

Tell Tale Signs: The Red Flags of Employee Fraud

Date: March 17, 2015

Original Newsletter(s) this article was published in: Employment Update: March 2015

Employee embezzlement and fraud cost Canadian employers hundreds of millions of dollars in losses every year. BBCG Claim Services, the leading fidelity insurance claims adjusting firm in Canada, receives an average of one new claim each day, with an average loss of approximately \$500,000. At least 20% of the claims involve under-insured employers.

Timely detection and handling of employee fraud is crucial. It can make the difference between a manageable loss with decent prospects for recovery, and a loss of hundreds of thousands (or even millions) of dollars with little or no prospects for any recovery.

This article canvasses some of the warning signs of employee embezzlement and fraud. We also examine some of the factors relating to payment processes and internal controls which either enhance the risk of employee fraud or - worse - indicate that it may already be happening.

Factors Relating to the Employee

There are several behaviours which may be suggestive of an employee's involvement in embezzlement or other fraudulent activity:

PERSONAL RISK FACTORS

Does the employee have debt or family pressures? Is the employee going through a divorce or separation? Is the employee a known gambler or "speculative" investor? Does the employee have any history of drug abuse? Is the employee, or his or her spouse, involved with an outside private business which could represent a drain on family finances?

REFUSAL TO TAKE VACATION/SICK DAYS OR REFUSAL TO SHARE DUTIES

Does the employee refuse to take his or her allotted share of vacation time (or any at all)? Does the employee refuse to share certain duties? Does the employee work outside of normal

business hours, when there seems to be no need to do so? Where an employee (i) is in a position to make or to receive cheques or other payments; (ii) is in an internal controls position; or, (iii) has financial or inventory record-keeping responsibilities, a refusal to take vacation or to share duties may indicate that the employee does not want anyone else to have access to records.

An employee's refusal to accept a promotion or transfer which would involve his or her losing primary access to payables/receivables processes, or to accounting records, may also be an indication of fraudulent activity.

RECENT CHANGES IN EMPLOYEE'S LIFESTYLE

Has the employee recently purchased a new property, vehicle or luxury good, or has he or she taken an expensive vacation? Does the purchase seem inconsistent with the employee's income, family income or other means? Such a development may merit discreet inquiries as to the source of the purchase funds.

THE "GAMBLING," "LOTTERY" OR "INHERITANCE" PRE-EMPTION

Some dishonest employees, anticipating questions surrounding questionable spending, seek to proactively deflect suspicion by announcing that they have won a large sum of money in a lottery, or through other forms of gambling, or that they have recently come into an inheritance. Significant lottery jackpots are typically publicized, with the winner's identity being made public through websites such as Ontario Lottery and Gaming Corporation's "Major Winners" page [http://media.olg.ca/?p=nmm_major_winners] or other press releases. This affords an employer some limited scope for verification of such claims.

UNUSUALLY CLOSE RELATIONSHIP WITH PURPORTED VENDOR

Does the employee act as the primary (or exclusive) contact for a particular vendor, while not doing so for other vendors? Does the employee seem to have an unusual degree of contact with the vendor? These may indicate that there is more to the relationship than meets the eye, and may merit further investigation with respect to the vendor's background or the goods or services which the vendor purportedly provides.

UNUSUALLY CLOSE RELATIONSHIP WITH AUDITOR

As strange as it sounds, a dishonest employee can seek to build a relationship with the employer's external auditor in order to gain the confidence of the auditor or colour the auditor's objectivity. This is seen more often with smaller employers and smaller accounting firms. In one case, the manager of a credit union worked assiduously to build a relationship with the accountant who had handled the credit union's audits for several years. Although the accountant was in no way dishonest, it was arguable that the accountant had lost objectivity as a result of the relationship, and did not pick up on evidence of malfeasance.

Factors Relating to Payment Processes and Internal Controls

There are several circumstances which either increase the risk of embezzlement or other fraud, or which indicate that such activities may already be occurring:

MULTIPLE ROLES/LACK OF SEGREGATION OF DUTIES

Does the employee occupy multiple key positions with access to the company's funds, banking records or accounting records? Is the same employee responsible for both preparing or drawing cheques for signature, and for signing them? Is the same person responsible for both payables and bank reconciliations?

PAYEES ON CHEQUES DO NOT MATCH GENERAL LEDGER ENTRIES

This may be indicative of inappropriate payments, and merits further investigation with respect to the entity that received the cheque.

"MIRROR" PAYMENTS

Where there are two or more identical cheque payments or wire payments in relative proximity, but to different vendors, this may indicate that one of the payments is fraudulent, but has been authorized on the strength of the supporting documentation for the other, legitimate payment. In one case, a bookkeeper showed the same supporting documentation to multiple signing officers, but covered the "payee" field on the cheque, thereby obtaining authorized signatures on multiple cheques in identical amounts. One cheque was directed to pay the legitimate expense, whereas the others were deposited into the bookkeeper's personal account.

MISSING VENDOR CONTRACTS OR VENDOR FILE MATERIALS

Employers should properly maintain vendor files, which should incorporate vendor contracts, current contact information and invoicing/payment history.

QUESTIONABLE INVOICES

Where invoices do not appear to have been prepared or printed professionally, or where they lack detailed information (i.e., missing contact information, or details regarding the goods or services provided), further inquiry may be appropriate. Also, if the invoices are serial-numbered, do the serial numbers "make sense" from the point of view of how often invoices are submitted, and with the known facts of the vendor's other customers or business activities?

PURPORTED VENDORS LACK LEGITIMATE WEB PRESENCE OR CONTACT INFORMATION

Where there is no independent corroborating evidence of a vendor's existence, such as a website, Canada411 search or other web presence, fraud may be occurring. Keep these points in mind:

- Most vendors of any substance use the Internet for promotional purposes. Even if a company does not maintain its own website, it may still be the subject of online reviews on sites such as Yelp [www.yelp.ca].
- A prudent spot-check would be to google a vendor's address, either as contained in the vendor contract or, more importantly, as used for cheque processing. Concerns arise where the address is: (i) non-existent; (ii) a residence, in circumstances where this does not make sense; or (iii) inconsistent with the address provided by the vendor's web presence.
- Other prudent spot-checks include verifying registration with the Better Business Bureau [<http://www.bbb.org/BBB-Locator/>]. In the case of corporations, federally-registered corporations are listed in Corporations Canada's online database [<https://www.ic.gc.ca/app/scr/cc/CorporationsCanada/fdrlCrpSrch.html>]. Some provinces maintain online databases as well. In other provinces, a corporate search is necessary.
- Almost all Canadian vendors are obligated to maintain HST numbers, and to include these numbers on invoices for goods or services. Where a purported Canadian vendor's invoice lacks a HST number (or where a Canadian vendor does not charge HST for goods or services sold domestically), further inquiry may be appropriate. The Canada Revenue Agency maintains a database of active HST numbers, searchable by number and transaction date: <http://www.cra-arc.gc.ca/gsthstregistry/>

CHEQUES PHYSICALLY TAKEN "OUT OF QUEUE"

If an employee states that (i) he will take a cheque out of the payment queue and provide it to the vendor directly; or, (ii) the vendor will come in to personally pick up the cheque, this may be an indication that fraud is occurring. In some cases of fraud, the address on the cheque is non-existent. In other cases, it is an address belonging to the employee's relative or other associate, or it is a post office box. Where cheques are taken "out of queue," it may be prudent to investigate the payee address on file for that vendor.

UNUSUAL NUMBER OF ADJUSTING ENTRIES OR WRITE-OFFS

An unusual number of adjusting entries can be a sign of concealment of shortfalls. Unverified write-offs of accounts receivable can be a sign that the receivables are being paid, but stolen by the employee. In one case, an accounts receivable clerk stole incoming cheques and added his name as second payee. The employee then proceeded to deposit the cheques into his own personal account, resulting in a significant loss to the employer.

A Note of Caution

Caution must be taken in dealing with suspected employee fraud. None of the red flags discussed in this article *necessarily* mean that an employee is defrauding the employer; they simply indicate that further investigation may be warranted. There may be an innocent explanation, and an unwarranted allegation of fraud against an employee can create numerous problems for an employer, including the possibility of civil liability.

Before confronting an employee, it is advisable to bring in counsel with experience in employee fraud investigation and litigation to assist in gathering and assessing evidence. Counsel can enlist other professionals, such as forensic accountants and, where warranted, private

investigators. Where there is strong evidence of fraud, counsel can also assist in taking the appropriate steps to secure available assets as part of a civil litigation recovery effort.