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FRAUD AND INTERNAL CONTROL

By MARY GERTRUDE HINDELANG, CPA

The tribute by industry to dishonest employees will exceed five hundred million dollars for the year just passed. This tremendous sum will represent only the known losses, based on claims filed against bonding companies and compilations by the Federal Bureau of Investigation and other law enforcement agencies. Unquestionably, there are additional untold millions in annual losses which are never known and, consequently, never recovered. The victims of this immoral epidemic are the owners and managers of businesses and other enterprises all over the country, in every field of endeavor, from giant corporations to tiny retail stores.

Sociologists tell us there are several explanations for this unwholesome condition. High tensions, low moral standards, inflation, the uncertainties and exigencies of modern life, are all significant contributory factors. However, these sociological considerations form a tremendous field in themselves. One of the principal reasons for this financial depravity lies in the attitude of employers—an attitude compounded of ignorance and complacency. Many employers realize that their enterprises would be driven to the wall if such an attitude governed the general conduct of their affairs, yet they are surprisingly trusting and ingenuous toward the employees who handle their assets.

The dictionaries define fraud variously as deceit, trickery, sharp practice, artifice, breach of confidence. These are fuzzy and adjectival words—the blunter terms used by the members of the legal fraternity are more to the point. They call fraud by employees by such names as larceny, embezzlement or forgery, or in a general sense, felony. A felony is a criminal offense, as Blackstone colorfully puts it, "of a deep and atrocious dye."

The composite fraud-doer is thirty-five years old; 93 percent male; has been employed nine years and three months; started stealing after three years and five months of employment. He is married, has two and one-half children, owns a late model car, attends church regularly, participates in community activities, drinks moderately and has other wholesome convivial habits. Usually, he has advanced to a position of trust and responsibility, has faithfully applied himself to his duties, has never given any indication of instability or irregularity prior to the ultimate discovery. In other words, he is a typical tried and trusted employee—frequently trusted first and tried later. He may occupy any position from watchman to president. It is axiomatic, in short, that anybody is a potential fraud-doer, at any time.

It is true that employees must be trusted in countless matters—they must attend to

many duties which involve the handling of assets. This trust must be justified by results, which are the fruit of management's guidance and supervision. Unless the owner or manager has a phenomenal memory for details, a genius for organizational mathematics, or an effective system of internal control coupled with adequate cost accounting records, the results cannot be measured and the trust proven.

Instead of trusting employees with proud and simple faith, management should protect them from fraud and its consequences. Remember, again, fraud may be committed by anybody, at any time. The long-time employee is often placed in the way of temptation made the sweeter by the careless, trusting attitude of his employer, who often is too busy selling or scheming or vacationing to look inward at his organization.

There is the story, somewhat apocryphal perhaps, of the Scotch ribbon clerk whose department was equipped with a new cash register. The store manager observed one day that MacGregor was not ringing up some sales, but was pocketing the money instead.

"Mac," he asked, "Why aren't you ringing up those sales"?

"Och," replied the Scot, "Ye ken I keep track in my head until I get a dollar, and then I ring it up, it saves the wear-r and tear-r on the machine."

Now perhaps that manager could trust MacGregor, especially in view of the worthy motive, but could MacGregor trust himself? Management has a responsibility to its employees to protect them from temptation, and from the circumstances which may result in unjust accusations and imputations.

I have mentioned that the incredible waste occasioned by employee frauds is due in part to an attitude componded of ignorance and complacency. The subject of fraud is almost taboo in genteel conversation today. Very little has been published about fraud—even in technical literature. Perhaps the reason for this is that a laboratory dissection of the methodology of fraud, a discussion of the technique of successful thievery, might have the same effect that lurid comic books are supposed to have upon immature minds. Because fraud is evil, we look the other way. We may doubt, we may fear, we may have inarticulate premonitions —but we do nothing. Business may be subjected to systematic looting over a period of years, yet no action is taken. Many shrewd, hard-bitten business men and accountants quail at the unpleasantness of attempting to grapple with internal fraud.

A case somewhat in point is that of the successful manufacturer, whose brother-in-law was the purchasing agent. This purchasing agent not only issued purchase orders to dummy vendors to whom the company eventually issued checks—but he also duplicated the invoices of legitimate vendors, whose endorsements were forged on the checks which were issued. The manufacturer knew that his material costs were in excess of standards, but he stood by helplessly for years—suspecting vaguely that he was being bilked, but without knowing whom to suspect. Finally, he engaged a firm of accountants, who reviewed the internal organization and control and developed, within a very short time, the sore spot of procedural weakness. Subsequent investigation proved many of the transactions to be fraudulent. A new purchasing agent was hired, and the internal control was tightened to vise-like proportions.

A contributing element to the attitude of complacency is the delusion that the fidelity bond is a protection from fraud. The bond provides merely for indemnity in a proven case of fraud—it cannot discover fraud, nor can it prevent fraud. It is true, however, that the bonding of employees may act as a psychological deterrent. It is true, too, that the investigation by the surety company of employees to be bonded is of considerable aid in evaluating the calibre of your personnel.

How does an employee steal?

He discovers a way around the accounting and control procedures which management, in what it believes to be its infinite wisdom, has instituted. That management may be brilliant in technology, foresighted in economics, astute in finance—yet dogmatically old fashioned in its accounting and, primly penurious about internal audit and control.

Many times the owner or manager laughs indulgently at the threat or possibility of fraud by employees. "What can it amount to?" or "It can't happen here," are two of the stock slogans. Many celebrated cases of large companies which had been lulled into this attitude have been well publicized—McKesson-Robbins, Interstate Hosiery, Merganthaler Linotype—to name a few. Of the smaller companies, the number is legion, and many are secret.

Fraud may exact an insidious and stupenduous toll. Many businesses have collapsed, their owners heaping bitter blame upon the administration, the competition, the unions, the market—even the weather. In a surprising number of such instances, the enterprises were looted and pillaged, or

as the phrase goes, "stolen blind," by the employees.

Many employee frauds do not start with the intent to steal, but rather to borrow. Thus the element of collusion with other employees is absent from the preponderance of such cases. Nevertheless, legally there is criminal intent followed by criminal act. Such frauds often reveal themselves in the fullness of time, because the displacement of recorded assets must be realized eventually. These are by no means as difficult to detect as those outright larcenies which are buried or cleared in the cycle of operations.

The common methods by which employees practice their frauds, based on the known statistics compiled through a recent year, may be summarized as follows:

1. By paying bills to fictitious firms, cashing the checks through a dummy.

2. By invoicing goods too cheaply and securing cash rebates from customers.

3. By raising checks and then destroying the raised checks upon return from the bank.

4. By issuing checks for returned goods which were never returned.

5. By lapping incoming cash receipts. This practice has many variants. The principal technique is the abstraction of incoming cash, with the application of subsequent cash collections against the amounts diverted earlier.

6. By false credits to open accounts where cash collections have been stolen. These may involve a processing of journal entries, credit memoranda or ledger face entries, or may involve the forcing of journal or ledger footings.

7. By withholding both sales invoices and concurrent or subsequent cash collections, thereby effecting the complete short-circuit of transactions.

8. By altering or removing account ledger pages or sources of entry to the accounts, such as checks, vouchers, sales invoices, petty cash slips.

9. By padding payrolls.

10. By the outright theft of cash, stamps, merchandise or securities.

In the light of these proven methods, many of them exercised in large organizations which boasted the showy shells of ostensible controls, serious and concentrated reflection upon internal control philosophy and practice may well be merited.

As a last fling at statistics, the myth should be dispelled or, at least, some refreshing doubts should be entertained concerning the basic honesty attributed generally to the common man. On the basis of 25,000 polygraph or lie detector tests, the results of which were published by a well known insurance company, sixty-five percent of the people who handle money, steal it. An even larger percentage of those who handle merchandise, have similar taking ways. Apparently, only the fear of getting caught deters from the temptation of dishonesty.

I am reminded of a particularly flagrant case which was investigated not long ago. Here was a bookkeeper—cashier who had been employed less than a year. It was discovered that he stole about $6,200 in less than eight months. Not only was he short in his cash fund, but he had been lapping cash receipts and withholding collections on cash sales. In the latter instance, he had destroyed the sales tickets after marking off cash sale numbers as having been recorded, although the actual accounts never showed the sales income at all. He was able to do all this even though he handled very little currency. He endorsed various checks and drafts, and cashed them at taverns. This case is a minor classic containing all of the elements of embezzlement and forgery. The exact amount of his peculations were determined through the use of various auxiliary records, and with the cooperation of certain carriers and customers. The surety company, in the face of the overwhelming evidence and notwithstanding protestations of the employee, made full indemnification.

The dishonest methods which have been outlined are almost as simple and direct as the bald theft of merchandise from a plant or store. There are many other cunning methods by which purchasing agents, traffic managers, clerks, bookkeepers, paymasters, salesmen and others can take sizable cuts at their employers property, without the benefit of collusion. Collusive fraud is a more difficult matter to police, but it is also more dangerous to the participants.

There are several positive ways of combatting fraud by employees. Probably the most effective and economical method of fraud prevention is the development of soundly engineered accounting procedures and records, implemented by eternal vigilance on the part of management. This preventive concept is described in the two much-abused, often misunderstood words—internal control.

Internal control is not merely a preoccupation of independent public accountants or corporate controllers. Cost accountants for example, realize that internal control is one of the mighty sinews of cost accounting It is difficult to conceive of a cost accounting

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Muskegon: Mr. Stephen H. Clink, Attorney at Law and President of the Muskegon Bar Association, spoke on "Legal Aspects of Record Life" at a recent meeting. New members: Madalyn Selma Joseph and Margaret J. Durham. **New York:** New York chapter entertained guests Paula Reinisch from Grand Rapids and Margaret Gnirk from Chicago. Phyllis O'Hara, former editor of "The Woman CPA," and a former member of the New York Chapter who transferred to the San Francisco Chapter, is back home with the New York Chapter again. President Lily M. Merkle resigned as president to live in Louisville. Mrs. Esther E. Brooke, Lecturer and Career Counselor spoke on "The Plus Factors in Personality." New member: Mary McNamara CPA. **Oakland:** Katherine McLeod, Oakland chapter member, spoke on "Accounting in the Electrical Construction Industry." New members: Mary Kasom, Fae Darbe and Dorothy Reinertsen. **Philadelphia:** Members were invited to attend the Tax Institute Inc. lecture on "The Limits of Taxable Capacity," at Princeton, New Jersey. At two recent meetings, Mr. John McFarland of the Sun Oil Company spoke on "Federal, State and Local Tax Problems of a large corporation and its affiliates", and Mrs. Mary Bowman spoke on "Industrial Psychology". **Pittsburgh:** New member: Mary C. Van Maele. **Richmond:** "Modern Pension Planning" was Frank H. Stringfellow's topic at a recent meeting. Nellie McClellan and Lucille Taylor took part in a study class presentation of "Closing Books and Preparation of Tax Returns." The study class was transcribed and was radio broadcast later. "Where the Accountant stops and the Attorney takes Over" was the topic of Charles A. G. Dawe, Lawyer-Accountant. **Sacramento:** Anita Nathanson and Erna Meyer attended the Tax Conference in San Francisco. Agnes Ramsey spoke on "Inheritence Tax Insurance" at a recent meeting. New members: Edith May Webb and Lucille Turri. **San Diego:** Clinton S. McCracken, CPA, spoke on "The Problems of Leases with Purchase Options" at a recent meeting. Mrs. Betty Marshall Graydon spoke on "Law Enforcement and the Accountant". New members: Ada Isenhour and Lyla Soule. **San Francisco:** Elizabeth Smelker and Marie Reynolds conducted the study group meetings on "The Break Even Point" and the Speech Class respectively. Mr. Vincent H. Kane, CPA, spoke on "Quality Standards for Accounting and Clerical Activities," at a recent meeting. New members: Carolyn M. Fett and Mariam L. Ashby. **Seattle:** Members are sponsoring a new Portland Chapter. A charter meeting will be held in April. **Spokane:** Mr. E. Roy Van Leuven, of the Estate Conservation Dept. of the New York Life Insurance Co., presented an illustrated lecture on "The Heirs You Can't Forget." Attorney Roy E. Redfield answered questions on the legal aspects of wills and probates. **Syracuse:** Syracuse Chapter accepted the invitation of the NACA to attend the all-day session Discussion Forum on "Inventory Practices." Ten members took part in the inspection tour of the Carrier Corp. Thompson Road Plant. Hazel Templar spoke to the Women's Group of the Syracuse Credit men's Association on "Credit and Collections." New members: Fay Brenner and Mary Dinet. Terre **Haute:** Mr. George S. Olve, Jr. was Moderator for a panel discussion composed of three members of the Indiana Assn. of CPA's. New members: Sarah Dillman and Florence Shoultz. **Toledo:** Harriett Silvers spoke on "Credit" at a recent meeting.

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system that can operate effectively without adequate internal controls, both with respect to general accounting procedures and with cost finding and cost control.

It has been argued by many cost accountants that internal control procedures and devices slow down the processes of cost accounting and involve much needless red tape with its attendant waste and expense. If the proponents of this theory are fair and objective, they must also recognize situations where being penny-wise is being also pound-foolish. In most situations, a balanced system of internal control is more practical than costly. As an example, assume an operation where the production department recorded its own costs. Suppose certain operations were running over the prescribed standards and certain other operations were actually running below standards. If the production manager could decide, on his own initiative, to manipulate the costs between the two operations, it may be seen readily that great damage could be inflicted upon the business through the misleading of management. Consider, too, that if rewards for good performance were based on such misrepresentations by the production manager, insult in the form of fraud is added to the injury caused by defective internal control. Accountants in internal accounting positions may render invaluable service to their employers and the community by giving fraud and its antidote, internal control, some well-deserved attention.