Small Business FRAUD PREVENTION Manual

ACFE®

Association of Certified Fraud Examiners

PART 1: INTERNAL FRAUD THREATS

I. INTRODUCTION TO EMPLOYEE FRAUD

The Shocking Cost of Employee Theft and Fraud

Occupational fraud is the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the organization's resources or assets. Simply stated, occupational fraud and abuse occurs when an employee, manager, or executive commits fraud against their employer. Occupational fraud and abuse is roughly a synonym for terms like *employee fraud* or *embezzlement*, although technically, the term *occupational fraud and abuse* is broader and better reflects the full range of employee misconduct through which organizations lose money.

The threat of occupational fraud looms over every business or public agency, regardless of its size, stature, or function. It is safe to say that organizations that have employees will eventually become victims of occupational fraud. These are not crimes that only happen to the company down the street; they occur in every organization, and employees at every level commit them—from top executives down to entry-level clerks. Research indicates that levels of occupational fraud and abuse are staggeringly high, both in their cost and in their rate of occurrence. For example, according to the *2014–2015 Global Retail Theft Barometer*, 45 percent of retail shrinkage in the United States was due to employee theft.

Of the 3,500 U.S. employees polled by KPMG Forensic for its *Integrity Survey 2013*, 73 percent reported that they personally observed or have had firsthand knowledge of wrongdoing within their organization during the previous 12 months. Nearly half of the employees reported that what they observed was serious misconduct that could cause "a significant loss of public trust if discovered." According to the survey, the misconduct is the result of pressures, incentives, inadequate resources, and job uncertainty.

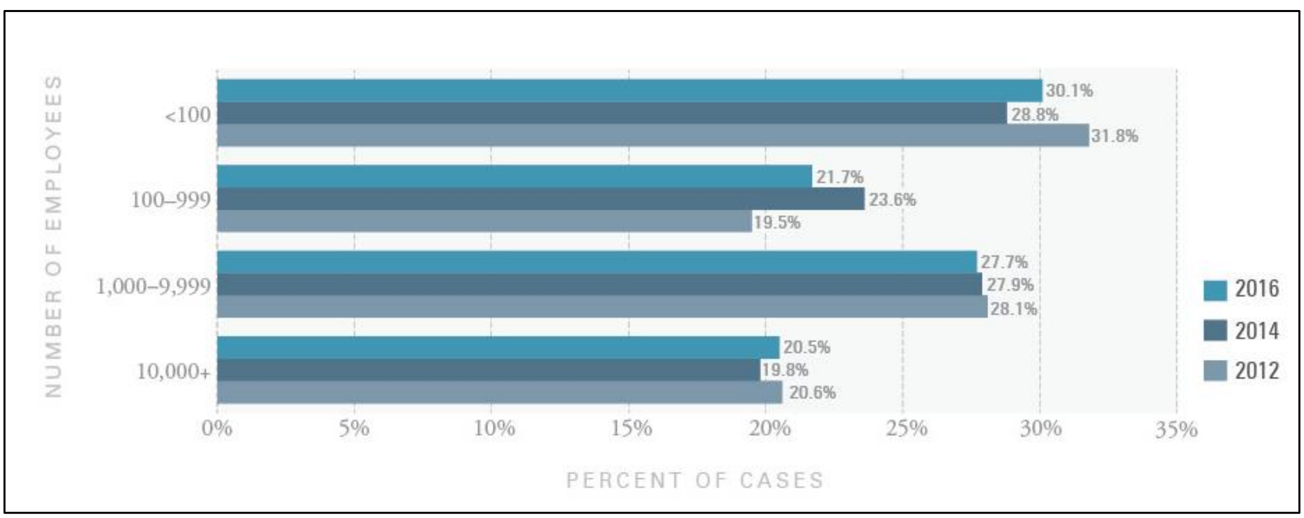
In 2016, the Association of Certified Fraud Examiners published its *Report to the Nations on Occupational Fraud and Abuse*, which was based on 2,410 cases of occupational fraud reported by the Certified Fraud Examiners (CFEs) throughout the world who investigated them. Those CFEs estimated that the typical organization loses 5 percent of its annual revenue to fraud. Applied to the estimated 2015 Gross World Product, this figure translates to a potential total fraud loss of up to $3.7 trillion worldwide.

Unfortunately, any estimate of the total cost that fraud imposes on worldwide economy is just that—an estimate. The 5 percent figure reflected by the report is simply the collective opinions of those who work in the anti-fraud field. The figure provides a best-guess point of reference based on the reported cases. Finding the actual cost might not be possible by any method. Many organizations are reluctant to report fraud when it occurs for fear that it will make them look vulnerable to consumers or that it will hurt their stock price. Some feel embarrassment at having been victimized and prefer closure to the ongoing process of discovery that comes with an investigation and prosecution. Even those who do report fraud cases frequently are unable to determine the true cost sustained by the crime. And, of course, there are the frauds that are not caught, which go on day after day, silently draining organizational resources. All these factors make it virtually impossible to determine how big a factor fraud is in the business world. But whatever the actual costs, it is clear that they are high, and organizations are unwittingly paying them already as a part of their total operating expenses.

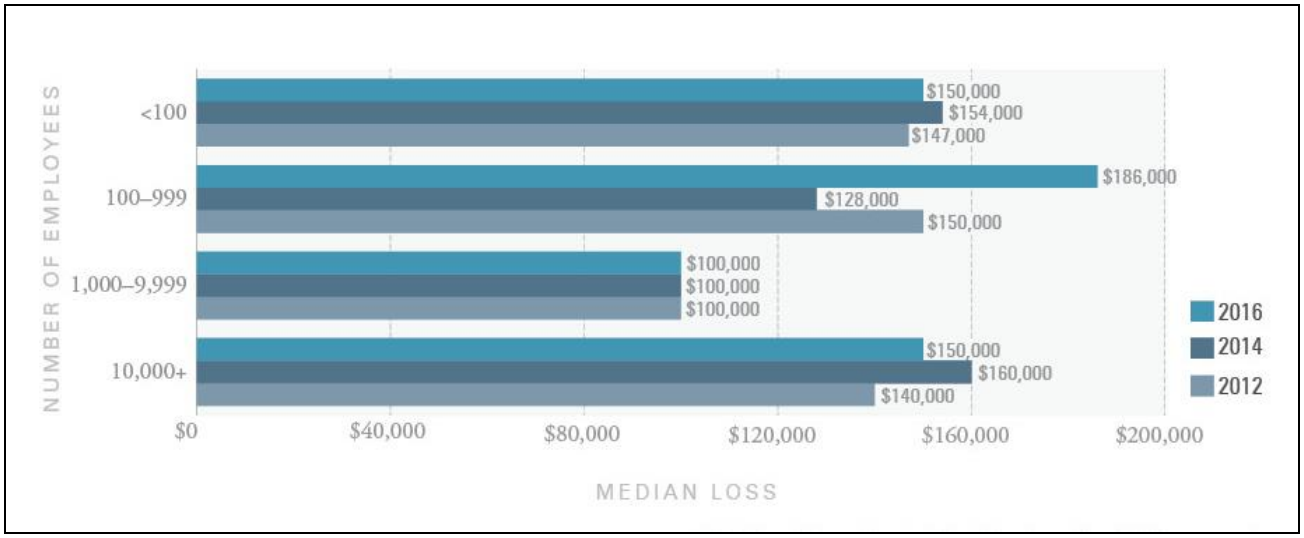
The Cost of Fraud to Small Businesses

The purpose of the 2016 *Report to the Nations* was, in part, to help measure the effects fraud has on businesses of various sizes. The fraud schemes studied were classified according to the victim companies' sizes (based on number of employees). The median cost of occupational fraud schemes was then determined based on the size of the victim organization. Small businesses—defined as those with less than 100 employees—suffered a greater percentage of frauds (30.1 percent), with a median loss of $150,000. These findings accentuate the unique problems in combating fraud frequently faced by small organizations—primarily the limited amount of fiscal and human resources available for anti-fraud efforts.

Size of Victim Organization—Frequency



Size of Victim Organization—Median Loss



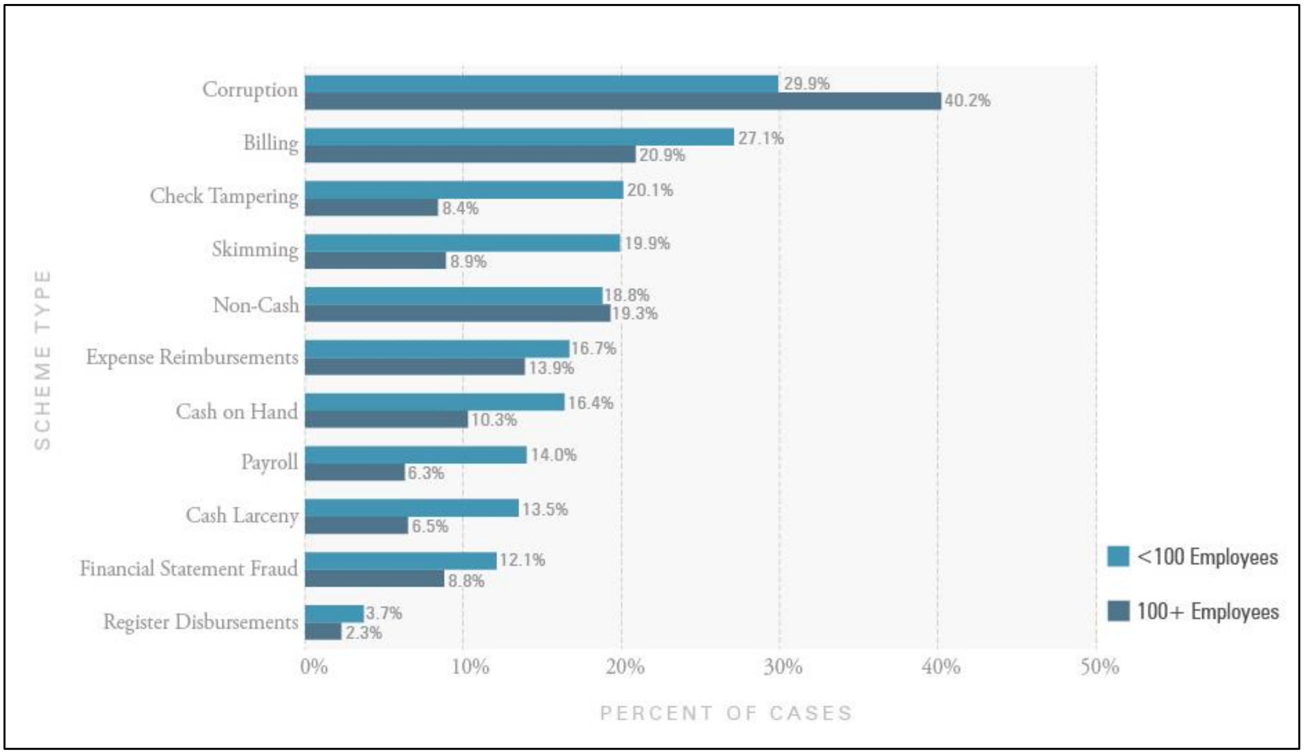
There appears to be two key factors that contribute to the large losses suffered by small companies. First, organizations with few employees often lack basic accounting controls. Many small businesses have a one-person accounting department—a single employee writes checks, reconciles the accounts, and posts the books. Whenever one individual controls every aspect of a company's finances, occupational fraud is easy to commit and conceal.

The second reason losses are so high in small organizations is that there tends to be a greater degree of trust among coworkers in small businesses. In an atmosphere where employees and management know each other on a personal basis, they tend to be less alert to the possibility of fraud.

Methods of Fraud in Small Businesses

Because of persistent evidence suggesting that fraud operates differently in small businesses than in larger organizations, the ACFE feels it is important to identify the most common schemes in small organizations. This can provide some guidance to small business owners regarding where to focus their anti-fraud efforts. To better understand the fraud issues faced by small businesses, the ACFE measured the frequency with which different fraud schemes occurred in these organizations. According to the following graph, corruption schemes were the most common type of fraud found in both large and small businesses. Check tampering schemes occurred in 20.1 percent of small business cases, but in only 8.4 percent of cases involving larger organizations. In addition, payroll and cash larceny occurred more than twice as often in small businesses.

Scheme Type by Size of Victim Organization



Why Employees Commit Fraud

Donald R. Cressey and the Fraud Triangle

When asked why employees commit fraud, most people would say it is because the perpetrators are "greedy" or "con artists." These terms imply that the offenders possess some defect of character that separates them from normal law-abiding citizens. By using these terms, people are able to view occupational fraud as an aberration—something far outside the norm—and as misdeeds committed by "bad" people. To extend the implication, as long as employers hire "good" people, the organization would be safe from falling victim to an occupational fraud scheme.

The truth, however, is that even "good" people commit occupational fraud. Yes, fraud constitutes aberrational conduct and necessarily involves both greed and deception. There are even some predatory employees who move from job to job with the sole intent of robbing whoever is unlucky enough to hire them. But most fraudsters are not career criminals. Most embezzlers do not take their jobs with the intention of stealing from their companies. The employee who steals from their company is typically an otherwise law-abiding citizen who, for a variety of reasons, crosses the line into illegal conduct. In fact, when fraud occurs in a small business, it is usually committed by a long-term, trusted employee. If a company is victimized by employee fraud, new employees who keep to themselves or those who seem a little shady probably won't be the ones to commit it. Chances are that the one who commits fraud will be the highly trusted employee, the hardest-working person in the company, the one who's been with the organization for ten years and knows other employees on a personal level. After small businesses become victims of an employee fraud scheme, the most commonly repeated sentiment is "I never would have thought it would be him." The biggest hurdle for most people to get over in terms of understanding occupational fraud is to realize that anyone can commit fraud.

Once organizational leaders understand that fraud can be committed by anyone, the obvious question is: Why do they do it? What causes certain employees to commit fraud? When trying to understand what motivates this form of criminal behavior, employers must first understand that there is no single factor that causes employees to commit fraud. Instead, there is a complex set of motivators that, when combined in the right environment, produce the impetus for an employee to begin committing fraud.

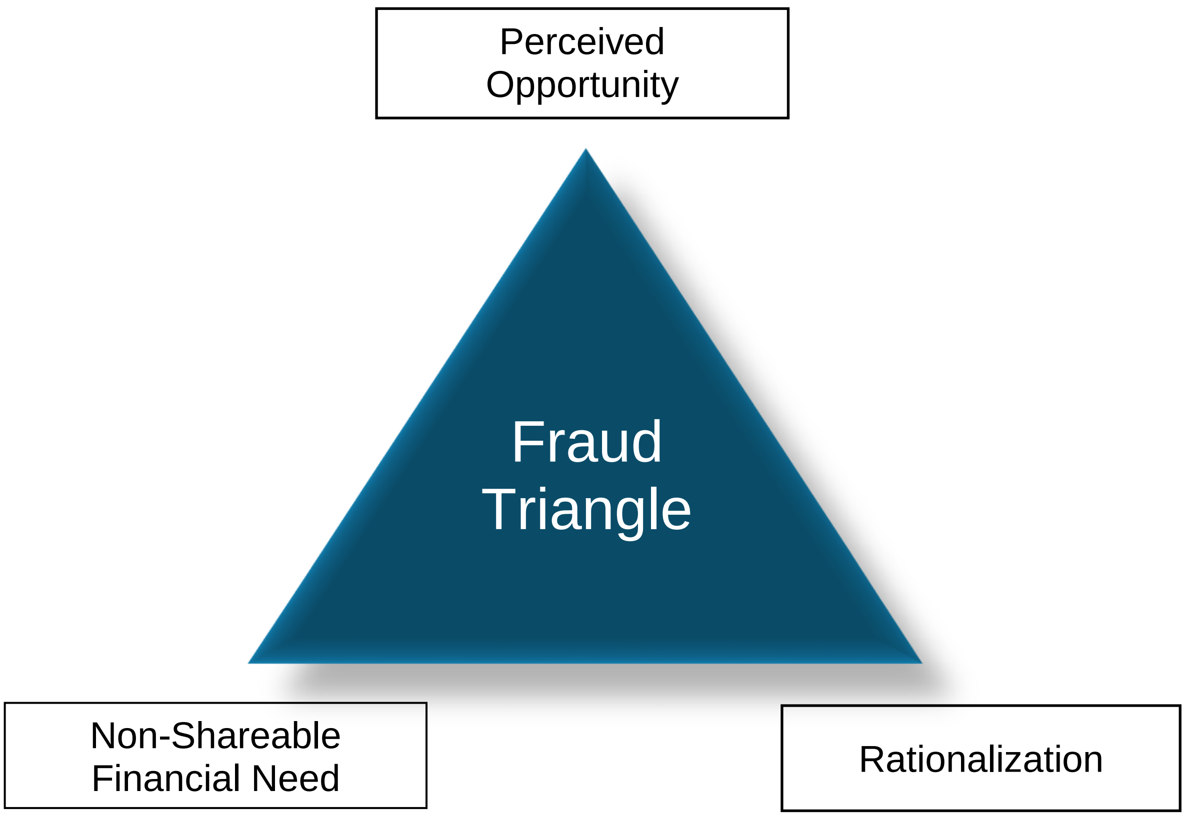
The most widely accepted theory for explaining why people embezzle was postulated by Dr. Donald R. Cressey (1919–1987). Cressey was intrigued by embezzlers, whom he called "trust violators." In 1953, while working on his doctorate at Indiana University, Cressey decided to focus his dissertation on the factors that lead people to embezzle. He was especially interested in the circumstances that prompted otherwise honest people to be overcome by temptation. For that reason, he excluded from his research those employees who took their jobs for the purpose of stealing—a relatively minor number of offenders at that time.

To serve as a basis for his work, Cressey conducted extensive interviews with about 200 inmates at Midwest prisons who had been incarcerated for embezzlement. Upon completion of his interviews, he developed what still remains the classic model for the occupational offender. His research was published in *Other People's Money: A Study in the Social Psychology of Embezzlement*.

Cressey's final hypothesis was:

> *Trusted persons become trust violators when they conceive of themselves as having a financial problem which is non-shareable, are aware this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property.*

Over the years, the hypothesis has become better known as the *Fraud Triangle*. According to the Fraud Triangle theory, there are three factors (each represented by a leg of the triangle) that, when combined, lead people to commit occupational fraud. One leg represents a *perceived non-shareable financial need*. The second leg represents a *perceived opportunity* to secretly resolve the financial need. The third leg represents the perpetrator's ability to *rationalize* the illegal conduct, or justify crime in their mind. One of the most fundamental observations of the Cressey study was that it took all three elements—perceived non-shareable financial need, perceived opportunity, and the ability to rationalize—for the trust violation (fraud) to occur.



Non-Shareable Financial Need

The role of the non-shareable financial problem is crucial. An otherwise honest employee usually only starts committing fraud when faced with some great financial pressure. The extreme need for money leads the person to engage in illegal acts—something the person probably would not do under normal circumstances. In his study, Cressey asked his subjects why they embezzled in one instance but refrained from doing the same thing in previous jobs or positions of trust when they had the chance. Their responses usually fell into one of the following categories: (a) "There was no need for it like there was this time." (b) "The idea never entered my head." (c) "I thought it was dishonest then, but this time it did not seem dishonest at first."

Keep in mind that the first leg of the triangle is not simply financial pressure. Everyone has financial pressure. The common element in the subjects Cressey studied was a *perceived non-shareable* financial pressure. Cressey wrote, "In all cases of trust violation encountered, the violator considered that a financial problem which confronted him could not be shared with persons who, from a more objective point of view, probably could have aided in the solution of the problem." In general, non-shareable financial problems are those that carry some sort of shame or stigma in the subject's mind. As a result, the subject feels unable to discuss the problem or seek help from others.

According to Cressey, that which is considered *non-shareable* is wholly in the eyes of the potential occupational offender. One person might lose $1,000 gambling at the racetrack but not consider this to be a non-shareable problem. Another person who loses the same $1,000 might feel a sense of shame attached to the loss and, therefore, feel the need to keep their loss a secret. Although both individuals experienced the same loss in terms of dollars, only the second person experienced a perceived non-shareable financial problem. It is the second person who is more likely to resort to secret, illegal means to rectify their problem.

Cressey divided non-shareable problems into six basic subtypes:

- *Violation of ascribed obligations*. The subject faces the prospect of being unable to pay their debts.
- *Problems resulting from personal failure*. The subject experiences problems, such as drug addiction, that result from poor personal judgment.
- *Business reversals*. The subject faces the prospect of a failing business.
- *Physical isolation*. The subject is isolated from people who could help them with their problem.
- *Status gaining*. The subject seeks to maintain a certain status level but does not have the financial means to do so.
- *Employer-employee relations*. The subject feels mistreated by their employer and needs to "get even."

Perceived Opportunity

Having a perceived non-shareable financial need is only one element of the Fraud Triangle. In order for an employee to take the next step toward committing fraud, they must believe they can to resolve their financial situation in secret. In other words, they must *perceive* that there is an *opportunity* to fix the problem without being caught. Cressey wrote:

> *Although the clear conception of a financial problem as non-shareable does not invariably result in trust violation, it does establish in trusted persons a desire for a specific kind of solution to their problems. The results desired in the cases encountered were uniform: the solution or partial solution of the problem by the*

> *use of funds which can be obtained in an independent, relatively secret, safe, and sure method in keeping with the 'rationalizations' available to the person at the time.*

The *perceived opportunity* leg of the Fraud Triangle is very important because it goes right to the heart of what employers do to prevent fraud. Generally, employees only commit fraud when they perceive that they can commit the crime in such a way that management will not realize that a fraud occurred. After all, if the fraud is discovered, the employee will face punishment, humiliation, and the loss of their job. Unlike the typical street criminal, the employee who commits fraud is not in a position to steal money and flee the scene. On the contrary, the employee-fraudster has to keep coming back to the scene of the crime every day.

If an employee knows, for instance, that they are the only person who writes checks, posts entries, and reconciles the checking account, then they might perceive that there is an opportunity to solve their financial problem by writing a check to themself or a creditor. If no one ever looks at the checkbook, the fraud will never be discovered. The employee sees an opportunity to solve their personal crisis without getting caught. However, if the employee knows that someone always reviews the monthly bank statement or that authorized check signers will question any suspicious checks, then they perceive that if they try to write a fraudulent check, the crime will be detected.

This illustrates the key to preventing fraud: *perception of detection*. Employees are less likely to commit fraud when they believe that the company will detect it. Therefore, establishing strong controls and letting employees know that management is looking out for fraud can deter employees from attempting to steal.

Rationalization

The third leg of Cressey's Fraud Triangle deals with *rationalization*—how offenders convince themselves that stealing is okay. Cressey found that they were able to excuse their actions to themselves by viewing their crimes as noncriminal, justified, or part of a situation that the offender does not control.

Recall that most employees who commit fraud are not career criminals. They are generally people who consider themselves to be honest, law-abiding citizens. Therefore, in order for them to begin stealing, it is critical that they develop some excuse to rationalize their conduct and help them maintain their image of themselves as moral people. By developing a rationalization, they also feel that they can explain their conduct if it is discovered. One of the simplest ways to justify unacceptable conduct and avoid feelings of guilt is to invent a good reason for embezzling—one sanctioned in the social group as a greater good.

There are several rationalizations that are common to embezzlers and repeated over and over by those who are caught committing occupational fraud. They include:

- "I was only borrowing. I was going to pay everything back."
- "I only did it because of unusual circumstances. Normally, I'd never have taken the money."
- "I did it to provide for my family (pay bills, keep up the mortgage, etc.)."
- "My employer had been cheating me/treating me unfairly. I only did it to get even."
- "My employer is dishonest. The company rips off its customers, so it deserves to be ripped off."
- "I had to have the money. I only did it out of necessity."
- "Everybody does it."
- "After all I've done for the company, I was entitled to it."

Conclusions

Cressey's classic Fraud Triangle helps explain the nature of many—but not all—occupational offenders. It is obvious that one model does not fit all situations. In addition, Cressey's study is nearly half a century old. There has been considerable social change in the interim. And now, many anti-fraud professionals believe there is a new breed of occupational offender—one who simply lacks a conscience sufficient to overcome temptation.

Cressey's model also does not fit the predatory employee who takes a job with the intent of stealing. But for the majority of occupational fraudsters, the Fraud Triangle provides a framework to explain why they commit their crimes. Companies can use Cressey's model to help them prevent employee fraud. For instance, because most employees start stealing when faced with a *non-shareable financial problem*, companies can be alert for employees who exhibit signs of stress or who indicate that they are in a bad financial situation. By establishing open-door policies, management can provide these employees with a place to discuss their problems, to seek help, and to hopefully find solutions before they turn to fraud.

With regard to the second leg of the Fraud Triangle, companies can attempt to limit *perceived opportunities* to commit fraud. This can be accomplished through various means, such as by establishing strong internal controls and separate duties, conducting random audits or cash counts (letting employees know that random tests will be conducted, but not indicating when), establishing a management presence wherever cash or merchandise is handled, and terminating anyone who is caught committing fraud and referring them for prosecution.

Regarding the third leg of the Fraud Triangle, management can look for signs of *rationalization* among employees, particularly those who are already at-risk fraud candidates. Management should be aware of employees who seem disgruntled or who feel they have been treated unfairly or passed over for promotions. It should also look for signs of extreme financial stress that could lead an employee to justify misconduct. Finally, it should review compensation policies to make sure employees receive adequate pay based on their jobs and the labor market. Simply stated, happy employees are less likely to steal.

Continuing Conduct

Cressey's model is a great tool for explaining why employees *begin* to commit fraud, but experience shows that once an employee starts stealing, they tend to continue to do so. The thefts usually get larger or more frequent (or both) until the perpetrator gets caught or leaves the company, or until the company is driven out of business. As fraud schemes progress, the importance of the elements that make up the Fraud Triangle begin to diminish. For instance, suppose Anne, a bookkeeper, begins writing company checks to pay off a personal debt. Once Anne sees that she can write checks to herself without getting caught, she becomes hooked on this source of extra income. Although the scheme might have begun because of a non-shareable financial problem, Anne tends to continue with it even after the immediate problem has been solved. She might start writing checks to pay for luxury items, vacations, and other non-essential purchases. Likewise, she might begin the scheme by rationalizing that she is only borrowing the money from the company. However, as the scheme progresses, she has less and less need to keep rationalizing her misconduct. The theft becomes the norm for her, to the point where she does not have to justify it to herself at all, until she finally gets caught.

The preceding example illustrates what some anti-fraud professionals have dubbed "The Potato Chip Theory of Fraud." As the theory goes, a perpetrator cannot stop at just one fraud. They keep nibbling and nibbling. Frequently, such employees continue their schemes even after they leave one company and start working for another. At this point, they have become "predatory employees." These people fall outside the Fraud Triangle model; they steal not because of a defined set of circumstances, but as a matter of course. Small businesses can best protect themselves against these perpetrators by conducting thorough background checks before hiring any employee, particularly anyone who will have access to the company's cash or merchandise.

The importance of screening out bad applicants or preventing existing employees from stealing cannot be overstated. Many small businesses resist measures like internal controls because they are costly and time consuming. But according to the 2016 *Report to the Nations*, the median loss in small business fraud schemes was $150,000. Just because this cost doesn't show up on the balance sheet does not mean it is not there. When employers realize how much can be lost by ignoring the threat of fraud, they see that measures like internal controls and background checks are actually a bargain.

Working Conditions and Fraud

The Hollinger-Clark Study: The Effect of Workplace Conditions

In 1983, Richard C. Hollinger of Purdue University and John P. Clark of the University of Minnesota published federally funded research involving surveys of over 9,000 American workers. In their book, *Theft by Employees*, they reached a different conclusion than Cressey. They concluded that employees steal primarily as a result of *workplace conditions*; specifically, Hollinger and Clark found that job dissatisfaction is the primary cause of employee theft. They also concluded that the true costs of employee misconduct are vastly understated: "In sum, when we take into consideration the incalculable social costs . . . the grand total paid for theft in the workplace is no doubt grossly underestimated by the available financial estimates."

Employee Deviance

Employee deviance is conduct detrimental to the organization and to the employee. Hollinger and Clark broke down employee deviance into two basic categories of deviant behavior: (1) acts by employees against property (e.g., theft or embezzlement) and (2) violations of the norms regulating acceptable levels of production (counterproductive behavior such as goldbricking).

Hollinger and Clark developed a written questionnaire that was sent to employees in three different sectors: retail, hospital, and manufacturing. Over the three-year duration of the study, they received 9,175 valid employee questionnaires, representing about 54 percent of those employees sampled. The following table represents the first category of employee deviance: acts against property. Approximately one-third of employees surveyed in all three sectors admitted to some form of property crime.