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Recent Increase in Defalcations and Embezzlements

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ONE of the great problems confronting business arises from recent increases in defalcations and embezzlements. There are no statistics available on the total amounts embezzled. They have been estimated to range from one to three billion dollars annually. Contrast this with U. S. police reports to the F.B.I. that the total value of property stolen in a recent year by robbery, burglary, larceny and auto theft was only $272 million.

INCIDENCE OF THE PROBLEM

As long as human beings exist, frauds in some form will be found in business, and therefore, detection and prevention of fraud must be an important function of the controller and the auditor.

The 'why' of fraud may best be left to the psychiatrist.

The 'how' is right up our alley.

When a fraud is reported, every one has an avid interest in finding out what motivated the embezzler to commit the crime.

MOTIVES

An official from a surety association has classified the motives as the three "B's", namely, "bookies, babes and booze." A review of recent case histories of losses from dishonesty indicated that the three "B's" were applicable in about 75 per cent of the cases. Embezzlement to pay medical, hospital and similar expenses of relatives and family motivated approximately the other 25 per cent.

There are no set patterns that motivate embezzlement any more than there is a typical embezzler. They include officers of companies as well as stock clerks and office boys. There has been an increase in embezzlement by women as more have come to be employed in business.

The variety of motives and lack of pattern suggest that controllers as well as CPAs must always be on the alert if they are to be successful in preventing embezzlement.

DISCOVERY

Although many of the irregularities are discovered by the auditors, external and internal, a sobering fact is that many are discovered almost accidentally. Based on an analysis of approximately 100 cases:

- Three came to light as a result of tips by fellow employees.
- Five were uncovered by inquiries from customers regarding their balances.
- Four came to light through voluntary confession by the perpetrator, apparently motivated by fear that detection was imminent.
- Two were detected during the enforced absence from work of the defaulter.
- One was uncovered by a tip from a supplier of merchandise on noting the receipt of a company check in payment for items delivered to the defaulter.
- One showed up when an employee made a service call to the address listed for a customer and found it to be a vacant lot.
- One was brought to light when the social security board communicated with the company to verify a social security number for what proved to be a fictitious employee.

FRAUDULENT ACTION

It has been possible to classify areas in which the greatest fraud losses occur. A recent study of fraud cases indicated that approximately three-fourths of the dollar losses were effected through cash disbursements, and the remainder principally through cash receipts and inventories. As to frequency of occurrence, however, cash disbursements accounted for less than one-half of the losses.

We must be ever mindful of the fact that the majority of transactions giving rise to disbursements originate in departments other than accounting or treasury. Rigid procedures may be prescribed for small petty cash funds, but a purchasing department or advertising department which spends millions of dollars annually may operate relatively free from adequate controls. Transactions giving rise to disbursements normally originate in many areas and the opportunity for fraud is multiplied in the absence of carefully planned and supervised controls.

Some examples of this type of fraud that have come to my attention are:

- Employees obtaining additional compensation through manipulation of production reports that served as the basis for incentive pay.
- Collusion between a shipping clerk and outside trucker for removal of merchandise from the warehouse without the proper shipping documents and subsequent disposition thereof by splitting the proceeds between them.
- Falsification of labor costs by subcontractors on contracts on a cost-plus basis.
- Kickbacks to purchasing agents by vendors who charge excessive prices to make up the difference. A dishonest purchasing agent only needs a small "spread" in the price of a commodity purchased in large quantities to make a substantial income for himself.

The most generally used methods of concealing the misappropriation of cash receipts are lapping and failure to report cash sales and miscellaneous receipts such as unclaimed wages, rentals, commissary and vending machine receipts and sales of scrap that are not properly controlled.

In lapping, cash received from one customer is appropriated by the cashier; at a later date cash received from another customer is credited to the first customer's account and the second customer's account is credited still later by cash received from a third customer. This delay of credits continues until it is detected or is covered up by a fictititious charge to operating accounts such as sales discounts and allowances or bad debts. If receipts are in currency, detection of lapping is difficult unless confirmation of all accounts receivable is requested. If receipts are in checks, the original misappropriation is more difficult, but not impossible, particularly if weak internal control procedures permit the cashier to control petty cash funds as well as receipts.

A number of frauds have also been accomplished through the failure to account properly for the receipts by means such as:

- Sales entered but not included in footings of the sales record.
- Sales entered and charged to customers' accounts, cleared by fraudulent credits for merchandise returned.
- Sales—cash or credit not recorded in the sales record.
- Receipts from customers entered in cash book but not included

in footings; discounts or some other expense or income account charged to offset the credit to accounts receivable.

Fraud through the medium of inventories is often difficult to discover because to a certain extent it is self-concealing. Since some inventory differences are normal in many companies, particularly in those processing commodities that are subject to shrinkage, shortages may continue for several years unnoticed inasmuch as they are written off each year as unexplained losses. The main problem confronting the embezzler of inventories is to remove the material from the premises without detection. Many thousands of dollars worth of merchandise, tools and equipment, ranging from food and small sundries to refrigerators and electronic equipment, have been stolen and sold off the market by employees. The net result in financial loss to the firm is just as serious as funds directly embezzled.

COUNTERACTING FRAUD

As I have previously commented upon in my opening remarks, fraud results in an enormous annual loss to business and is a particularly insidious form of loss because it strikes from within, often in areas that are ostensibly well managed and carefully controlled. It may be perpetrated by trusted employees with long experience and considerable responsibility. The best protection against this form of loss is management's determination to maintain good internal controls that will minimize the opportunities for an employee to misappropriate company assets.

Management therefore looks to the controllers for installing and maintaining a good system of internal control to assist them in their stewardship of the assets of the company.

The independent auditor is also very much concerned with internal control. He is retained by management to express an opinion on the fairness of the financial statements of the company. To guide the auditor in preparing himself to do this, the American Institute of Certified Public Accountants has adopted as one of the generally accepted standards of field work the following:

> There is to be a proper study and evaluation of existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted.

When this review indicates apparent weaknesses in important areas we consider it desirable that the management be advised so that the necessary steps can be taken to correct them.

The internal auditor also has responsibility in the area of internal control. He performs staff functions for management. They pertain principally to safeguarding the assets of the company, to preventing or detecting irregularities, and to ascertaining that managerial policies are being observed.

The administrative officers of the company are responsible to the Board of Directors and shareholders for preserving the assets entrusted to them. They exercise their responsibility directly by constantly reviewing oral and written reports and by observing the various activities of company personnel. When necessary, some of this responsibility is delegated to staff assistants.

It can therefore be said that the primary responsibility for internal control rests with the controllers and other officials of the company. Where portions of this responsibility have been delegated, for convenience or of necessity, to others, we can usually define the limitations placed on delegated responsibilities. It is especially true that as we examine the nature of the particular delegated responsibilities in the area of internal control, we begin to understand more clearly the limitations under which the various staff groups perform their work.

MEANING OF INTERNAL CONTROL

Before we look too closely at the responsibilities of the controller and staff personnel, however, we should first have a rather clear conception of the meaning of internal control. Just what do we think this term implies? Does it refer only to methods and procedures or does it also include personnel training and organizational structure? What is the objective of internal control? Does not internal control relate to how an enterprise actually functions rather than to the formal plan for its functioning? As we explore some of the answers to these questions we shall probably resolve the answer to the particular questions of the responsibility for internal control.

Here again the American Institute of Certified Public Accountants has given us this definition:

> Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within the business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies.

EVOLUTION OF INTERNAL CONTROL

We can better understand this definition by tracing the evolution of internal control in our own business community.

In the single-proprietorship type of small business we can observe one person, the owner, using his talents to earn a profit. He can watch the activities of all employees and he can personally supervise the handling of his cash and inventories. When the owner manages in this manner, internal control is absolute, since he is protecting his own resources and controlling the methods for realizing a profit.

When a function (such as bookkeeping, for example) is delegated to another person, there arises a need for establishing means of insuring the accuracy of the delegated work and for controlling the activities of the bookkeeper to prevent defalcation.

DELEGATION OF AUTHORITY

When the enterprise grows in size and becomes more complex, work is divided among more employees. More of the owner's functions are gradually delegated to others. Even management is delegated in most of our larger enterprises. As this process goes on the need for more extensive internal control measures becomes acute.

In instances where management is delegated by the owners, there is also delegated (by implication) the responsibility for preserving the owner's property and for operating the business efficiently. To accomplish these objectives some means must be devised to relieve the manager of personally assuring that no unauthorized action occurs permitting dissipation of assets or diminution of operating efficiency. Delegation of management authority within a limited area of responsibility is the means devised to enable a manager to so function.

PLAN FOR INTERNAL CONTROL

Under good management these duties, authorities, and responsibilities are set forth in some formal manner—usually in a management guide manual. The specifications contained in such a manual constitute part of the plan for internal control. Proper division of authority within the organizational structure should result in control through interdepartmental checks. For example, pre-listings of cash by persons opening the mail serve as a check on cash recordings in the controller's department. A policy that machinery may not be acquired by the manufacturing department without proper authorization by the financial department serves as a check both on the manufacturing department and on the purchasing department.

This same pattern of internal control through organizational structure is usually carried down into each branch or department of the organization by dividing the duties of departmental employees. The resulting system accords with the auditing principle whereby one person checks the activities of another person.

Business enterprises have manifested a long-term trend toward greater complexity. Multiplicity of products and locations require more internal control through division of duties, since personal supervision by management has become virtually impossible. We will therefore investigate and appraise the tools available for controlling complex enterprises.

TOOLS OF INTERNAL CONTROL

Although we ordinarily do not think of the tools of scientific management as internal-control measures, many of them are part of the system of internal check. These are the devices of standard costs, budgetary control, quality control, operations research, statistical sampling, time and motion studies, and periodic operating reports and analyses.

Such controls apply principally as measures of operating efficiency or of the degree of effectiveness of the business activity. They also assure control of the pattern adopted by the enterprise, setting standards for such matters as maintaining an acceptable level of income, securing a fair share of the market for the product, obtaining a proper return on invested capital, or achieving an effective allocation of resources.

Various documents, records, and reports are also part of the system of internal control. These afford means of internally checking the operation of the enterprise and of exhibiting its condition for visual study.

The tools of internal control just discussed are of primary importance to management. Whereas the independent auditors are concerned with these controls in general, they, like yourselves, are more particularly concerned with controls through records and procedures that permit an internal check. These are the paperwork and the methods entering into the accounting system of the enterprise that serve to insure the accuracy and reliability of the accounting records. These controls are concerned with such matters as serially numbered documents, separation of the maintenance of control accounts and maintenance of subsidiary ledgers, matching of all transaction documents before approval for payment, signatures and approvals of documents, and periodic reports and statements. Control here is accomplished by a paperwork-flow design providing for review by persons other than those employees who originate the transaction.

PRINCIPLE OF THE DESIGN OF SYSTEM OF INTERNAL CONTROL

The principle of the design of the system of internal control is simple. It aims to provide a watchdog for every operating procedure. In practice it is found that the complexities of modern business operating procedures make it impracticable to apply this principle universally. This is where judgment and skill are required to provide a good internal control system that is economically feasible.

There are some other spheres of activity that contribute materially to internal control within the enterprise. Several of these, which may appear intangible in their effect on internal control but are nevertheless real factors, are the mental attitude of key employees, protective areas for storage of tools and materials, plant security measures, training programs for new employees, and quality control of the finished product.

It is not sufficient, however, just to create a system. Management must be alert to see that the system functions effectually as designed. This is where the internal auditors with a well conceived and sound internal auditing program fit into the picture.

SELECTION OF PERSONNEL

In carrying out their responsibility, controllers should make sure they hire people of the character and integrity to function according to the plan of organization. Such an investigation must include inquiries of former employers. Too often it is discovered after a loss has occurred that an employee had been previously convicted of theft or had been denied insurance by a bonding company.

Here again, the responsibility does not cease with hiring, as experience has shown that a large number of employees who commit fraud are in positions of trust for a number of years before they take advantage of the opportunities afforded them to embezzle funds. Good management requires regular vacations of all employees and rotation of job assignments as part of their personnel training programs so that one employee's work will come under the scrutiny of another employee.

Continual surveillance of employee work habits is also necessary in good administration. Frequently one finds the amazed employer saying, "I'm shocked, he was a most trusted and hard-working employee." Subsequent investigation disclosed the employee was there early and late sometimes over the week ends for the specific purpose of covering up his peculations. The fabulous Minnie Mangum who embezzled $3 million over a 22-year period from a Norfolk building and loan association was one who never took a vacation and even worked week ends and holidays to "get her records in order."

In March of this year, a former vice-president of one of the ten biggest brokerage houses in Wall Street was arrested and charged with stealing $170,000 from his employer over the last five years. According to the New York district attorney's office he took another $100,000 and "change" for which he can't be prosecuted because of the statute of limitations. The money helped to finance some high living in Manhattan and Las Vegas night spots.

The embezzler was in charge of the back office where all accounting and bookkeeping was done. He was thoroughly familiar with the accounting system because he had designed it and installed it in 1949. To carry out his manipulation, he used to come to work at 5:30 A.M. on Sunday, the only time in the operations when nobody was in the office. Then he punched up several IBM cards that altered the records, effected changes in the company's interest income account and in his and his wife's personal accounts. The company's interest income was reduced and the credit passed to their respective personal accounts. He then purchased securities for their personal accounts, held them for a few days and then sold them. When the stock was sold he simply drew out the proceeds.

What he did was the same as taking ink eradicator to an old-fashioned ledger book; only in this case he used an IBM punch machine.

It is the general consensus in the public accounting profession that a good internal audit department would have detected this manipulation. The brokerage house had hired an internal auditor last November, but other problems had prevented him from putting an effective internal audit procedure into effect.

I could go on far into the night citing examples of defalcations and embezzlement and what might have been done to detect them. I trust that I have at least alerted you to the recent increases in defalcations and embezzlements and aroused your thinking about your responsibilities as controllers in connection therewith. The watchword is "Eternal Vigilance" on the part of management, of which you are a very important part, the internal and external auditors. Only by doing this can we hope to reduce and minimize these mounting financial and economic losses.