Detecting and Deterring Embezzlement in the 21st Century

By Frank W. Abagnale

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"If you make it easy for people to steal from you, they will."

Over the years I have found this simple principle to hold true: Most crimes committed are crimes of opportunity. For example, if you do not want to be a victim of check fraud, use highly secure checks and Payee Positive Pay. If you do not want to be embezzled, follow appropriate internal safeguards. In most embezzlement cases, basic controls would have prevented or substantially reduced the losses.

Each year for the last several years, embezzlement has made new records, surpassing the previous season's "blockbuster year." With the turmoil and disarray caused by COVID-19, it's likely the upward spiral of internal fraud will continue for some time to come.

The following is a summary of research to better understand the mechanisms of embezzlement and protocols to detect and deter it. In developing this list of recommendations, I have solicited the comments and experience of Greg Litster, president of SAFEChecks, a former 18-year senior-level banker and expert witness in national and international embezzlement cases, and the research of Robin Johnson of SAFEChecks, MBA and MAPP (Master of Applied Positive Psychology, Penn). Their insights also draw from embezzlement studies conducted by the Association of Certified Fraud Examiners (ACFE), Hiscox USA, Marquet International, and others. (See Resources below.)

Real Life Examples

- Two sisters working as "lunch ladies" embezzled almost $500,000 from two school cafeterias over five years. Officials found inconsistencies in how cash was handled and asked police to investigate.

- A high-end New York department store suffered $430,000 in fraudulent purchases by employees who used stolen credit card information to buy designer goods on store computers. The employees then sold the designer goods on the black market before being caught.

- The chief fiscal officer of a state agency wrote checks to herself using the agency's bank account and with the help of her son who also worked there, created bogus invoices from vendors. During a seven-year period the CFO and her son embezzled over $1 million from the organization.

Every type and size of organization has suffered embezzlement losses, and a typical organization loses 5% of annual revenue to fraud. This has resulted in bankruptcy or layoffs, cutbacks, and salary freezes, and damaged reputations. The victims are not only the organizations, but their partners, suppliers, vendors, customers, clients, and families. The 2020 Hiscox Embezzlement Study found that typical losses from "occupational fraud" in the United States surpassed $500,000, and 55% of victim organizations recovered <u>none</u> of their losses.

The Psychology of Embezzlement

Internal fraud occurs when the "fraud triangle" is present – motive, opportunity, and rationalization. Workplace conditions are a major predictor of fraud, and usually reveal overconfidence on the part of owners and managers and a lack of preparation in establishing effective fraud prevention controls. In almost 30% of cases there were no internal controls to prevent embezzlement, and the number rose to over 40% of small business cases. In 19% of cases, controls were in place but were overlooked or were overridden by upper management. In 18% of cases there was a lack of management review.

An overlooked but vital factor is the *tone* set by executives, especially in cases over $1 million. An unethical management tone contributing to fraud includes "wheeler-dealer" attitudes and behavior, overriding established safeguards, and pressuring employees to meet unrealistic goals.

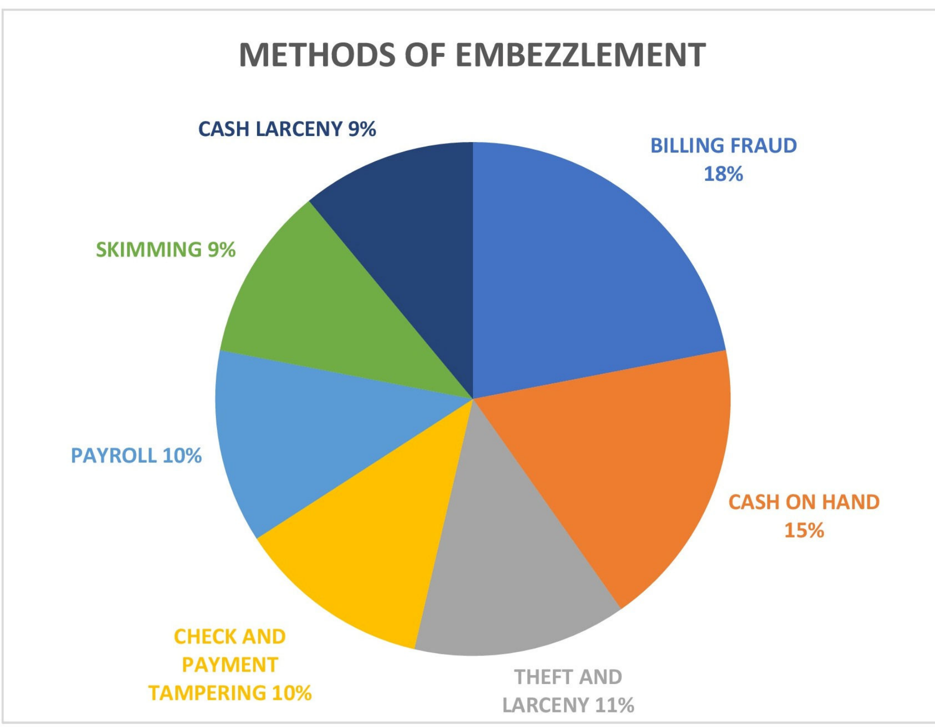
There are six behavioral "red flags" which have been the most common in every internal fraud study conducted by the Association of Certified Fraud Examiners since 2008. Managers, employees and auditors should be educated on these common behaviors to help spot fraudulent activity. Those who ignore these red flags do so at the company's peril. These red flags are:

- Living beyond one's means
- Financial difficulties
- Being unusually close to a vendor/customer
- Control issues, such as being unwilling to share duties or take vacations
- Divorce/Family problems
- A "wheeler-dealer" attitude

Other motivating factors include a shopping addiction, substance abuse, an attitude of entitlement, a desire to support a romantic relationship, and a gambling addiction. In the cases where gambling addiction was the primary motivator, all but three occurred in states where casinos and/or Indian gaming facilities were permitted. Also, employees who feel unfairly treated sometimes believe they can get "justice" by embezzling.

Methods of Embezzlement

Organizations of different sizes have different fraud risks. For example, corruption is more prevalent in larger organizations, while check and payment tampering schemes are more common in small organizations. Review Resources (below) to determine your organization's and industry's risks.



Who embezzles?

Embezzlers were most likely to hold accounting or upper management positions. Although studies vary whether males or females embezzle more often, males have always caused the greatest losses. The perpetrator's level of authority was strongly linked to the size of the fraud. In the cases studied by ACFE, the median loss in the schemes committed by an owner/executive was $600,000. This was significantly higher than the median loss caused by managers ($150,000) and regular employees ($60,000).

The majority of embezzlers are in their early 40s, but the greatest losses come from those aged 60 and above. In some studies, about 40% had been at the organization for one to five years, and over 50% had been there more than five years. Almost 80% of the schemes involved more than one person, and usually involved three people.

Only about 5% of perpetrators had previously been convicted of a fraud-related offense, so background checks, while important for other reasons, are ineffective in preventing this type of crime.

Detecting Embezzlement

Most embezzlement schemes are long-term, with over 70 percent lasting more than a year, and a few lasting decades. Anonymous tips are one of the most important means to detect fraud. Almost 40% of all cases were detected by a tip, higher than any other detection method, including audits. Organizations without tip hotlines had almost twice as many median losses as those with a hotline.

Tip hotlines should be designed to receive tips from both internal and external sources, and should allow anonymity, confidentiality, and include a reward. Tip hotline reporting programs should be publicized to employees, as well as outsiders. Employees, noticing that something was amiss, provided more than half of all tips that led to the discovery of fraud. Customers, vendors, and even competitors have also provided valuable tips on fraud.

Management review and internal audits are the next most common forms of detection. One of the least effective methods of detecting fraud was through external audits of financial statements. In fact, more fraud was discovered by accident than by external audits! While external audits are important, they should not be solely relied upon to detect embezzlement.

Strategies for Preventing Embezzlement

Having anti-fraud controls in place – and following them – directly led to quicker detection of embezzlement schemes and lowered fraud losses. Companies without these controls experienced almost twice as many losses as those with controls.

In addition to the hotlines, management reviews, and internal audits mentioned above, organizations can reduce losses by establishing employee support programs that help employees struggling with gambling or drug addictions, mental or emotional health, and family or financial problems.

Surprise audits can be an effective deterrent. They provide a psychological benefit: potential embezzlers believe that they will be caught.

Additional internal controls include a separation and rotation of duties, proactive data monitoring and analysis, mandatory vacations, written protocols for issuing and reconciling checks, proper documentation of payments and receipts, and independent verification of all new vendors and any change of remittance or banking information for existing vendors.

Education is significant element in an effective fraud prevention program. Organizations with anti-fraud training programs for employees, managers, and executives have fewer losses and shorter durations of fraudulent schemes than those without these programs. Training should include what constitutes fraud, how it hurts everyone in the company, and how to report questionable activities.

Using your bank's Lockbox service is the best and most cost-effective way to prevent embezzlement via diverted deposits.

Certain schemes are more prevalent based upon the industry or department. Organizations need to consider the specific fraud risks they face when deciding which controls to implement.

The Internal Revenue Service requires embezzlers to report embezzled funds as income in their annual tax filing; compliance is rare. Failure to report embezzled funds as income can result in tax evasion charges. The threat of the IRS should be well-publicized to deter would-be embezzlers.

Since most losses will not be recovered, it is advisable to obtain appropriate "crime and fidelity coverage" for fraud losses.

If You Suspect Embezzlement

DO:
- Create a small internal team to confidentially investigate.
- Bring in outside help as needed to add objectivity and deal with complex situations.
- Take thorough notes on the various steps in the investigation.
- Examine pertinent records.
- Restrict access to bank accounts, credit cards, etc. by those who are under suspicion.
- Find witnesses.
- Correct internal controls that allowed fraud to occur.
- Praise honesty.

DON'T:
- Rush to judgment or confrontation.
- Conduct group interviews.
- Interview employee alone.
- Interfere with law enforcement.

Resources
Association of Certified Fraud Examiners "Report to the Nations" (2010 – 2020)
Hiscox Embezzlement Study (2016 – 2018)
Marquet International "Marquet Report on Embezzlement" (2010 – 2014)
"Effective Solutions for Combating Employee Theft –Implementing and Managing a Fraud Hotline" by Donald L. Mullinax, ACFE 2004
"Enemies Within" by Joseph Wells, ACFE 2001
http://topics.law.cornell.edu/wex/embezzlement

Frank W. Abagnale is one of the world's most respected authorities on secure documents, embezzlement, and forgery. For over 40 years he has lectured to and consulted with hundreds of financial institutions, corporations and government agencies around the world, including the FBI.

Mr. Abagnale believes the punishment for fraud and the recovery of stolen funds

are so rare, prevention is the only viable course of action.