

Small Businesses Warned to Beware of Employee Fraud

(This article, written by Michael Cohn, appeared in *Accounting Today* on November 18, 2011.)

Small businesses and nonprofit organizations often overlook the warning signs of employee fraud, especially by senior managers, according to accounting firm Marks Paneth & Shron.

The firm advises management and board members to recognize the red flags and act early to stop fraud.

"Organizations pay a high price for fraud," said Sareena Malik Sawhney, a forensic accountant who serves as a director in the Litigation and Corporate Financial Advisory Services Group at the New York-based accounting firm. "The damage can be particularly severe at small organizations where losses can be extremely threatening. These organizations often do not have the systems in place to detect fraud and prevent or limit their losses."

According to the Association of Fraud Examiners 2010 Report to the Nations on Occupational Fraud and Abuse, the typical organization loses 5 percent of its annual revenues to fraud. Frauds last a median of 18 months before being detected.

The report found that frauds committed by senior executives or owners were more than three times as costly as frauds committed by managers, and more than nine times as costly as employee frauds. Executive-level frauds also took much longer to detect.

"There are warning signs for the most common types of fraud," said Sawhney. "If management and board members recognize them, they will be better able to detect fraud early and prevent or minimize the losses."

She warned of signs of fraud such as shrinking inventories. "Skimming is defined as diverting funds before they get recorded into an organization's books," she noted. "For example, employees often skim funds by pocketing customers' checks and trying to cash them, but customers will complain if they don't receive their goods, so the employee ships them. The result is that goods disappear from inventory, but no sale has been recorded. Inventory comparisons can reveal the fraud, as can analytical procedures such as gross profit analysis."

Bank deposits that don't match cash receipt records are another telltale sign. "Cash larceny involves diverting funds after they're on the books—it's clearly outright theft," she said. "An example might be an employee who steals checks or cash before they can be deposited at the bank. The best detection method is to compare receipt records to deposits. Data analysis software can help an organization check for this kind of fraud."

Checks made payable to an employee, an unknown person, an unapproved vendor, or "cash," are another warning flag. "Any of these are signs of a kind of check fraud known as a 'forged maker scheme' where an employee intercepts, forges or alters one of the organization's own checks," said Sawhney. "Usually, the check is made out to the employee, but it might be made out to an accomplice, an unknown vendor, or simply to cash. Strange endorsements can also be a sign of fraud, as can missing checks or missing disbursement documentation."

She said organizations should also beware of payroll fluctuations—or poorly documented employees on the payroll. "In a payroll scheme, fictitious employees are added to the company's payroll. If you find unusual fluctuations in payroll, or employees with minimal or no personnel records, or employees with missing social security numbers receiving payroll checks, you should suspect payroll fraud," said Sawhney. "High overtime for a particular job category can be a red flag, as can discrepancies between net payroll and payroll checks issued."

Changes—or unusual patterns—in employees' expenses are another red flag. "It's common for employees to commit fraud by inflating their expenses or submitting fictitious expense reports," warned Sawhney. "Look for unusual fluctuations or changes in patterns in employees' expenses. Also watch for expenses that end in round numbers, recurring expenses for the same amount, and expenses that fall just below the reimbursement limit. This is another area where data analysis software can reveal the patterns and help detect the fraud."

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