

## **Morrison & Associates, CPA's PLLC**

### **Fraud Detection & Prevention**

In the present business environment, owners and managers of closely held enterprises have to be both astute at managing day-to-day operations and also acutely aware of the need to safeguard the assets that have already been accumulated. The following data will provide you with some guidance regarding fraud detection/prevention and insurance coverage.

#### **I. EMBEZZLEMENT**

Government statistics reveal that employees pilfer billions of dollars in money and goods from their employers, and this crime is rising by 15% annually.

The typical profile of an embezzler may come as a surprise. He or she is between the ages of 26 and 45, has above average intelligence, and has worked his or her way into responsible positions, making theft easier. The majority of embezzlers act alone. Many times, the embezzler is a newly-hired employee.

Weaknesses in internal controls of a company can help embezzlers flourish. The weaknesses include failure to segregate jobs, such as authority to make purchases and authority to write checks, inadequate record keeping, and no performance reviews of the employee.

#### **A. The following are some danger signs of embezzlement:**

1. Unusual rise in accounts receivable write-offs.
2. Unexplained differences between physical inventory counts and inventory records.
3. Missing files.
4. An employee who never takes a vacation or days off. Maybe this person is super dedicated, or maybe the person can't take the chance of someone else taking over and finding out what he or she has been up to.
5. Extremely complicated accounting entries.
6. Unusual and unexpected decrease in profits.

Obviously, one or more of these signs does not necessarily mean an embezzler is at work. But a business owner should be alert to the possibility. You can deter thieving tendencies by close involvement in the company's day-to-day activities.

**B. Weaknesses in controls:**

Some of the most commonly overlooked weaknesses that make embezzlement easier for the dishonest employee are as follows:

1. Checks received in the mail go directly to the person who records, posts them and prepares the deposits, with no independent record being made of the receipts.
2. Bank statements go directly to the person who reconciles them.
3. Checks and cash are allowed to accumulate before being deposited.
4. Cash sales are loosely handled and sales slips are not accounted for by renumbering.
5. There is no separate cashier to reconcile daily cash receipts with sales slips.
6. Cash register amounts are not compared with bank deposits.
7. Monthly statements are mailed by the very same person who works on accounts receivable without being checked by a superior and compared to the accounts receivable schedule.
8. Customers report discrepancies on their statements, but no one in authority attempts to reconcile them.
9. Accounts receivable are never confirmed with the customer.
10. Uncollectible accounts are simply written off without being first turned over to an attorney or collection agency for collection.
11. No one bothers to count and review petty cash because the fund is only a few hundred dollars.
12. Petty cash slips are made out in pencil and are not canceled after use.
13. No one cancels invoices, vouchers, supporting documents and checks to make sure they are not resubmitted for payment.
14. Invoices are often paid without the initials of the person who is supposed to authorize their payment.
15. The person authorizing payment of invoices does a perfunctory examination of the supporting documents; receiving reports, purchase requisitions, freight bills, etc.

16. Physical inventories are not compared to book inventory figures and differences satisfactorily explained.
17. Anyone with packages can walk out of the plant or other facility without question.
18. Payroll checks are distributed by the same person who prepares the payroll or maintains the time records.
19. The person signing payroll checks does not scrutinize the payroll, has little idea of its approximate total or who the employees are.

Some businesses may not have sufficient personnel to provide the desired segregation of functions, but if the proper procedures are carefully followed, they can reduce the possibility of losses due to employee dishonesty.

## **II. REVIEW OF COMPANY'S INSURANCE COVERAGE**

How long has it been since your company's insurance coverage was reviewed? In these days of rapidly changing values and increased risks, a periodic insurance review is highly recommended.

The following checklist, which is organized by the major types of coverage, may help you identify areas of vulnerability in your company's insurance coverage.

### **A. Property and Casualty Insurance:**

#### 1. Liability

- Are the policy limits high enough to cover the company's exposures and protect its assets? (An excess liability or umbrella policy can provide higher limits, often at minimal cost.)
- Is the coverage broad enough? (Since most policies have many exclusions, endorsements may be added to cover some of the excluded risks.)
- Are key employees included as additional named insureds? (If not, should they be?)
- Does the premium base include employees who should be excluded? Many liability policies are based on payroll and companies often report total salaries and wages to the insurance company instead of deducting excluded salaries.

## 2. Property

- Should any exposures be self-insured?
- Do actual property values greatly exceed the insured values?
- Are deductibles realistic?
- Have co-insurance clauses been complied with? (If not, there may be a problem in the event of a loss.)
- Is there business interruption coverage? (Many companies go out of business after a loss because they don't have the necessary capital to pay continuing expenses until normal operations resume.)
- Are you covered for the expense of reconstructing records, such as accounts receivable?
- Does it pay to have blanket insurance covering several locations?
- Is there proper coverage on goods in transit, both incoming and outgoing?
- Is inventory covered by a reporting form contract or by peak-season endorsement? (This is important where there are wide inventory fluctuations.)

## 3. Automobile

- Are the policy limits high enough? Should an excess liability policy be purchased?
- Are the deductibles for collision and comprehensive coverage realistic? (Premium costs can be reduced by increasing deductibles.)
- Should property damage be self-insured?
- Is the personal injury protection for owners and key employees sufficient?
- Does the policy contain employee non-ownership coverage?

#### 4. Fidelity

- Is there sufficient protection against employee dishonesty? (The absence of fidelity coverage is probably the greatest gap in most insurance programs.)

### **B. Employee Benefit Plans:**

#### 1. Major Medical

- Are the maximum benefits sufficient to take care of catastrophic illnesses?
- Are premiums being paid on employees who are no longer with the company?

#### 2. Salary Continuation (Sick Pay)

- Are the plan benefits realistic?
- Does the plan include employees whom the company would rather not cover? (If so, can these employees be excluded?)
- Is inventory covered by a reporting form contract or by peak-season endorsement? (This is important where there are wide inventory fluctuations.)

#### 3. Life Insurance

- Are the benefits commensurate with responsibility and authority?
- Does the company have insurance on key employees? (If not, should this be considered?)
- Has coverage intended to fund a buy-sell agreement been brought up to date?
- Should split-dollar insurance be purchased?
- Is there travel accident coverage? (If not, should there be?)
- Is your coverage at competitive rates?

We have attached a list of some common embezzlement methods.

[Insert Company Name] will be pleased to discuss any questions you may have regarding the safeguarding of your assets.

## **SOME COMMON METHODS OF EMBEZZLEMENT**

### **Misappropriation of Cash Receipts**

#### **A. Cash sales** (both by salesmen on premises and salesmen in field).

- Covered by:
1. Not recording sales; destruction or omission of sales slips.
  2. Tampering with cash register tapes; understating footings of cash sales reports.
  3. Charging customer more than duplicate slip shows.
  4. Controversial charges collected, but reported as uncollectible.

#### **B. Collections on accounts and notes receivable**

- Covered by:
1. Lapping (both of bank balances and - with currency collections - petty cash).
  2. Kiting, or inter-bank check transfers.
  3. Write-off of accounts as uncollectible.
  4. Improper credits for allowances or discounts.
  5. Entry in customer's accounts only, concealed by:
    - a. Over-footing of cash receipts book and tampering with adding machine tapes.
    - b. Tampering with bank statements, pass books, and customers' statements.
    - c. Insertion of fictitious ledger sheets at time of audit.
  6. Reporting fake robberies of cash.

#### **C. Receipts of miscellaneous income and credits**

- Covered by:
1. Not recording (including proceeds of illegitimate note executed to company bank).
  2. Recording as exchange item.

## **Misappropriation of Disbursements**

### **A. Cash on hand**

Covered by:

1. Cashing vouchers a second time.
2. Payment of same expense out of petty cash and by check.
3. Use of fictitious vouchers.
4. Raising amounts on legitimate vouchers.
5. Cashing worthless "exchange" checks.
6. Unauthorized borrowing by employee.
7. Unclaimed wages and dividends pocketed, or check endorsements forged and cashed through petty cash fund.
8. Transfer of cash from one fund to another at time of audit.

### **B. Cash with banks**

Covered by:

1. Fictitious creditors' invoices (checks cashed through petty cash, secret or falsely named bank accounts, or forged endorsements).
2. Increasing amounts on creditor's invoices; refund of excess pocketed or split with creditor.
3. Paying creditor's invoices twice and appropriation of second check.
4. Failing to record purchase returns, allowances, and discounts, and appropriating check or cash payments therefor.
5. Payment of fictitious refunds or allowances.
6. Increasing telephone and electric bills, etc., by employee's personal bills from same utility.
7. Making off with check property drawn to creditor.
8. Padding payrolls as to rates, time, production or number of employees.
9. Fictitious "advances" to employees, and neglecting to deduct them from subsequent payrolls.

10. Duplicating payment for same payroll or invoice by two checks signed by each of two authorized officers or partners.
11. Appropriating check to "cash" or bank, supposedly for creditor's account, payment of note or expense.
12. Buying improper disbursements in personal accounts of partners and officers.
13. Altering name of payee or increasing amount of check after signature.
14. Forging checks and destroying them on return by the bank; concealed by forcing footings in cash book, or raising amounts of legitimate checks.
15. Mingling cashier's funds with company funds and withdrawing company's funds after cashier's are exhausted.
16. Charging illegitimate withdrawals to fictitious customers' accounts.

**Securities (owned or held for safekeeping)**

- A. Unrecorded illegitimate sale, or hypothecation for speculation.
- B. Utilizing securities of one company as cover for appropriation of securities of another, by officer or both.
- C. Misappropriation of coupons on bonds and dividends.

**Merchandise**

- A. Illegitimate removal of merchandise.  
Covered by:
  1. Overstatement of lists of physical inventory.
  2. Unauthorized requisitions.
  3. Entry only in stock records of fictitious purchase returns.
- B. Reporting as received, items not received (usually associated with collusion between the creditor and the receiving clerk).

**Miscellaneous**

- A. Undercharging customer (through reduction in unit prices, quantities or calculation).
- B. Allowing officer or employee free services or merchandise, or at reduced rate, when not entitled thereto.
- C. Manipulating financial showing to secure excessive commissions, bonuses or dividends.