

Are You Teaching Your Employees to Steal?

By Gary D. Zuene, CPA

My Employees Wouldn't Embezzle: Yeah, Right

Have you taught your employees to embezzle? Yes No

“Yes” is the right answer.

Here's a typical situation: You have an employee working out of town for several weeks. One evening, she has dinner and returns to the hotel room. Flipping through the TV channels, she watches a movie. What's on the hotel bill when she checks out the next day? \$5. For what? A pay-per-view movie. The employee submits her expense report for the week. The hotel bill is \$500. What does your accounts payable clerk do? She crosses off the \$5 movie charge and reimburses the employee \$495 for the hotel bill. Why? Because movies are a personal expense and against company policy.

What does the traveling employee do on the following week's expense report? Records a fake charge—for how much? Not \$5. Maybe \$15, \$20, or more (revenge—the employee is mad) for a taxi, meal, or any expense under the maximum that doesn't require a receipt. What's the employee thinking? “I'm out here working my butt off—10 or 12 hours a day. I'm earning this company three times my salary of \$65,000. I'm missing my kids' soccer games and parent-teacher meetings. And some \$12-an-hour A/P clerk dings me for five bucks? She's home sleeping in her own bed, giving her kids hugs and good-night kisses.”

What did you do in that two-week period? You taught the employee that in order to be treated fairly, she has to cheat—to embezzle. The following week's expense report complied with the company policy, but the policy “drives” employees to behave in a manner you don't want. Not only does the employee resent the way she was treated, but her productivity drops while she's plotting how to get repaid. Result: Your loss is much greater than \$5. But since lost productivity isn't explicitly measurable, you don't even know it.

WHAT ARE EXPENSE REPORTS?

How would you like to get rid of an entire process on which you spend a ton of time but doesn't earn the company a dime and also causes other employees to call you “bean counters”?

Question: What are expense reports?

Answer: A complete waste of time.

Let me give you a personal example. I have a speakers bureau for white-collar criminals called “The Pros & The Cons.” My ex-con speakers have committed frauds of up to \$350 million. We're on the road a lot, so travel expenses are significant. To make their lives easier, I charge their plane fare and hotel room and tax to my American Express card (so

I get the frequent flyer miles). The first year I reimbursed their miscellaneous travel expenses. They had to prepare a report. We had to foot, cross-foot, look at receipts, and finally write a check two or three weeks later. It was very time consuming and didn't make me any money. I realized reviewing expense reports was a complete waste of my time, and I wanted out of the "control business."

I analyzed this process and found that miscellaneous travel expenses (meals, tips, taxis, and so on) ran about \$75 to \$80 per day. So I told all my speakers that we would give them \$100 per day for miscellaneous travel expenses. When I reimbursed their expenses, they would take a taxi from the airport to the hotel for \$30 and have dinner at the hotel for \$45. Now that they get \$100 per day for these expenses, they take a \$12 shuttle to the hotel. And where do you think they have dinner? At McDonalds. And here's the best part. I don't care how they get from the airport to the hotel or where or what they have for dinner. And my ex-cons love it. I can pay them as soon as they are done. No more filling out an expense report, then waiting two or three weeks for the check. (Ex-cons have significant cash-flow issues.)

The \$100 per day is included in the Form 1099-MISC each year. It's up to the speakers to save their receipts for tax purposes. There's no magic about \$100 per day. Nor does the daily reimbursement have to be the same for the entire country. It can vary by how expensive the area/city is. Notice what has happened: My speakers get paid faster, with significantly less work on both our parts. Since they eat and travel cheaper, they make more without increasing my cost. It's a win-win structure. But when employees get both a W-2 and 1099—something independent contractors don't have to worry about—the situation becomes more complex. Consult a tax expert.

FRAUD AND ABUSE ARE COSTLY

Fraud and abuse cost the U.S. economy \$400 billion a year. That translates into 6% of revenue or \$9 per day, per employee.¹ And relatively speaking, small companies are at a higher risk of fraud than large companies. Why? Because small companies don't have as sophisticated systems of internal controls as large companies.

And the situation is getting worse. A recent Association of Certified Fraud Examiners survey of executives found that:

- 67% said fraud is worse today than five years ago;
- 70% said fraud detection is getting better (that's encouraging);
- 75% said fraud detection resources aren't adequate; and
- Asset thefts made up 82% of the cases.

Example: The headline screams, "'Trusted' worker stole \$1 million."² Beverly Kunkel not only was a trusted secretary who handled bookkeeping for Kendrick Mollenauer Painting, she was the wife of a lifelong friend of the company president.

"When Ford married Beverly, his second wife, we took her in like one of the family." She worked at the painting company 13 years and embezzled for 11. Kunkel was sentenced to eight to 15 years. Hired in 1985, she told the owners she had been unfairly fired from a prior job when \$50,000 was missing. She admitted that theft also. When Kunkel told the owners customers were slow pays, they withdrew savings to pay bills. They also noted that Kunkel had embezzled more money in a year than they both had earned, combined. The company has received about \$135,000 in restitution.

MY EXECUTIVES WOULDN'T STEAL

And don't think fraud and abuse are limited to lower-level employees. At a recent seminar, I asked the 200+ CFOs in attendance, "How many of you have executives that steal?" Three or four brave souls raised their hands. Then I asked, "How many of you do the company's tax return?" Everyone held a hand up. Last question: "Now, again, how many of you have executives that steal?" Everyone roared and raised their hands.

When the executive pays for the mostly personal trip to Las Vegas with company funds, it's called "tax fraud." When the bookkeeper, who hasn't had a raise in three years, writes the \$5,000 check to the executive for the trip, it gives everyone in the company permission to steal. You can't expect any better ethical behavior from employees than executives exhibit.

NOW YOU'RE BEING SUED

The risk of this culture isn't just to the company. It can put you at risk personally. Let's assume you prepare and/or sign the company's tax return. And the return has those trips to Las Vegas for the past five years. Now the company gets into financial difficulty. It can't pay the bank loan, or the stock price declines 30%. In addition to suing the company, the plaintiffs' attorneys sue you personally. You. The following exchange takes place while you're on the stand trying to defend yourself:

ATTORNEY: Mr. Wilson. You were the company's chief financial officer. Is that right?

YOU: Yes.

ATTORNEY: And you have the highest standards of integrity?

YOU: That's right. (What else are you going to say?)

ATTORNEY: But yet, it's okay with you if the company's executives commit fraud and embezzle, isn't it?

YOU: No. Of course not.

ATTORNEY: Isn't this your signature on the company tax return?

YOU: Yes.

ATTORNEY: Then how do you explain this \$5,000 for the CEO's personal trip to Las Vegas the past five years?

YOU: But it's only a small amount. We're a \$250 million company.

ATTORNEY: So your company saved \$2,500 each year in taxes. Now Mr. Wilson, who had to make up that shortfall? (Answer: the members of the jury.)

YOU: (Dumbstruck at this point and fidgeting for an answer. [No answer will get you out of trouble with the jury.]

ATTORNEY: Clearly, it's okay with you if the CEO steals a little bit. So tell me, Mr. Wilson, how much does the theft have to be before it's not okay with you?

What do you say at this point? Nothing. You're done. You're now protesting that the attorney backed you into a corner. No. You backed yourself into a corner by allowing deductions that are illegal. The fact that it's only \$5,000 does not make it legal. Plaintiffs' attorneys are very good at asking questions that have no right answer, like, "Have you stopped kicking the dog yet?" Understand the risks you're taking. It's your decision.

WHEN DO PEOPLE EMBEZZLE OR ABUSE THE COMPANY?

Generally, three things have to be present before someone commits fraud or embezzles: need, opportunity, and rationalization. This is known as the "triangle of fraud." (See Figure 1.)

Need takes two forms—direct and indirect. Direct need is stealing to fund cash needs and is often driven by an addiction—drugs, alcohol, gambling, or an extramarital affair. So the next time someone brags about an affair, warning flags should go up. Indirect need, on the other hand, is usually keeping the company afloat. This results in cooking the books to make sure the loan is obtained or

Figure 1: Triangle of Fraud



renewed to buy time to fix the problem.

Opportunity is defined as the perception that there's a low probability of being detected. In accounting we call this "poor internal controls."

Rationalization is the employees' mental process of making the action fit within their personal code of conduct. In other words, the employees must be able to "talk themselves into the action"—"the ends justify the means."

RATIONALIZATION OFTEN RESULTS IN "SITUATIONAL FRAUD"

Employees' propensity to steal or embezzle can be described as a normal distribution. (Remember that from college?) About 5% to 10% of employees would never—ever—do anything wrong. About 5% to 10% of employees are always scheming. (I hope you don't have many such folks working for you.) The real problem is that 80% to 90% of employees who'll commit "situational fraud." Remember: Who are the only employees who can steal from you? Employees you trust. This isn't meant to imply you shouldn't trust your employees. It simply means you don't go soft on internal controls because you trust employees.

Here are some warning signs and risks to watch for:

- Employees who are being downsized;
- Employees who are bored and may steal for excitement;
- Employees who make an honest mistake, discover a hole in internal controls, benefit from it, and are going to "pay it back";
- Thrill seekers who like bending the rules;
- Employees who are under personal stress: money, divorce, illness (especially spouse or children);
- Employees whose financial problems suddenly disappear;
- Employees with addictions: drugs, alcohol, extramarital affairs, gambling;
- Employees who always have to be number 1 and/or can't stand not being the center of attention.

CREATE A "SELF-CORRECTING" SYSTEM

Modern CFOs know a lot about human behavior. Behavior never remains static. World-class CFOs understand that any time they change a reward, the compensation system, or the control system, people will always change their behavior to maximize the benefit to themselves.

Example: Many years ago traffic engineers set out to reduce the accident rates at intersections. They set up cameras and videotaped the traffic patterns. At that time, the green light would turn red and the red light would turn green at the same time. But that one last car tried to get through while cars with the green light had permission to go. So the engineers changed the sequence to add two or three seconds' delay (both lights are now red), giving that one last car time to go through the intersection. The accident rate declined significantly for two or three months. Then what happened? Drivers coming to an

intersection with a yellow light or just-changed-to-red light realized they had several extra seconds to make it through the intersection. Instead of one car going through on the red, now it's three or four. The drivers adjusted their behavior to benefit themselves.

Change the compensation system, and employees will change their behavior. Count on You may solve one problem but create an even worse problem. Hockey players don't skate to where the puck is, they skate to where the puck is going to be. To become an indispensable member of the management team, you must anticipate how employees (and executives) will react to any changes.

MINIMIZE FRAUD

Sometimes you can minimize risks with a little creativity. For example, an owner of a small company where there's little segregation of duties can have the bank statement sent to his or her home, not to the company. To show he/she's paying attention to the statements, the owner reviews them and then asks about several items in each statement. This procedure creates the perception that a theft will probably be detected, thus reducing the "opportunity" and increasing the risk of getting caught. Minimizing the opportunity for theft and embezzlement is probably the most powerful deterrent—they might "get caught." (This would have prevented/detected Beverly Kunkel's \$1 million embezzlement.)

If you're an outsider (accountant, auditor, whatever), be aware that you have to "sell" this idea from the bottom up. Few small business owners will make this change. It sends the message to the long-time employee that he or she isn't trusted anymore. Get the employee (probably a bookkeeper or controller) to ask for the change. Say, "You know, you have complete control of everything. You pay the bills, you make the bank deposits, and you reconcile the accounts. If any money is missing, who do you think Sally (the owner) will suspect? For your own protection, you should get Sally to look at the bank statements and initial the envelope every month. I know she's busy, but it won't take her more than five or 10 minutes."

DRIVE BEHAVIOR

Theft and embezzlement are a serious drain on company resources. Your job as CFO is to protect the company's assets. Simply assuring compliance with company policy isn't enough. World-class CFOs create self-policing or self-correcting systems. You must understand how your internal controls, compensation, and measurement systems drive behavior and structure them so people will do what you want without intervention. The job of the 21st Century CFO is to "drive" the desired behavior.

Less work. Happier employees. More profits. Anyone interested?

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1 Report to the Nation on Fraud and Abuse, Association of Certified Fraud Examiners, 1995.

2 The Columbus (Ohio) Dispatch, April 11, 2000, p. A1.

3 The Wall Street Journal, September 8, 1999, p. A1.