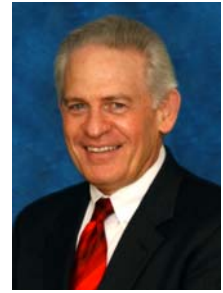




EMPLOYEE THEFT SCHEMES



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Innocent investors in publicly traded entities know all too well how costly fraudulent activity can be to them. The media covers these stories at nauseam on evening news programs, as well as in the press. Why all of the media attention? Because it is scandalous and many people are financially devastated by the actions of a few dishonest, yet highly compensated senior executives who are frequently involved in these cases. Stories, like Enron, WorldCom and Tyco are newsworthy because of the negative impact they have on the company and economy.

Obviously less newsworthy is the fraudulent activity that takes place at smaller, often privately owned companies. Maybe less noteworthy, employee theft at these companies can have more serious consequences because they do not have the resources of their larger counterparts. Often a lifetime of hard work can be lost because of a single unscrupulous employee.

To understand the significance of employee theft to all businesses, large or small, a valuable resource is available from the Association of Certified Fraud Examiners (“ACFE”). Based in Austin Texas, this international organization is one of the best when it comes to learning how to detect, prevent and fight fraud. Since 1996 the ACFE has published its Report to the Nation on Occupational Fraud and Abuse (“Report to the Nation”), a study compiled from submissions from its worldwide membership. The 2006 Report to the Nation is based on the submission of 1,134 actual fraud cases investigated by its member Certified Fraud Examiners. Although cases at large companies are included in the general fraud statistics, the data related to small companies with less than 100 employees, will shock even the most savvy small business owner.

The Report to the Nation data shows that “small organizations tend to suffer disproportionately large fraud losses,” a trend also found in the ACFE reports in 2002 and 2004. Noted in the 2006 Report to the Nation was “the median loss for fraud cases attacking small organizations in our study was \$190,000; this exceeded the median loss for cases in any other group.” The median loss attributed to all companies in the study was \$159,000; small companies suffer losses from employee theft of almost 20% more than larger companies. Additionally, “Small organizations were also the most heavily represented group, making up 36% of all frauds in the study.” When stratified by gross revenue other interesting statistics emerge. The Report to the Nation shows that entities with revenue from \$1 million to \$10 million incur median losses of \$200,000, while companies with revenue between \$10 million and \$50 million suffer median losses of \$275,000. The analysis of small company losses also include firms with revenue under \$1 million, \$50 to \$500 million and over \$500 million, resulting in the general median employee theft loss for small companies of \$190,000.

If the impact of employee theft is so pervasive, the question becomes how do the employees steal from their employers? One common method is *skimming*; stealing the proceeds from a cash sale before it is recorded. Skimming is an off-the-books theft that leaves no paper trail. For example, a retail store cashier failing to ring up a sale and keeping the cash, or ringing up a sale for less than the amount received and keeping the difference.

Another favorite of the errant employee is the *theft of daily deposits*. This is a simple cash fraud scheme in which a partial or an entire deposit is stolen, and for which there should be a paper trail. As with skimming, actual and expected receipts and deposits will differ, and there will also be inventory discrepancies.

Void sales and fictitious sales returns are other favorites of the dishonest employee. In a void sale the cashier enters the transaction properly, allowing the customer to leave with the merchandise and the sales receipt. Thereafter, the dishonest cashier voids the sale, removes the money from the register replacing it with a phony void sales form. With a fictitious sales return, the cashier completes a refund form for merchandise that is not actually returned, and the cash is stolen from the register.

Accounts receivable fraud is also a popular activity among employee fraudsters. This type of fraud involves the manipulation of customer accounts receivable and sales in order to steal cash and other assets from an unsuspecting employer. *Lapping* customer accounts, a common form of accounts receivable theft, involves stealing a customer payment made on account and concealing the theft by applying a payment from a second customer to the account of the first customer whose payment was stolen. The misappropriation of the second customer's payment is concealed by applying the payment of a third customer; the payment from a fourth customer is applied to the account of the third customer and so forth. Since invoices to different customers are usually not for the same items or dollar amounts, this cumbersome scheme eventually falls apart especially if the perpetrator goes on vacation or is out of the office for any period of time.

Issuance of false credits and discounts are another way that stolen accounts receivable remittances are covered up, as are unauthorized shipments invoicing fictitious customers, then crediting or writing-off the related accounts receivable. The inventory is then shipped to and received by the employee.

Other *inventory schemes* involve scrapping good inventory and selling it, using sales return schemes and purchasing frauds. Stolen inventory includes raw materials and finished goods for personal use or for resale by the employee causing unexpected or frequent out-of-stock conditions, and unexplained increases in cost of goods sold with corresponding reductions in gross profit margins. Other assets are stolen less frequently than cash or inventory. They tend to be small in size, portable, lack owner identification and are easy to sell. Unusual or frequent purchases of certain types of equipment such as laptops and PDAs could be symptomatic of asset fraud.

Payables and disbursement fraud often involves collusion with other employees and/or third-parties. *Kickbacks* are a favorite because they generally enrich the employee without employer awareness. In this scheme, an employee with the authority to purchase materials or services receives a benefit from a vendor in the form of cash, gifts, services, trips, or employment favors for relatives. In return the employee may buy inferior or excess goods and services, or agree to pay a higher price. Since employees in management positions who have the power to override internal controls are often involved, kickback schemes can go on for a long period of time before being discovered.

Inflated or false invoice schemes are often undetected for the same reason. In these cases employees submit false invoices for payment or they purchase goods and services in excess of the company's requirements, stealing company funds. The perpetrator has the authority to approve payment, or they conspire with someone who has the authority. Employees also plot with vendors to submit inflated or bogus invoices.

In the end employee theft is a large drain on the United States economy. The Report to the Nation estimated that "...US organizations lose 5% of their annual revenue to fraud." In the context of the 2006 Gross Domestic Product this would "...translate to approximately \$652 billion in fraud losses." The answer is to have internal controls that will deter employee fraud in the first place, or at least detect fraud when it occurs.

For more information on uncovering employee theft schemes contact Marshall Morris, CPA/ABV, CFE, at 732-741-2624 ext. 214 or mmorris@cowangunteski.com.

About the Author

Marshall A. Morris, CPA/ABV, CFE, Principal, brings more than thirty years of experience in investigative accounting and litigation support services to Cowan, Gunteski, & Co., P.A. He has provided forensic accounting, investigative and expert witness testimony services in employee embezzlement cases. Mr. Morris specializes in accounting malpractice, business valuation, damage calculation, embezzlement, funds flow tracing, fraud, partnership dissolution, matrimonial, union pension fraud investigation and wrongful termination defense. He has hands-on case experience in the financial operations of businesses in numerous industries.