

Fraud is my Neighbor's Problem. Really?

By Dima Berdiev

When they are running a business, fraud is perhaps the last thing on the minds of business owners, regardless of the size of their businesses. Who can blame them? When you need to manufacture a product, make a sale, find an affordable health insurance provider, or interview and hire a new employee, there is no time to be afraid or think of fraud. Business is moving at a hundred miles per hour, and business owners have no time for “nonsense.”

Could this be the reason that white-collar crimes are on the rise, increasing \$40 billion dollars annually? Nearly 60 percent (some estimate closer to 80 percent) of businesses are affected by fraud and white-collar crimes and have no idea that they are being victimized. It is frightening to discover that occupational fraud impacts a company's bottom line by 5 percent of total revenue. The list of fraud-related statistics is quite extensive.

Story Number One: “Allow me to introduce myself. I am an embezzler.”

Barry Webne had a successful career in finance and climbed the corporate ladder until authorities discovered that he had embezzled more than \$1 million from a small manufacturing company in Ohio. Barry spoke of his earlier days. Before starting at that company, he worked at a couple of businesses that did not allow him to commit his crime because they had simple and effective controls in place. At the new employer, however, the internal controls were full of flaws. The greatest of these permitted the same person who handled accounts payable to write company checks. The company also had a complex structure and was composed of eight separate companies; this set-up made it easy for Barry to steal and conceal his fraud.

It is a widespread misconception that the only people who defraud their companies face financial problems. Barry was not experiencing financing hardships that would warrant putting his reputation on the line to make big bucks. In his speech to the Symposium, he explained that embezzlement and other types of financial crimes are an addiction. Stealing money for the first time was the hardest thing Barry had ever done, but each incident that followed made it easier. One develops an internal justification that becomes stronger and stronger and grows into a sense of entitlement. Barry compared embezzling to an addiction to drinking, gambling, or drugs.

When Barry stole money for the first time, he paid himself about \$2,000 to \$3,000 and no one noticed. Over time, he became bold enough to take \$7,000 to \$8,000, which eventually increased to \$50,000 a month. Again, nobody noticed. He fooled the auditors who came in once a year. He fooled his boss who thought that Barry was a hard-working person, dedicated to the company. Of particular help in Barry's cover up was downsizing.

As you probably know well from your business experience, when a company is not doing well, the first jobs to be cut are the non-revenue producing jobs, such as human resources, administrative, and finance and accounting. After Barry's department was reduced from five to three employees, things got easier. Less segregation of financial duties and fewer checks and balances were good fortune for a fraudster who was on track to hit and exceed a \$1 million mark.

Educating businesspeople about fraud and motivating them to take action to prevent financial crimes was the driving force behind the Fraud Defense Symposium, which Boston Private Bank organized on September 27, 2007. The Symposium featured two speakers who, under normal circumstances, would not cross paths in the capacity of educators. Their stories showcased two opposite sides of the spectrum. One speaker, a convicted embezzler, is now a fraud prevention advocate and consultant. He works to help educate business owners to ensure that people like him do not ruin the good fortunes of businesses, their owners, employees, and even customers. The second speaker had seen his companies quietly but surely ripped apart by a very smart and voracious controller who brought his businesses to the brink of extinction.

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During his narration, Barry focused on a concept known as the Fraud Triangle, which consists of three elements that must be present for fraud to take place:

1. Perpetrator must feel under financial pressure;
2. Crime needs to be rationalized in the individual's mind;
3. Opportunity must be present.

As a business owner or manager, you cannot control the first two, but you can and must control the third. As Barry continued recounting his odyssey at the Ohio company, he reiterated several times that the company's senior management had a one-track mind. They wanted to see profits. When they did, and Barry made sure that they did by providing "cooked" financial statements, he was able to continue pillaging his employer's coffers without much effort.

Nobody wants to talk about fraud

Sweeping an issue under the rug and thinking that it will never impact you is hardly the way to avoid fraud. You should know that statistics show that given the right circumstances, at least 65 percent of accounting clerks or managers, controllers, and CFOs will violate their position of trust and commit some type of occupational fraud. In addition to the financial devastation and reputation risk that internal fraud can bring onto a company, its owners, and employees, it brings moral damages, a sense of helplessness, loss of trust in everybody, and various psychological traumas. These pains will haunt you and your company for a long time.

Nobody has time to prevent fraud

Another powerful force that allows fraud to take place is the fact that business owners commonly do not have or do not make time to prevent it. As a result, the smaller your business, the more susceptible it is to fraud. A fact discussed at the Symposium was that occupational fraud is nearly ten times more likely to occur in businesses with fewer than 100 employees. Business owners are passionate about their businesses and keep extremely busy running the various aspects of them. Unfortunately, fraud is the last thing on their minds until it is too late. There are even examples of entrepreneurs who have been victims of fraud but still did nothing or not enough to prevent another occurrence, and fraud happened to them again.

Nobody but yourself is to blame when you get hit with fraud

The following conclusion has been made time and again by former fraudsters, business owners who were victims of fraud, and members of law enforcement:

In the majority of fraud cases, the owners and senior managers are to blame for not putting in place simple and typically inexpensive (compared to the cost of fraud) measures to prevent fraud.

You and your employees work too hard to build your financial success to let somebody rob you of it in the blink of an eye. So unless you are committed to making the necessary changes in your business, do not expect mercy from financial criminals. And for those who rely on an occasional audit, you should know that independent auditors uncover only 10 percent of the occupational and financial fraud that occurs with the businesses they audit.

Story Number Two: "I can't believe you stole from me!"

The Symposium's second guest told a story of business successes that he achieved through hard work and perseverance. Mike¹ started his construction company on very little cash, a strong desire to be a business owner, and an exceptional work ethic. Starting as a one-man show, his company has grown to include several different businesses and over 100 employees. His company's fortunes changed, however, when he hired Jenny¹ to help his controller manage finances. In Mike's own words, she seemed quite poor but a hard working and dedicated employee; Mike had grown to value such qualities in employees. Over several years, Jenny rose through the ranks, and, when the company's controller left, she took over the job.

Jenny worked for Mike for about seven years, and it never occurred to him that she turned the business into her personal bank account. During her time with the company, she stole in excess of \$7 million, at an average rate of

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\$1 million a year. As Mike launched new businesses and expanded existing ones, his revenue reached several tens of millions of dollars. However, he always struggled with unexplainable cash flow shortage. Little did he know that his businesses were actually making good profits!

Cash flow problems became so prevalent that Mike was forced to sell some of his business assets. In addition, he began to feel a growing sense of exhaustion and failure, which affected his state of mind and personal life. Mike hired a new bookkeeper to help provide better reporting for a company he was hoping to sell in the near future. Imagine Jenny's dissatisfaction when she learned that her "Klondike gold" was at risk. She was only able to perpetrate the crimes because she was solely responsible for various accounting and cash management functions in the company. In fact, it was the new bookkeeper who accidentally uncovered some financial irregularities, which led to an extensive and lengthy investigation that shocked not only Mike and his family but his entire business.

Now on the way to recovery and luckily still in control of several profitable ventures, Mike fixed his accounting department and implemented simple procedures, which he should have done long ago. He now separates duties and has different people handling various cash management responsibilities. Any checks over a certain amount must be signed by two individuals from different departments. The investigation uncovered that the controller used to open and reconcile the bank statement by herself. She destroyed the original statements and used high quality computer equipment to create false statements that concealed her theft and reconciled cash balances from month to month.

Other control faults that she took advantage of included closed business accounts. In the course of running his business, Mike typically started new companies or created accounts for specific projects. As he completed those projects, he closed the accounts. However, Jenny wrote expense checks that paid those closed accounts. Again, she did not get caught because she was careful and did not use any single account for extended periods of time. She also purchased equipment to print checks that looked exactly like the company checks. She then destroyed the checks signed by the owner and senior managers and issued new ones. Nobody questioned the fact that she was not an authorized signer, even the company's bank (**not** Boston Private Bank). She then forged invoices and paid them, and the money went into her account.

Conclusion

To summarize the lessons and experiences discussed at the Fraud Prevention Symposium organized by Boston Private Bank, we have listed below a few suggestions for preventing fraud in your company.

- Separate accounting and financial control responsibilities—keep accounts payable management, check-writing, and financial reporting separate from bank reconciliation.
- Require more than one signature on checks over a certain amount, and review all checks paid during each month to ensure that there were no unauthorized or missing signatures.
- Make sure management has access to bank statements and other financial information and conduct periodic internal audits, including surprise audits.
- Ensure that internal audits are conducted by people who are not familiar with your finance employees and that they have minimal to no interaction during audits.
- Conduct employee background checks, including criminal checks, when hiring for certain or all positions.
- Before downsizing your finance department, make sure that you still have strong financial controls to prevent fraud.
- Create a process that will encourage and protect employees who come forward with information about suspicious activities.
- Take advantage of accounting and other professional service firms that can help you implement better financial controls.
- Trust, but verify!

¹ Names were changed out of respect for the confidentiality of the people involved.

Test Your Embezzlement Defense Effectiveness

QUESTION	NO	YES	SCORE
1) Do you review your account and cash position [online] daily AND personally open and review your bank statement(s)?	0	25	<input type="text"/>
2) Are checking accounts reconciled to bank account statements promptly each month?	0	15	<input type="text"/>
3) Is the person reconciling the account separate from those who issue checks and those with signing authority?	0	10	<input type="text"/>
4) Do you have more than one check # range active in the same account or use multiple check books simultaneously for the same account?	10	0	<input type="text"/>
5) Is someone in your employ living a lifestyle beyond their means (cars, jewels, vacations, etc.)?	10	0	<input type="text"/>
6) Is your blank check stock inventory kept physically secure, and reconciled frequently?	0	10	<input type="text"/>
7) Do you have a facsimile signature stamp and/or do you sign blank checks ahead of issuing them?	5	0	<input type="text"/>
8) Do you review each payee name and the invoices for disbursements (especially for payments to credit card companies)?	0	5	<input type="text"/>
9) Do you periodically verify the existence of employees on the payroll (example: handing out paychecks as opposed to mailing paychecks)?	0	5	<input type="text"/>
10) Do you require at least two approvals for unusually large expenses?	0	5	<input type="text"/>
90 - 100 Generally effective	Total Score		<input style="border: 2px solid blue;" type="text"/>
70 - 85 Need to reduce risk			
0 - 65 Dangerously exposed			

Resources:

- For more data on fraud, consult the National White Collar Crime Center (www.nw3c.org), the Association of Certified Fraud Examiners (www.acfe.com), and the Institute of Internal Auditors (www.theiia.org).
- Barry J. Webne: www.barrywebne.com.
- "Business owners never think they will be a victim," by Alison Grant, Newhouse News Service, 8/6/07.
- "White-collar crime far too easy at most companies, man who embezzled \$1 million warns," by Alison Grant, Plain Dealer Reporter, 7/20/07.