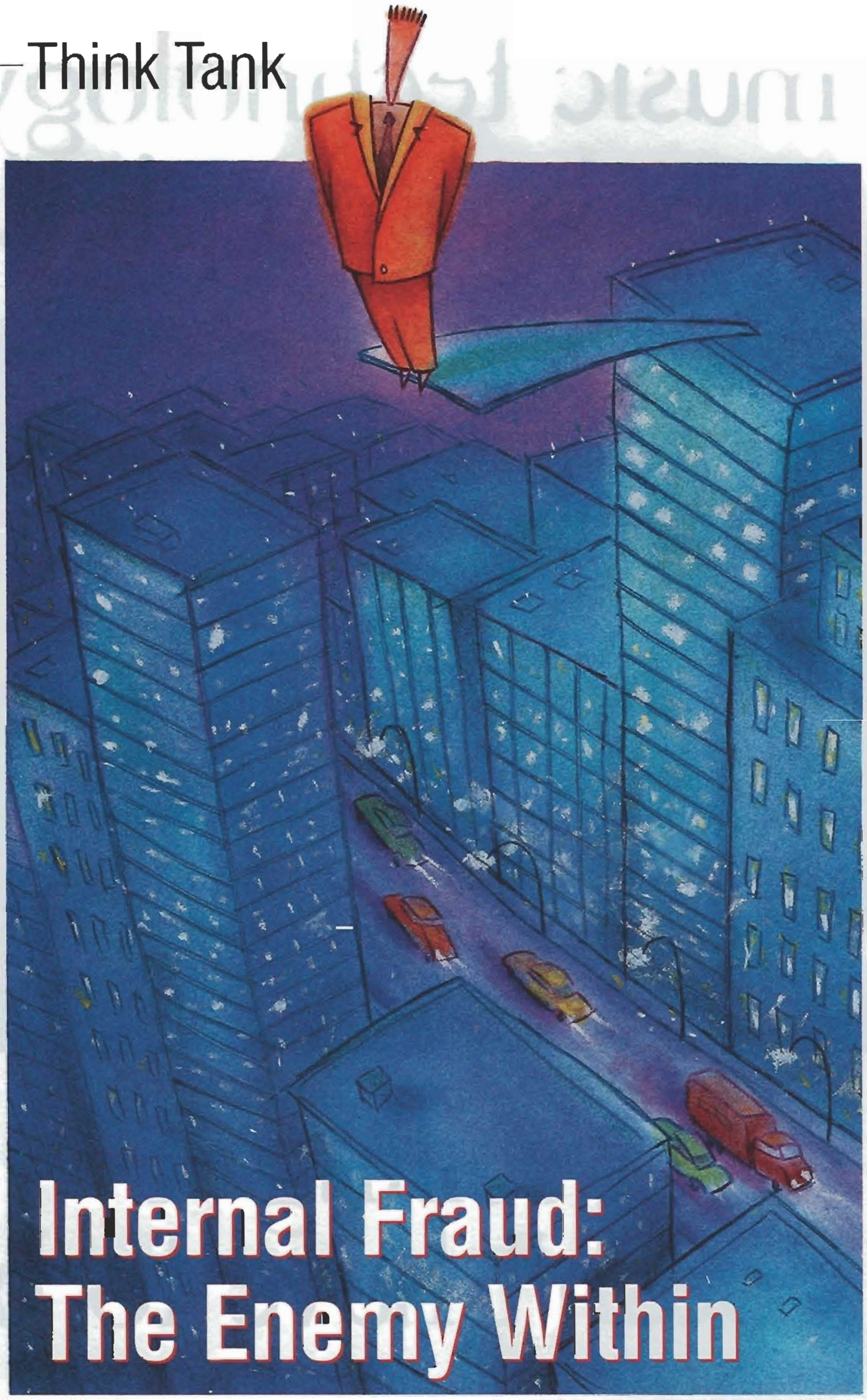

Internal Fraud: The Enemy Within

By Alan Friedman

Your cashier at the front counter can't stop him, nor can your new electronic security system. Nothing can stop this criminal from getting in, because he's already in. He doesn't sneak into your store at night dressed in dark clothing to conceal his identity. Instead, he strolls right in through the front door and walks through any department without question. As you say good morning to him, he greets you with a smile and asks about your golf game. He has the trust, knowledge and opportunity to steal from your company. Who is this master criminal? He is your employee.

He is your sales manager, your shipping and receiving clerk, your repair technician, your bookkeeper and he can also be a she. You think your cash is running low due to increased overhead? No, it's running dry from unauthorized payments to fictitious vendors set up by your trusted bookkeeper. You think your inventory shrinkage comes from customer theft? Guess again, loser. It's from your combo department manager. In fact, only 30 percent of inventory theft comes from your customers—the other 70 percent comes from your employees!

According to the U.S. Chamber of Commerce, 30 percent of all business failures are linked directly to employee theft. And for those of you retailers that scoff at the absurd notion of having a thief employed in "your" store, beware: The music store owner who denies internal fraud is most likely the one suffering an immeasurable loss due to it.

The Dirty Little Secret

Internal theft is the dirty little secret prevalent in many businesses today, especially in music retailing. In a "Report to the Nation" on fraud and white-collar crime, the Association of Certified Fraud Examiners reported the following, startling statistics:

- Internal fraud and abuse costs U.S. businesses more than $400 billion annually;
- The average organization loses about 6 percent of its total annual revenue to fraud and abuse committed by its own employees. That means if your store is doing a million dollars in sales, $60,000 is lost to fraud and abuse very year!;
- Internal fraud is usually committed by long-time employees in a position of trust;
- The typical perpetrator is a college-educated white male;
- Men commit nearly 75 percent of the internal fraud;
- Losses caused by store managers are four times that caused by their employees;
- The most costly abuses occur in organizations with less than 100 employees;
- 18 percent of internal fraud is found by auditors and accountants, 33 percent by tips and 49 percent by accident;

And don't start thinking the spiritual artistry and divine nature of musicians (your employees) prevents theft from occurring in your store. Make no mistake, internal fraud is running rampant in music product retailing. To understand why, let's take a look at the profile of a fraudster.

The Portrait of a Fraudster

Given the high statistics associated with employee theft, a wide spectrum of employees—from the recently hired 19-year-old shipping and receiving clerk to the 50-year-old store manager—could be among the guilty. However, there is a profile for the individuals that are most commonly caught.

Statistically, fraudsters are hard-working, white, educated males between 26 and 40 years old who are in a position of trust and lead a private lifestyle that demands high maintenance. The individual could be disgruntled at work and/or experiencing problems with gambling, drug abuse, divorce or compulsive buying.

So who is most likely to commit fraud? Believe it or not, about 80 percent of our population would commit fraud as long as three key elements are in place: the "opportunity" to commit fraud; the "motive" to commit fraud; and the "ability" to rationalize the fraudulent act.

Who has the opportunity to commit fraud? A valued employee in a position of trust. Who has the motive to commit fraud? The employee who doesn't make a lot of money or who needs the business assets they are stealing. Who has the ability to rationalize the act of fraud? Because theft is often viewed by employees as an appropriate justice system for any suffering they feel they've been subjected to by their employer, anyone.

Why are so many music stores suffering from internal fraud and theft? By taking a closer look at the typical music store, we see how the three key elements can easily exist. Who has the opportunity to commit fraud? The store manager, a department head, the bookkeeper and the shipping/ receiving clerk. Who has the motive to commit fraud? Any musician-employee who has a deep desire/need for cash or music product inventory. Who has the ability to rationalize the act of fraud? Given that most music store employees are generally not highly paid executives, they often feel underpaid and view "stealing" from the company as only taking what is owed to them.

In that internal fraud is committed against a company, its perpetrators often perceive it as a victimless crime. But it is not. The crime against a company can cause store owners and employees to forgo compensation, raises and ultimately causes families to suffer. Unfortunately, a common perception among fraudsters is that no one will notice if inventory is gone, and no one will care.

More Than Garbage Smells

There are many signs that warn the existence of internal fraud. I recall the story of a music retailer who told me about his most trusted worker, the 15-year-employed store manager. Each day this store manager would set a great example to the rest of the staff by cleaning up his department and emptying the trash in the outside dumpster behind the store. Only when it was too late did the owner figure out that the store manager was coming back late at night to pick up expensive recording gear buried under the day's trash that he threw in the dumpster. What were the common warning signs that could have helped the owner discover the internal fraud before it was too late? Here's 10 of them:

1. Store owners who insist they don't have a fraud problem, because all their employees are trustworthy;

2. Vendor payments are made without any or supporting documentation;

3. Vendor payments are made to "unusual" places or "unknown" vendors;

4. No financial reconciliation of bank accounts to bank statements, time cards to payroll records or physical inventory counts to inventory records;

5. A lone bookkeeper, who has many duties and rarely takes a vacation;

6. A department that is frequently out-of-stock and no one understands what's going on in that department;

7. A department manager that has complete control over sales and purchasing, and displays erratic behavior and/or resents intrusion by others;

8. Customer orders or vendor back orders that are causing disorder and confusion in record keeping;

9. An employee with a lifestyle inconsistent with their financial status or earnings;

10. A store operated with minimal managerial control by its owner.

Take heed of these warning signs. Recognizing them can help point a business owner to fraud occurring in the form of pilferage, asset misappropriation, embezzlement, corruption, false documents and financial statements, petty theft, use of company property for personal benefit and payroll as well as sick time abuses. (Don't you find it funny that none of your guitar-playing employees ever buy strings at your store?)

Running a Tab

All internal fraud comes with a price tag to the employer. There's a myth that the typical fraud is a one-time big hit, and the employee quits to leave for Fiji with their newfound wealth. This is totally untrue. These unscrupulous employees start running their own personal tab with relatively small amounts of company money that accumulate over time.

In most cases, these thieves are repeat offenders, stealing from the company on numerous occasions. If the individual gets away with the crime the first time, there's little incentive to give up this access to easy money, and the tab keeps building. Most frauds are kept small enough by the perpetrator to go unnoticed, yet big enough to make an impact over time on the fraudster's lifestyle.

The Art of Catching a Thief

Catching an employee red-handed is difficult and could backfire on the company, placing the owners in the middle of a legal nightmare. When management suspects internal fraud, it must be cautious and follow proper channels when attempting to expose the thief. Seeking outside help from experts (i.e. a private investigation firm, law firm, accounting firm) is often the best solution for companies who may not have the manpower, time, resources or know-how to conduct an investigation on their own.

Whether a company opts to consult with an outside source or conduct its own investigation, some important elements must be remembered. Try to accumulate as much written data and documents as possible, proving the existence of fraud and its perpetrator. But don't forget you must preserve the rights of the person suspected. At a minimum, you should consult your lawyer before you accuse any employee of theft or fraud.

Once the investigation process is complete, and the violator has been caught, it is up to the company to decide the next step. Unfortunately, many victims of fraud actually contribute to the problem because of their lenient attitudes toward guilty employees, firing them without pressing criminal charges. Business owners often favor this agreement, as a prosecution would become public knowledge, signifying an internal accounting control problem within the company.

An Ounce of Prevention

So, what can you do to prevent fraud? Personally, I don't think internal fraud can ever be eliminated, only minimized. Accordingly, here's some easy steps you can take to minimize the costly effect of internal fraud, theft and abuse:

• Set an example at the top. Employees who view their leaders as honest people are more inclined to emulate that behavior.

• Establish written company policies on theft and fraud. An

employment policy manual outlining these policies should be given to each and every employee, and it should clearly spell out the company's code of ethics. Companies should also be thorough when interviewing new employees, including background checks, employment references and possibly drug testing.

• Create a positive work environment. Employees frequently commit fraud as a way of "getting back" at their employers for perceived workplace injustices. By creating a positive and open work environment, employers can reduce the motivation to commit fraud.

• Segregate duties. Management needs to examine their internal processes to discover if accounting and transaction areas leave themselves open for fraudulent activity. Installing controls, checks and balances as well as a separation of duties is the best prevention. Don't let the person who writes checks be the person to sign them. Look for unusual patterns, odd endorsements, unfamiliar vendors and unfamiliar financial trends. In summary, don't give too much authority to one person.

• Routinely conduct physical inventories. Physical inventories are a must for every music retailer, and any differences between physical counts of inventory and inventory records should be reconciled to assure the absence of employee theft. If nothing else, this creates the appearance that store owners are paying attention to the safekeeping of their business assets.

• Utilize a hotline. Many incidents of fraud are discovered through tips and complaints by fellow employees. Employees are often in a position to observe improper conduct, but frequently have no way to report it without fear of retribution.

Some Final Thoughts

Internal fraud is a huge—and all too often—silent problem for business owners. Internal fraud can happen to any company regardless of their size, yet few actually talk about it or do much to prevent it.

If more music retailers brought the problem of internal fraud out of the dark and into the light, perhaps many incidents could be prevented. The topic of internal fraud should not be a skeleton in the retail closet, but instead a guest at the your next management meeting. Let's bond together to clean up our industry's dirty little secret and kill the enemy within.

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