

Employee Fraud: Recognizing and Preventing

Employee fraud is one of the most costly and preventable risks facing organizations today. This introductory course sets the stage for understanding how fraud occurs in the workplace, who commits it, and why. Designed for CPAs and tax professionals, it explores the foundational concepts behind employee fraud, including common motivations and the conditions that allow fraud to thrive. Whether you advise small businesses or work within larger organizations, this course helps you build the awareness needed to spot warning signs before they become major financial losses.

CREDIT HOURS 2 | FIELD OF STUDY AUDITING | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify various employee fraud schemes.

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Recognizing and Preventing Employee Fraud

Chapter Objective

After completing this course you should be able to:

- Identify various employee fraud schemes.

INTRODUCTION

Employee fraud is a type of occupational crime. It is the use of fraudulent means to take money or other property from an employer. It usually involves falsification of some kind—false documents, lying, exceeding authority, or violating an employer’s policies. It consists of three phases: (1) the fraudulent act, (2) the conversion of the money or property to the fraudster’s use, and (3) the cover-up. Most employee frauds can be placed in the legal categories of embezzlement and larceny. Sometimes, an employee fraud will result in misstated balance sheet accounts and financial statements.

This PES short course deals with the characteristics of employees’ fraudulent acts, conversions, and cover-ups. The focus is on schemes employees have used.

CASH SCHEMES

Cash on deposit in banks and petty cash can be misappropriated through on-book schemes (involving falsified accounting entries) or off-book schemes (no accounting entries in the books and records). Generally, cash schemes are smaller than other internal fraud schemes because companies have a tendency to use comprehensive internal controls over cash. Cash fraud schemes follow general basic patterns, including skimming, voids/under-rings, alteration of cash receipt documentation, fictitious refunds and discounts.

Skimming

Skimming involves removing cash from the business before the cash is recorded in the accounting system. This is an off-book scheme. Receipt of the cash is never reported to the business. A related type of scheme is to ring up a sale for less than the actual sale amount. (The difference between the actual sale and the amount on the cash register tape can then be diverted.) Skimming is of particular concern in retail operations (for example, fast food restaurants) where a significant portion of the daily sales are in cash and not by check, debit card, or credit card.

Example of Cash Skimming

According to an investigation, fare revenues on the Chicago Transit Authority's (CTA) rail system allegedly were misappropriated by agency employees. The statistics indicate that the thefts were not confined to the one station that originally was suspected and that the fare-skimming by transit workers might have been reduced by news of the investigation. In the four days after reports of skimming surfaced, about \$792,000 was turned in by station agents system wide. In a similar Monday through Friday period only \$723,000 was turned in by station agents.

CTA officials estimated that a planned installation of a \$38 million automated fare-collection system would eliminate \$6.5 million annually in revenue "shrinkage," mostly from employee theft. At least 10 workers were investigated, including nine ticket agents and one supervisor. Early reports indicated that agents pocketed money after recording "transfer" or "monthly passes" as cash-paying customers passed through turnstiles.

Source: Urban Transport News

Voids/Under-Rings

Three basic voids/under-ring schemes are common. The first is recording a sale/cash receipt and then voiding the same sale, thereby removing the cash from the register. The second, and more common variation, is purchasing merchandise at unauthorized discounts. The third scheme, which is a variation of the unauthorized discount, is selling merchandise to a friend or co-conspirator using the employee's discount. The co-conspirator then returns the merchandise for a full refund, disregarding the original discount.

Example of Voids/Under-Rings

Roberta F., a former Ball State University employee, was indicted on federal charges of stealing about \$105,000 from the school's bookstore operations. She was charged with stealing the money over a 33-month period.

The thefts allegedly were from proceeds of the sales of books to students who took Ball State courses through an "off-campus" program at many cities around Indiana. Roberta F. was in charge of the sale of the books from the bookstore.

Roberta F. was accused of altering records and taking currency from a cash drawer. She was also charged with income tax violations for failing to report the stolen money on her federal tax returns.

Source: United Press International; Dateline: Indianapolis.

Alteration of Cash Receipts Documentation

A lack of segregation of duties can create an opportunity for an employee to misappropriate company funds. For example, if the same person is responsible for both collecting and depositing the cash receipts, this person has the opportunity to remove funds from the business for personal use and conceal the theft through the deposits. This is often the case in small organizations where a few personnel divide the daily cash operations. A variation of this scheme is to mutilate or destroy the cash receipt documentation so that any attempt to reconcile the cash deposited with the cash receipts is thwarted.

Example of Document Alteration

An elected county treasurer allegedly stole \$62,400 over a three-year period from property tax receipts. Every other day, after cash receipt transactions were batched and posted to the subsidiary accounting records, the treasurer altered the total cash receipt and the actual deposit. Therefore, the control account and the deposit were equal but that total did not match the total postings to the individual taxpayers' accounts. In each of the three years, the difference between the control account receivable and the summation of the individuals in the subsidiary accounts was written off. These were unsupported accounting adjustments.

Evidence was obtained by reconstructing the three years' cash receipts and matching the differences between the total cash receipts, control account, and the individual (subsidiary) accounts with the unsupported accounting adjustments.

Source: Asotin County, Washington; Special Examination Report No. 47242.

Fictitious Refunds and Discounts

Fictitious refunds occur when an employee enters a transaction as if a refund were given. However, no merchandise is returned, or no discount is approved to substantiate the refund or discount. The employee misappropriates funds equal to the fictitious refund or discount. This scheme is most prevalent in the retail industry. However, it can occur in any operation in which a refund or discount is given.

Example of Fictitious Refunds

Dora M., a former New York University student financial aid official, was charged along with her husband Salvatore with embezzling \$4.1 million. The operation was carried out by falsifying more than a thousand tuition refund checks. The loss was described as one of the largest embezzlements ever uncovered at a U.S. university. The money was allegedly taken from the Tuition Assistance Program, operated by the New York State Higher Education Services Corporation to provide expense money to needy students. However, NYU officials assert that the funds came from a University account, not from State money.

Dora's job was to assure that students entitled to funds from the Corporation received their checks. According to the U.S. Attorney, she arranged for checks to be made out to hundreds of legitimate NYU students who were not entitled to receive any funds. These students were unaware because the checks were deposited into bank accounts in Manhattan and New Jersey that allegedly were controlled by the M's. These checks were made over to Elizabeth P. before being deposited into accounts in that name. Some other checks were made payable directly to P. The FBI was unable to locate Elizabeth P. and believes that such a person never existed.

Reportedly Dora and Salvatore spent \$785,000 of the funds on expensive jewelry and \$85,000 on Florida real estate.

Source: Predicasts, A Division of Ziff Communications Co./Elsevier Advanced Technology Publications; Computer Fraud Security Bulletin.

Kiting

Kiting is the process whereby cash is recorded in more than one bank account, but in reality, the cash is either nonexistent or is in transit. Kiting schemes can be perpetrated using one bank and more than one account or between several banks and several different accounts. Although banks generally have a daily report that indicates potential kiting schemes, experience has shown that they hesitate to report the scheme until the balance in the customer's account is zero.

To be successful banks must be willing to pay withdrawals on unfunded deposits. This is not to say that all payments on unfunded deposits are kiting schemes, but rather, that all kiting schemes require payments be made on unfunded deposits. When a bank allows its customers to withdraw funds on deposits for which the bank has not yet collected the cash, kiting schemes are possible.

Customers who use wire transfers can perpetrate kiting schemes very quickly and in very large numbers. However, with the "Check Clearing for the 21st Century Act" (aka "Check 21"), the possibility of check kiting is significantly reduced. Basically, this act requires U.S. banks to clear domestic checks very fast, thus reducing the float.

Auditors should still understand what check kiting is because it is still relevant to international checks and firms located outside of the USA.

ACCOUNTS RECEIVABLE SCHEMES

The basic schemes in accounts receivable are lapping, diversion of receipts on old written-off accounts, and fictitious sales with corresponding accounts receivable.

Lapping

“**Lapping**” is the term used to describe a method of concealing a defalcation, wherein cash received from a customer is originally misappropriated by the employee, and, at a later date, cash received from another customer is credited to the first customer’s account. The second customer’s account is credited still later by cash received from a third customer, and so on. This delay of payment applications (credits) continues until it is detected, the cash is restored, or it is covered up by credit to the proper customer and a fictitious charge (write-off or return).

The basic lapping scheme operates as follows: the employee misappropriates cash received on customer A’s account. To conceal the misappropriation, the employee must now record receipts on customer A’s account. When customer B makes a payment, the employee posts the cash receipt to customer A’s account. When customer C makes a payment, the employee posts it to customer B’s account, and so on.

Old or Written-Off Accounts Receivable

Another internal fraud scheme in accounts receivable is the diversion of cash received on old or slow-paying accounts. In this scheme, the employee has the opportunity to collect receivables that have been written-off and keep the money. Companies typically do not keep track of old, written off accounts receivable.

Often, old accounts receivable are assigned to a collection agency. These agencies typically are paid on a percentage of the collected amounts. Fraud schemes can be perpetrated by these collection agencies if the company does not monitor the method by which the agency receives old accounts and the collection process itself. The assignor company needs assurance that the collection agency is being assigned truly old accounts and not good accounts, which can reasonably be expected to pay within the normal course of business. Also, the company needs to be sure that the collection agency cannot compromise (settle) the indebtedness so that collections are not reported. This would allow the collection agency to compromise indebtedness for its own collection and not remit amounts owed the company.

Fictitious Accounts Receivable

Generally, the motive for recording fictitious accounts receivable in the accounts is to disguise fictitious sales. This scheme is covered in more detail in the PES short course entitled *Management Fraud*. However, two employee fraud related benefits also can be accomplished with fictitious accounts receivable and sales:

- Meet sales quotas
- Receive sales-based compensation

These two benefits enable employees to receive pay, promotion, and perhaps other rewards that seem to be based on merit.

Meet Sales Quotas

Establishing unobtainable sales quotas that employees think are arbitrary will increase the pressure to establish fictitious performance levels. If the pressure becomes significant, an employee may resort to recording fictitious sales and accounts receivable.

Example of Fictitious Receivables

The SEC filed a civil action against Coated Sales, Inc., alleging that some of the company officers were engaged in a scheme to inflate accounts receivable and inventory. The officers allegedly created phony sales invoices and recorded the corresponding accounts receivable. The purpose of the scheme was to make Coated appear to have more sales than it really did. Proceeds from the sale of common stock were used to reduce the accounts receivable making it appear that the fictitious accounts receivable were being paid in a timely manner.

Source: The Associated Press; Byline: Dwight Oestricher, Associated Press Writer.

Receive Sales Based Compensation

When a salesperson's primary compensation is based on sales, without regard to collection, the employee has an incentive to produce quantity rather than quality sales. Companies often push for higher sales levels to sustain growth. However, if the salespersons' compensation is based solely on quantity and not on a combination of quantity and quality, then the compensation incentive is misplaced. This may create an atmosphere which, if coupled with opportunity, will produce inflated or fictitious sales.

INVENTORY SCHEMES

Most fraud perpetrated in inventory and warehousing involves misappropriation for personal use, embezzlement of scrap proceeds, and false charges to inventory-related accounts. The most common inventory scheme is appropriating inventory for personal use. When this fraud is

performed by a custodian, it is embezzlement; when performed by other employees, it is theft (larceny).

Appropriating Inventory for Personal Use

How many times have we heard someone say, “I’m just going to borrow this”? Or “I took it home to work on the project over the weekend.” In fact, a great deal of inventory is taken under the pretense that it is being borrowed. In actuality, the inventory is simply converted to personal use. Most personal thefts tend to be small. In other cases, theft rings can be operating.

Misappropriation can occur in many and varied forms. A common scheme requires collusion between delivery personnel and receiving personnel, where receiving personnel will sign for less merchandise than was actually received. The merchandise is then sold to fences. The delivery and the receiving personnel then divide the proceeds.

Example of Misappropriated Inventory

A former executive with the LTV Corporation who was convicted of taking more than \$1.5 million in kickbacks and bribes was sentenced to four years and three months in prison and ordered to make full restitution. U.S. District Judge Sid Fitzwater handed Lewis B. the maximum prison sentence, with no provision for parole.

Lewis B. was indicted in a federal indictment charging him with 36 counts of fraud. He was in charge of buying and selling pipe, as well as billing for the purchased pipe. The indictments charged him with accepting tens of thousands of dollars in “commissions” from pipe supply companies. He also profited by selling pipe stolen from LTV’s inventories.

Under an agreement with prosecutors, Lewis, 58, pleaded guilty to one count each of mail fraud, wire fraud, and tax evasion. Lewis worked for LTV for 37 years and used his illegal income to build and furnish a new home and purchase other luxuries

Source: United Press International; Dateline: Dallas, Texas.

Embezzlement of Scrap Proceeds

Misappropriation of scrap sale proceeds is a common practice. Because the amounts are generally insignificant to the financial statements of the company, scrap sales are usually not well controlled and good inventory records are not kept. However, when inventory is inappropriately designated as scrap, the proceeds of sale can be substantial.

False Charges to Inventory-Related Accounts

Since inventory accounts are generally not reconciled until the end of each year, it is a simple matter to charge embezzlements to these accounts. Embezzlements are often concealed through an