

# Bank Fraud & IT Security

November 2004  
Volume 2, Number 11

Prepared by  
Southeast Consulting, Inc.

SCI

## REPORT

### Guarding Against Embezzlement Fraud

By *Ralph Q. Summerford*  
CPA, CFE, CIRA, CVA

Over the past several decades, financial embezzlement has been the leading form of asset misappropriation schemes, annually costing U.S. employers an estimated \$40 billion. In a 2003 global survey conducted by a leading international accounting firm, research revealed that the average loss because of embezzlement has been more than \$1.3 million *per entity*. These statistics are monumental, proving that embezzlement continues to be a formative and expensive crime.

**Fraud Prevention Action Plan.** The best defense against embezzlement remains informed prevention. The following preventative measures provide a basic approach to avoid falling victim to embezzlement fraud within your organization:

- Maintain strong employee recruiting controls to assure that candidates with questionable backgrounds are eliminated from the employment process.
- Guard against bogus employees being added to the payroll system.
- Maintain strict access controls for all personnel files.
- Maintain strong access controls over the employee wage rate database to assure that inflated pay rates are not surreptitiously added to the payroll system.
- Design and implement strong control procedures governing additions and modifications to vendor files and databases.
- Maintain adequate separation of duties between banking, cash management, and accounts receivable functions.

#### Table of Contents

Guarding Against Embezzlement Fraud .....	1
Strengthening Customer Data with the Account Security Freeze .....	3
Foiling Corporate Fraud .....	5
Deciphering Credit Bureau Reports .....	6

#### Editorial Board

*Frank W. Abagnale, Abagnale & Associates*

*Tom Bartolomeo, Senior Vice President, Information Security, Wachovia Corporation*

*James Bauerle, Esq., Legal and Fraud Prevention Services, DKW Law Group, PC*

*Dr. Bill Chu, Chairman, Department of Software and Information Systems, University of North Carolina at Charlotte*

*Peter Mihaltian, President, Southeast Consulting, Inc.*

*Jerry Licari, National Financial Institutions Practice Director, KPMG, LLP*

*Jim Mathews, SVP/Bank Security Officer, First Charter*

*Ralph Summerford, President, Forensic Accounting & Fraud Examination Services*

#### A.S. Pratt & Sons

2004 A.S. Pratt and Sons. All rights reserved.  
The Pratt logo is a trademark, used herein under license.



- Maintain blank company checks under lock and key.
- Assure that obsolete check stocks are properly destroyed.
- Assure that payment checks are mailed directly to the vendors and not routed through the person or functional area that requested the payment.
- Reconcile bank accounts expeditiously, assuring

that there is an appropriate separation of duties between the employees who issue checks and those who handle cash deposits.

- Regularly rotate staff within critical financial areas such as cash management, accounts receivable, accounts payable, vendor relations, and vendor database management.

**What Can Go Wrong.** Even with the aforementioned controls adequately in place, things can go awry. The following case study exemplifies how even the best fraud prevention intentions can lead to unexpected problems.

In this particular example, the management of a regional midsized corporation discovered that a key accounting department employee had embezzled more than \$300,000 in company funds. As a result of this discovery and the subsequent investigation, the company's outside auditing firm issued a report indicating that the accounting employee was responsible for the loss. The company ultimately filed a claim with its insurance carrier recouping only \$25,000 of the original \$300,000 loss. This shortfall was primarily because of policy coverage limitations.

While management realized that the embezzled money had been gambled away and, therefore, would not be recouped, it insisted that the employee be punished for the theft. Accordingly, management turned the matter over to the local district attorney who subsequently presented the case to the grand jury, obtained an indictment, and prosecuted the employee for criminal fraud. Having presented limited evidentiary materials at trial, including the employee's schedule, copies of various daily accounting reports, periodic bank deposit statements, and direct management testimony, the jury acquitted the employee.

Once acquitted, the vindicated employee filed a \$1 million defamation law suit against the outside auditing firm and the company. The case was ultimately settled out of court, leaving the company with substantial legal fees and a large monetary settlement in addition to its initial embezzlement losses.

**Defensive Measures.** When dealing with employee fraud and embezzlement, employers run the risk of defamation and libel lawsuits by not understanding the importance of an adequately controlled investigation. Accordingly, the moment embezzlement or fraud is suspected, steps should be taken to mitigate the company's damages while assuring that the criminal activities cannot be repeated. However, as with all criminal investigations, there is a right way and a wrong

way to approach a fraud or embezzlement investigation. To avoid the various legal landmines associated with an internally focused investigation, the following defensive measures should be followed where an employer has been financially victimized by an employee who is suspected of fraud or embezzlement:

*Time is of the essence.* It is important to recognize that, by the time the fraud has been discovered, the scheme has probably been in place for some time.

Moreover, the financial impact of the criminal activity will most likely be significantly higher than it may first appear. For this reason, management must mitigate the company's losses by moving quickly to curtail further criminal activity.

*Prompt notification.* Once fraud or embezzlement has been discovered, it is important to promptly contact your insurance provider. Most corporate insurance policies have a 60-day notification provision. Failure to promptly notify your insurance company may void your coverage.

*Contact legal counsel.* An attorney with fraud experience can be invaluable in developing and executing a litigation plan. Additionally, an attorney with employment experience can be helpful in guiding you through the maze of employer and employee rights.

*Developing an investigative plan.* The next important step in conducting an embezzlement investigation should be to hire a certified fraud examiner (CFE). Moreover, cooperation between the employer and the CFE investigator is vital. Following a well thought-out plan will optimize the efficiency and, ultimately, the effectiveness of your fraud investigation. Additionally, an effective fraud investigative plan should include the following elements:

- Organizing and reviewing pertinent documents;
- Conducting confidential meetings with managers and staff to determine who may be useful in the investigation; and
- Arranging for identified individuals to be made available for interviews.

*Preserve evidential materials.* Any evidence supporting the issue of fraudulent intent must be adequately preserved. Data to be secured includes any documents that the suspected employee has originated, handled, processed, or modified in connection with his company responsibilities. Accordingly, management should promptly implement the following actions to assure the adequate preservation of any underlying evidential data:

- Assemble copies of computer data, files, and reports.
- Secure all pertinent original data and catalog all documents.

- Secure any related computer data or media.
- Review plans with your attorney to search the employee's desk and office. While this is company property and you are generally within your employer rights to conduct a search, you do not want to make a mistake here.
- Once an employee has been notified that he is the subject of an investigation, the employee should not be allowed to handle or remove anything from the office with the exception of personal items.
- Offsite and remote computers that the employee may have used for work-related purposes or to access office data and files must not be overlooked as part of the investigative process.
- Restrict the employee's access to company computers while changing all passwords to prevent unauthorized access or destruction of evidence.

*Decide how to deal with the alleged perpetrator.*

Avoid the urge to immediately terminate the employee, as an assumption of guilt that is later proven wrong can lead to litigation for wrongful termination, defamation, slander, or even libel.

Additionally, retaining the suspected employee can be advantageous, as employees have a common law responsibility to cooperate with employers in a legitimate investigation. This may make obtaining records needed to prove fraud easier. Only after sufficient evidence has been gathered in support of the fraud examination should an employee be placed on leave or terminated.

*Know your employer rights.* You have a right to conduct a fraud examination. You also have a responsibility to your stockholders to investigate and recover any losses suffered via theft. Laws dealing with employee rights in the workplace do not have to hamper your investigation. However, they do need to be followed.

*Know your employees' rights.* While the company does have a right to conduct an investigation and, generally, an employee has a fiduciary responsibility to comply, the employee does have some protective rights. Before taking adverse action against an employee, consult with corporate counsel to protect the company from possible legal retaliation.

*Where there is smoke there is fire.* What may initially appear to be a simple scheme may ultimately prove to be a much bigger operation with fraudsters both inside and outside the company. A common

embezzlement scheme, for example, may involve outside vendors and associated accomplices. Also remember that a perpetrator's first admission is likely only a small part of the whole story. Don't stop digging too soon.

**Concluding Thoughts.** A successful outcome requires the interplay of many diverse elements, not to mention a delicate balance between the rights and responsibilities of both the employer and the employee.

Hiring seasoned professionals on the legal and accounting fronts will help an employer avoid missteps that could result in further loss of revenue and assets. Further, professional assistance may also prove helpful in identifying failed accounting procedures and remedial actions.

Finally, a professionally managed fraud investigation is often a major catalyst in protecting the employer from further fraud, embezzlement, and related criminal activities.