



## Embezzlement Prevention and Detection for Small and Mid-size Businesses and Tax Exempt Organizations

The purpose of this article is to provide information to small and mid-size businesses and tax exempt organizations about embezzlement prevention and detection. This is not the first article we have published on the topic and, unfortunately, it will not be the last.

According to the U.S. Federal Bureau of Investigation embezzlement is the *unlawful misappropriation by an offender to his/her own use or purpose of money, property, or some other thing of value entrusted to his/her care, custody, or control*. It is a serious problem in the United States. Some estimate that annual embezzlement related losses are now up to about \$600 billion dollars per year.

It might be argued that small and mid-size businesses and tax exempt organizations are more susceptible to embezzlement than large businesses. Unlike large business, they do not have the resources to establish sophisticated internal controls. For example, in a small tax exempt organization a bookkeeper's routine duties might require him/her to issue invoices to customers, record the receipt of the customer payments and then deposit the amounts in the organization's bank account. The lack of other individuals involved in the process could provide opportunities for the embezzler. For instance, the bookkeeper/embezzler, without the knowledge of management, could simply establish a separate bank account, deposit a customer's check in the account and then cover up the misappropriation by crediting the customer's account using one or more bogus transactions. If the bookkeeper has access to incoming mail along with the general ledger, it would be easy to perpetuate the fraud with little risk of detection.

Given the lack of resources to develop and maintain sophisticated internal controls, how might the small or mid-size organization prevent embezzlement? Well, to be honest, it's virtually impossible to **prevent** embezzlement. As they say, *if there's a will, there's a way*. On the other hand, management could make it more difficult for the would-be embezzler by the implementation of policies and procedures designed to **reduce the opportunities** to steal.

Good **internal controls** can not only make it difficult for a thief but they could also enable management to detect embezzlement when it occurs. While this article is not designed to cover everything about internal controls, a few simple steps are worth mentioning.

- Adopt a policy of **mandatory vacations and mandatory duty rotations**. It is not uncommon for the embezzler to interfere with the customary workflow to effect the embezzlement. However, if your policies require the embezzler to give up control of his/her work, he/she will recognize that the fraudulent scheme might be more easily detected, and thus be detoured from committing the illegal act.
- Establish a **hotline for whistleblowers** and train employees how and when to use it. While most hotline calls do not trigger fraud investigations, one of the best ways to detect fraudulent activity is through other employees. Let employees know about the organization's ethics from the top down. Explain that any unethical conduct imposes costs on everyone. Employees who believe that they are being monitored are less likely to steal.
- **Don't hire thieves**. This means that if you intend to place an individual in a position of trust, you should conduct a background check. The typical background check involves employment and education verifications, reference checks, criminal conviction checks, drug screenings and a credit check. You may need the candidate's consent prior to conducting some components of your background check, so you should seek the advice of a qualified attorney.
- Conduct periodic **surprise internal audits**. These are most effective after identifying high risk areas and designing procedures to achieve the desired objectives. It is not uncommon for management to engage a qualified CPA to help them plan the audits and perform the procedures. It is important to note that simply knowing that the organization has a policy of conducting surprise internal audits can act as a deterrent to the would-be embezzler.

In addition to internal controls, one should be mindful of the *motivating factors* that could drive one to steal. It might be surprising to learn that greed may not always be the motivator. Moreover, recognition of these factors could help identify risks so you can prioritize your prevention efforts. Some factors follow (the list is not all inclusive).

- Family drug, alcohol or gambling problem
- Deteriorating health of a family member
- Death of a family member
- Extramarital affair
- The assumption of too much debt
- Embarrassment because of lack of material possessions
- The outward desire to be accepted by an affluent group

You might also be surprised about the *characteristics of the typical embezzler*. While the list that follows should not be considered a profile, it should give you a general sense of one's risk areas.

- The amount of the embezzlement is generally larger for long term employees.
- While over two-thirds of all embezzlers are between 31 and 50 years old, those in their 60s caused the largest loss per incident.
- The higher the embezzler's education level, the larger the loss per incident.
- Over 60 percent of all embezzlers were men.
- About 75 percent of all embezzlers work in accounting, executive, sales, or customer service positions.

We found it most unsettling to find that a high percentage (one study found 40%) of fraudulent cases involved *collusion* with others. These schemes are not only the most difficult to detect, but they are by far the most costly.

Finally, *don't rely on your CPA* to detect embezzlement during his/her normal end-of-year engagement. That might sound counterintuitive but the fact is that only about 5 percent of all fraud is detected by external auditors. If you want your CPA to help improve the chances that fraud will be detected if it exists, consider engaging him/her to design and perform custom tailored procedures (see *surprise internal audits* above).

Embezzlement prevention and detection is not an exact science. All your best efforts may not prevent it and if it occurs it might not be detected for years! Nevertheless, it would be imprudent to rely on your instincts or hope that it will never happen to your organization. And, although you may not have the resources of a large business, there are indeed certain important yet inexpensive steps you can take to reduce your risks. We trust that this article has given you a few ideas.

If you have any questions or if you need more information please do not hesitate to contact Vincent Ruocco, LLC, CPA at 203.932.2931.

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