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Anatomy of a Corporate Fraud

Though not as dramatic as the evening news, white collar crime does violent damage to America's bottom line.

BY JAMES A. STAVROS

White collar crime costs North American business more than $100 billion annually, or roughly 2 percent of the gross national product, it was recently estimated. Further, white collar criminals commit up to three quarters of all monetary thefts.

Yet media coverage of financial crime focuses primarily on daring bank robberies and violent muggings. It's not surprising the inherent danger and drama of a bank robbery captivates our attention. Anything that directly threatens our personal or collective safety naturally takes priority. It's also an easy story for the media to tell—and for its audience to digest.

Complex white collar scams are often difficult for the media to understand and even more challenging to boil down to the brief reports that predominate in the broadcast and print media. As a result, most Americans have little sense of the extent of nonviolent financial crimes.

But when billions of dollars are lost each year, from petty theft of company equipment to elaborate frauds, the time has come for the public to realize how much white collar crime actually costs society in higher prices for goods and services.

Who commits these financial crimes and how do they do it? Sadly, as the following case history illustrates (some details have been changed to protect client confidentiality), the typical perpetrator of fraud is a trusted, longtime employee.

Employee Background

Jonathan Spencer worked at Fabulous Furniture for eight years. He'd started when it was struggling to survive and had lived through the bad years before the company began to prosper.

Trusted and respected, Spencer was the corporate accountant, bookkeeper and office manager rolled into one. He made $55,000 a year, supervised several people and reported directly to the owner. His duties included paying vendors, depositing receipts and reconciling bank accounts for the company of more than 200 employees.

Spencer was a single father of two boys in their mid-20s, one still in college. His house was modest but impeccably decorated. He always drove a newer model expensive car, and his clothes were trendy and fashionable. When a group of employees went out for a meal or drinks, Spencer always picked up the tab.

The Theft

Spencer's downfall began during an enforced vacation. Over Spencer's protestations, the owner insisted he take some time off. Prior to this vacation, Spencer very seldom took time off. But when he did go on vacation, it was extravagant.

While Spencer was absent, a fill-in employee noticed something unusual while reimbursing the petty cash account. She realized that Spencer was writing large reimbursement checks to the petty cash account each week that far exceeded supporting expense receipts. She notified Fabulous' owner, who in turn informed his accountant.

When Spencer returned from vacation, the company's owner confronted him with the petty cash discrepancies. At first Spencer denied any wrongdoing. But when the owner offered not to press charges in return for a confession and documentation of how much he'd stolen, Spencer quickly relented. He admitted taking approximately $5,000 over a one-year period.

Emotions were running high in the company. People at all levels were experiencing, to one degree or another, the four mental states triggered by fraud detection: denial, then anger, resentment, and finally, acceptance.

At first they couldn't believe Spencer would steal, and they felt his betrayal personally. As anger set in, there was a strong sense he had to be punished, the quicker the better. Often, when feelings boil up, premature and damaging actions can result, such as the leveling of accusations that cannot be proved.

Fabulous was insured for employee dishonesty. To help quantify the loss and prepare a proof of loss for the insurer, the company retained forensic financial investigators. By engaging outside expertise, Fabulous benefited from an objective approach, which ensured that proper fraud investigation steps were taken.

Even more important, Fabulous learned the complete truth of Spencer's activities, which far exceeded those to which he had admitted.

Spencer refused to assist the financial investigators, which raised their suspicions. Through interviews with Fabulous' staff, the investigators learned of Spencer's lavish lifestyle, which included tales of opulent parties, state-of-the-art audio and video equipment, renovations to his house, and a penchant for expensive new cars.

Clearly, Spencer was living beyond his apparent financial means. This information led the investigators to look into his financial transactions at work, involving more than just petty cash.

Theft Analysis

The investigation revealed that Spencer indeed was stealing money through petty cash. He reused expense receipts, created fictitious receipts, altered receipts, and did not provide an

accounting or reconciliation of the system.

The investigation also discovered Spencer was writing company checks for his own personal benefit. A signatory on the corporate operating checking account, he had the facsimile signatory stamp of the owner—required for check amounts over $500—in his possession when the financial investigators performed an inventory of his office.

Each check Spencer authorized was painstakingly examined in the operating account to determine if it was used for business or personal purposes. A credit check, which showed him heavily in debt, listed many of the credit card companies as payees on the operating account.

When the investigation was completed, it was apparent that Spencer had been paying personal expenses with company funds and outright stole cash from the petty cash account. This was verified through statements taken from the credit card companies (and other vendors) for both insurance and possible criminal actions. According to the financial investigators' determination, Spencer took approximately $500,000 from the company, over seven years.

Although other areas were examined for fraud, such as payroll, invoice files, computer records, and purchasing, it was determined the bulk of Spencer's theft occurred in the company's petty cash system and operating account. His theft in these areas was easy because there were not internal controls and no one reviewing his work.

Spencer may have committed other frauds within the company, but the investigation was discontinued at this point because insurance coverage limitations had been exceeded. Fabulous decided against incurring additional costs just to document more fraud, although the company considered recovery of the excess loss against Spencer personally. An asset search determined he had insufficient assists for a civil recovery suit.

A proof-of-loss was submitted to both the insurance company and police (at the company's direction) to help prove the pending criminal charges against Spencer. The investigation and resulting report produced a winning situation for both Fabulous and the police, although the loss of Spencer as a trusted employee rocked company morale.

At press time, Fabulous anticipated recovery of several hundred thousand dollars from the insurance company and was able to write a portion of the loss off on its tax return. The police were handed court-ready documents to prove their case. In addition several internal control procedures were instituted to ensure this type of fraud would never happen again.

Prevention Techniques

The following recommendations can limit exposure to white collar crime within a company.

• **Internal controls**. There are no substitutes for segregation of duties among people and departments. Many smaller companies, however, cannot afford to hire additional people or split responsibilities.

In these instances, key management/owners can be used as substitutes. Sales and shipping, receipts of cash and bank deposits, and check writing and bank reconciliations are all important duties that require segregation. Spencer was able to perpetrate his crimes for so long because there were no internal controls over his areas of responsibility.

• **Verification of work**. Instigate a process whereby internal or outside bodies review and monitor employees' and/or departments' activities and records on a regular or ad hoc basis. This control acts as a powerful deterrent to fraud.

• **Create a written code of ethics and department policy and procedures**. Written codes and procedures prescribe how employees should behave and perform their departmental tasks. Is it okay to accept gifts from clients? Can old company equipment be taken home? Can expenses be paid without receipts? When should customers' accounts be written off?

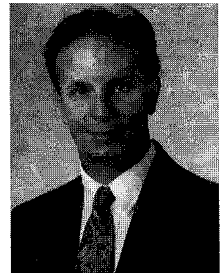
By providing a detailed policy, the company not only sets a moral tone for employees to follow, but it eliminates the defense of, "I didn't know," if something goes wrong.

• **Management philosophy**. Communication between management and employees should be clear and uninhibited. If employees have a real problem or financial concerns, management should listen and react.

Open communications may reduce the risk of need-motivated fraud, in which employees steal because of financial pressures. A greed-motivated fraud may be deterred by management's strong commitment to terminate and prosecute any wrongdoing by employees.

• **Insurance coverage**. Obtain employee dishonesty or fidelity insurance coverage. The insurance is relatively inexpensive for large amounts of coverage.

If employees have a low expectation of getting caught, the chance that fraud and other abuses will occur increases. Through strong internal controls and other fraud prevention and detection policies and procedures, a company's profitability and reputation is protected.



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