

“Internal Fraud”

The Enemy Within



Presented by

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Objectives of this Seminar:

- 📄 Reveal the “shocking” truth about internal fraud
- 📄 Teach you how to detect fraud within “your own” music retailing operation
- 📄 Illustrate, through “real-life” music retail store **Case Studies**, the “dangers” of *undetected* internal fraud
- 📄 Teach you how to “prevent” fraud

Profile of a Fraudster

- ✓ **Male**
- ✓ **Age 26-40**
- ✓ **Educated**
- ✓ **Intelligent**
- ✓ **Egotistical**
- ✓ **Inquisitive**
- ✓ **Risk Taker**
- ✓ **Hard Worker**
- ✓ **Under Stress**
- ✓ **Greedy**
- ✓ **Disgruntled**
- ✓ **Big Spender**

Profile of a Fraudster

(1) Opportunity

(2) Motive

*(3) Ability to Rationalize
the act*

Why is fraud so rampant in “Music Retailing” ?

-  **Tens of thousands of inventoried items**
(makes it easy for product to go unnoticed)
-  **Many items are small in size, yet expensive**
(thereby creating the opportunity to steal, and cause the retailer significant financial harm)
-  **Sales staff are musicians and love inventory**
(thereby creating the motive to steal)
-  **Most employees don't earn executive pay**
(thereby creating the rationalization to steal)

Music Retailing Case Studies in Internal Fraud

- ❖ **“ Bonnie Bookcooker ”**
- ❖ **“ Missy Morepay ”**
- ❖ **“ Rob Register ”**
- ❖ **“ Ivan Taken ”**
- ❖ **“ Trixie Tradein ”**

Bonnie Bookcooker

- ❖ **Bonnie Bookcooker is the full-time bookkeeper of Al's House of Rock 'n Schlock (AHRS). She's been with Al for the past 8 years and handles many of the store's accounting and bookkeeping functions.**
- ❖ **Specifically, she reconciles the checking account and pays all of the store's vendors and related accounts payable.**

Bonnie Bookcooker

- ❖ **The store has had some decent cash sales over the past few months, but continues to suffer from severe cash flow shortages.**
- ❖ **The owner, Alvin Izadope, asks Bonnie for the check register over the past couple weeks. Al is interested in who's been getting paid, since he has so little cash.**
- ❖ **Bonnie hands him the following check register....**

Bonnie's Cookbook

Big Al's House of Rock 'n Schlock

Check Register

| Mon/Day | | Ck# | | <u>Amount</u> <u>Disbursed</u> | <u>Inventory</u> <u>Purchases</u> | <u>Bank Loan</u> <u>Payments</u> | <u>Payroll</u> | <u>Telephone</u> |
|---------|---|-----|-----------------------|-----------------------------------|--------------------------------------|-------------------------------------|------------------|------------------|
| June | 1 | 728 | Yamaha Corp | 12,657.44 | 12,657.44 | - | - | - |
| | 1 | 729 | NationsBank (Korg) | 7,791.33 | 7,791.33 | - | - | - |
| | 1 | 730 | AV Pro Audio Supplies | 1,993.10 | 1,993.00 | - | - | - |
| | 2 | 731 | Roland Corp. | 16,772.33 | 16,772.33 | - | - | - |
| | 2 | 732 | St. Louis Music | 4,366.00 | 4,366.00 | - | - | - |
| | 3 | 733 | Kaman Musiccorp | 7,722.29 | 7,722.29 | - | - | - |
| | 3 | 734 | Bank of America | 5,229.12 | - | 5,229.12 | - | - |
| | 4 | 735 | ADP Payroll (net) | 9,545.18 | - | - | 9,545.18 | - |
| | 4 | 736 | ADP Payroll (taxes) | 3,391.42 | - | - | 3,391.42 | - |
| | 4 | 737 | MCI | 748.43 | - | - | - | 748.43 |
| | 5 | 738 | Peavey | 2,395.00 | 2,395.00 | - | - | - |
| | 5 | 739 | Ernie Ball | 1,734.22 | 1,734.22 | - | - | - |
| | 8 | 740 | Pearl Drums | 3,029.66 | 3,029.66 | - | - | - |
| | 8 | 741 | Hammond | 2,390.65 | 2,390.65 | - | - | - |
| | 8 | 742 | Yamaha Corp | 15,933.55 | 15,933.55 | - | - | - |
| | 8 | 743 | AV Pro Audio Supplies | 1,872.48 | 1,872.48 | - | - | - |
| | 9 | 744 | Hal Leonard | 2,190.00 | 2,190.00 | - | - | - |
| | 9 | 745 | Roland Corp. | 8,975.00 | 8,975.00 | - | - | - |
| | | | | <u>108,737.20</u> | <u>89,822.95</u> | <u>5,229.12</u> | <u>12,936.60</u> | <u>748.43</u> |

“ What’s Bonnie doing ? ”

Answer: **She’s
paying a fictitious
vendor (herself,
doing business as
“AV Pro Audio
Supplies”)**



How could AI have prevented this ?

-  Establish an A/P policy whereby all vendor payments must be supported by a) vendor invoice and b) packing slip
-  Segregate the bookkeeping duties of A/P processing and check writing
-  Owner should open bank statements and review all checks written
-  Owner sign all checks (or over \$\$ limit)

Missy Morepay

- ❖ Missy Morepay is the full-time office manager of AHRS. She works Monday thru Friday, and handles all office administration, personnel issues, hiring of office staff and weekly payroll processing.
- ❖ Specifically, she gathers all timecards and sales data, calculates commissions earned by the sales staff, and calls in the store's payroll to ADP Payroll Service.

Missy Morepay

- ❖ Missy has been working long hours each workweek, as the store has grown. Al has suggested she take some time off, but she tells him “My loyalty and hard work are more important than time off for fun; plus I enjoy my work.” Al also knows her spouse recently lost his job, and she needs the pay.
- ❖ Al has noticed payroll costs have increased, but assumes it’s growth related. He asks Missy for last week’s payroll register....

Missy's Pay Scam

| Big Al's House of Rock 'n Schlock | | | | | |
|--|----------------------|--------------------|------------------------|---------------------------|----------------------------|
| Payroll Register | | | | | |
| Payroll Week Ending: January 29, 2000 | | | | | |
| | Hours | Hourly | | | Total |
| | <u>Worked</u> | <u>Rate</u> | <u>Wages</u> | <u>Commissions</u> | <u>Compensation</u> |
| Batten, Jennifer | 40.00 | 7.00 | 280.00 | 173.00 | 453.00 |
| Beck, Jeff | 40.00 | 7.00 | 280.00 | 210.00 | 490.00 |
| Bookcooker, Bonnie | 40.00 | 9.00 | 360.00 | - | 360.00 |
| Dudek, Les | 25.00 | 7.00 | 175.00 | 132.00 | 307.00 |
| Gallagher, Rory | 40.00 | 7.00 | 280.00 | 98.00 | 378.00 |
| Gambale, Frank | 37.50 | 7.00 | 262.50 | 113.00 | 375.50 |
| Gomez, Ray | 35.00 | 7.00 | 245.00 | 101.00 | 346.00 |
| Huff, Dan | 38.00 | 7.00 | 266.00 | 193.00 | 459.00 |
| Landau, Mike | 25.50 | 7.00 | 178.50 | 141.00 | 319.50 |
| Lukather, Steve | 40.00 | 7.00 | 280.00 | 215.00 | 495.00 |
| Morepay, Missy | 55.00 | 9.00 | 495.00 | 245.00 | 740.00 |
| Page, Jimmy | 40.00 | 7.00 | 280.00 | 127.00 | 407.00 |
| Perry, Joe | 32.00 | 7.00 | 224.00 | 113.00 | 337.00 |
| Satriani, Joe | 40.00 | 7.00 | 280.00 | 188.00 | 468.00 |
| Vai, Steve | 38.50 | 7.00 | 269.50 | 201.00 | 470.50 |
| West, Leslie | 40.00 | 7.00 | 280.00 | 139.00 | 419.00 |
| Whitford, Brad | 24.50 | 7.00 | 171.50 | 91.00 | 262.50 |
| | <u>631.00</u> | | <u>4,607.00</u> | <u>2,480.00</u> | <u>7,087.00</u> |

“ What’s Missy

doing ? ”

Answer: **She’s**
paying herself
more wages, by
calling in extra
hours and commi-
ssions to ADP.



How could AI have prevented this ?

 **Owner should authorize all overtime**

 **Owner should periodically review the payroll register, and compare it to personnel files or a master payroll sheet to validate the correct base pay**

 **Owner should be aware of lifestyle changes of his employees**

 **Owner should approve all hires / fires**

Rob Register

- ❖ **Robert Register (his friends call him “Rob”) is AHRS’s best guitar and amp salesperson. He’s been with AI for 5 years and handles most of the cash register sales transactions in the Combo Department.**
- ❖ **Rob enters any items sold on the Point-of-sale register’s computer screen, which then opens the register drawer, prints out a customer invoice and adjusts inventory.**

Rob Register

- ❖ **Given his vast product knowledge, Rob does the annual physical inventory of the Combo department all by himself. He's also aware that the store doesn't count any accessory inventory under a \$100.**
- ❖ **Al has noticed an increase in customer traffic in Combo (mostly by Rob's friends and bandmates), but hasn't seen an increase in register cash/checks/credit cards. Al's unsure what's up; but he trusts Rob emphatically....**

“ What’s Rob doing? ”

Answer: **He’s**
pocketing small
register cash sales,
and is getting paid
by his friends for
pilfered
accessories.



How could Al have prevented this ?

-  Owner should compare register tapes to cash counts and bank deposits
-  Owner should have a friend make a purchase and verify whether the sale was recorded and the cash deposited
-  Install surveillance cameras
-  Put a sign on the register: “If you don’t receive a receipt, call Al and get \$25”

Ivan Taken

- ❖ Ivan Taken has been AHRS's inventory receiving clerk for the past 8 years. Accordingly, he also possesses an in-depth product knowledge of all the stuff carried at AHRS. Besides being a great guitar player, he's also known as the guy to go to for answers on inventory stock status.
- ❖ Specifically, he logs in all incoming goods on the computer, tags the inventory, and moves them to their proper location.

Ivan Taken

- ❖ Given Ivan's vast product knowledge and desire to learn other important tasks, Al had recently given Ivan the additional responsibility of ordering vendor product, based on order lists submitted by each dept. manager.
- ❖ Al recently overheard Ivan bragging about his new Mesa Boogie Mark IV amplifier and TC Electronics G-Force, although he doesn't recall Ivan buying it from AHRS. Al assumes Ivan must have gotten a better deal elsewhere.

“ What’s Ivan doing? ”

Answer: **He’s stealing small non-inventoried items, and having large items drop-shipped directly to his friend’s house.**



How could AI have prevented this ?

-  Segregate the duties of purchasing and receiving goods
-  Take periodic counts of Inventory (also known as “Cycle Counts”)
-  Take physical inventory counts in teams of two, to minimize “collusion”
-  Keep an eye on unusual inventory (book to physical) adj., and use analytical techniques (F/S’s, ratio calculations, industry averages)

Trixie Tradein

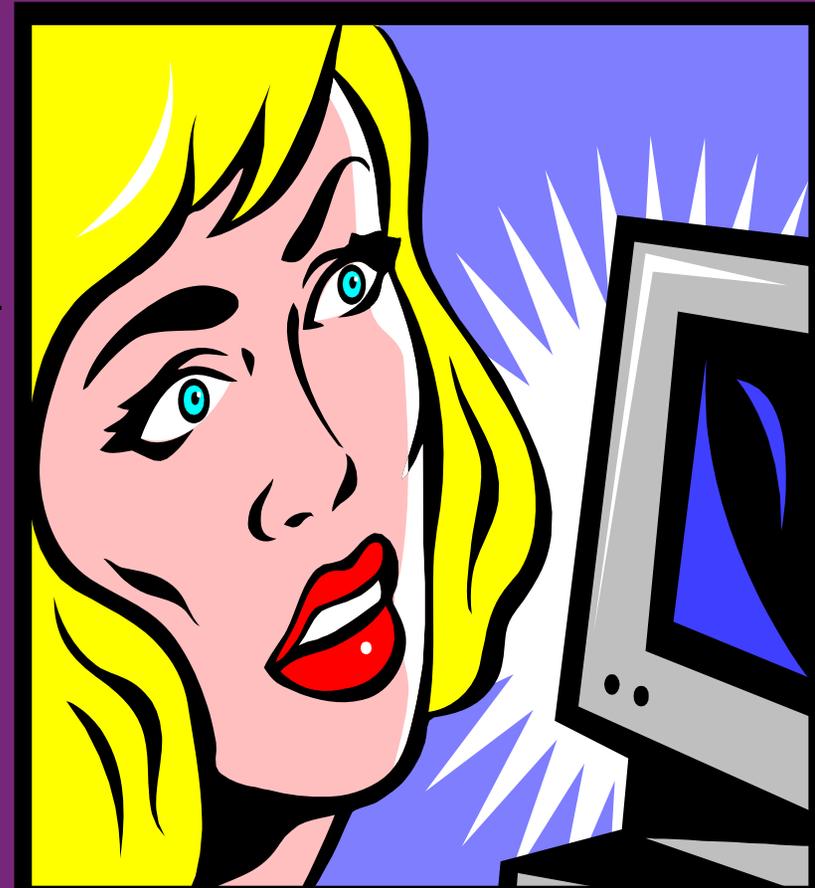
- ❖ **Trixie Tradein is the key salesperson in AHRS's recording/P.A. department. She's known for her ability to acquire quality used gear and sell it off in relatively short periods of time.**
- ❖ **It's AHRS's policy to allow key salespersons (like Trixie) to purchase used gear under \$500. The salesperson rings in the purchase through the POS system, and pays cash to the customer from the register, which is later reconciled. This prevents sales staff from bothering the bookkeeping department for checks.**

Trixie Tradein

- ❖ Although gross sales have been really good, Al has become concerned about profit margins in Trixie's department. He keeps hearing that music stores can achieve 40-60% gross profit from the sale of used gear. The recording/PA dept has been at 31%, even though they've been getting top-dollar on every used item sold.
- ❖ Al has also been hearing complaints about paid commissions. Specifically, all recording/PA sales staff are frustrated with the commissions they're earning on low gross profits from used gear sales. Oddly, the only one not complaining is Trixie.

“ What’s Trixie doing? ”

Answer: **She’s ringing in the purchase of used gear at a higher amount than what she’s giving the customer, and pocketing the difference.**



How could Al have prevented this ?

- ▶ **Owner should handle all “cash” purchases**
- ▶ **Any purchase of a customer’s used gear should be done by check**
- ▶ **The customer’s name, address, phone no. and purchase data should be recorded and printed on a pre-numbered purchase receipt**
- ▶ **Periodically contact customers, by phone or confirmation letter, to verify purchase data**
- ▶ **Even if you don’t confirm data, make sure your employees think you do**

“ What’s one of the easiest and best ways to control customer theft? ”



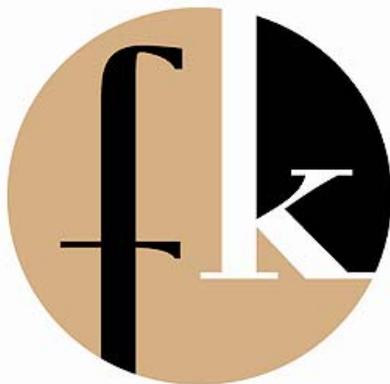
Answer: **When a customer walks in your store, say “hello, may I help you?”... It lets the customer know that you’re aware they’re in your store.**

Dealing with the Employee Thief

- ✓ Gather as much (written) evidence and proof of the theft(s)
- ✓ Contact your attorney to determine the appropriate course of action
- ✓ Fire the employee? Civil suit??
Criminal Prosecution?? *Bear in mind the “statement” you want to make to the rest of your employees*

Prevent internal fraud with these SIX important “internal controls”

- Segregation of bookkeeping duties**
- Maintain perpetual inventory records**
- Have all shipping, receiving, transfer and sale of inventory documents signed and dated to fix responsibility**
- All transactions by check, not cash**
- Frequent physical inventory counts, in teams of two, all differences reconciled**



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