audit departments.
- *Segregation of duties* is a type of internal control that can prevent many instances of fraud by limiting the opportunities for dishonest employees to engage in check tampering or billing schemes. If possible, the manager or officer of the organization who will review, authorize and sign checks on behalf of the organization should not be the same person requesting the payment. Similarly, the person who is responsible for receiving and recording payments to the company should not be the same person with the authority to assign payments to customer accounts and make write-offs of delinquent or uncollectible accounts.
- *Fraud reporting* or *hotline programs* can be a significant deterrent and prevention measure against fraudulent activities. In fact, "tips" account for the second most frequent detection of fraudulent activity in small businesses, second only to accidental discovery.
- *Fraud awareness* and *ethics training* should be provided to employees and managers of a small business. An organization will reduce the fraud-related risk by alerting managers to the types of fraudulent schemes utilized by dishonest employees and informing employees of their duties to report questionable activity.

This article is designed to introduce the myriad of issues a small business faces in connection with occupational fraud and employee dishonesty. It is not intended to identify all the risks associated with employee fraud or every type of fraud risk that businesses in today's complex financial environment face. Hopefully, this article provides a basis for thoughtful discussion and reflection on the fraud risks associated with owning a small business and some loss prevention strategies that small business owners should consider.