The Role of Internal Controls in Fraud Prevention

Arthur F. Rothberg, Managing Director, CFO Edge, LLC

In our last article, we talked about how in a sluggish economy like the one we're now facing, companies may be at an increased risk for internal fraud and embezzlement. When times are tough, it's easier for some employees to consider perpetrating acts of fraud against their employer that they might not even think about if not facing severe personal financial challenges and stress.

Some CEOs and CFOs think that their employees would never steal from them. In reality, though, embezzlers often turn out to be long-time, trusted employees whom CEOs would never suspect of stealing.

Types of Fraud
Among the most common types of employee fraud and embezzlement are:

Skimming and cash larceny — With the former, cash is stolen before it is recorded in the books, often simply by an employee pocketing cash and not recording the sale. With the latter, cash is stolen after it has been recorded—for example, by stealing cash and checks from receipts before they are deposited.

Cash register theft — Here, employees make false cash register entries (by voiding a sale, for example) to cover up their theft.

Billing and payroll schemes —With billing schemes, employees submit invoices for fictitious goods or services, or inflated invoices that are higher than the actual amount. Payroll schemes include adding ghost employees to the payroll and making false compensation claims.

Check tampering — This occurs when an employee forges or alters a company check and makes it out to him or herself.

Fake expense reimbursements — These are claims by employees for fictitious or inflated business expenses.

Internal Controls Are Key
Implementing internal controls is one way to reduce your company's exposure to fraud risk. This will help limit the opportunities employees might have to commit fraud. Following is a look at some of the most effective internal control measures for reducing the risk of fraud and embezzlement in your business:

Draft an official company policy on ethics.
Your policy should spell out in detail what is and is not acceptable employee behavior, as well as the consequences for noncompliance with company ethics.

Ensure proper financial oversight.
You should maintain some personal oversight of the business' finances. For example, carefully examine the bank statements each month, and take the time to review invoices, delivery receipts and purchase orders before personally signing all checks (instead of letting accounting staff use a check stamp). Steps like these send the message to staff that you are serious about fraud prevention.

Segregate financial duties among accounting staff.
What this means is that different employees should handle different accounting responsibilities (like filling out deposit slips and entering cash receipts). This will make it harder for employees to cover their fraud tracks.

Watch out for "lapping of receivables."
With this scheme, customer payments are stolen by an employee (instead of deposited), who then applies the payment of another customer to the account to cover up the theft. Since the employee must repeat this process over and over (kind of like a pyramid scheme), he or she eventually gets caught — although perhaps not until tens of thousands of dollars have been stolen.

Use fraud prevention services from your bank.
Many banks offer a service called Positive Pay, which helps guard against check fraud by comparing checks presented to the bank with a list of checks that have been issued by the company. Only exact matches are paid by the bank—you decide whether to pay any suspect items.

Establish a fraud hotline for employees.
According to the Association of Certified Fraud Examiners, many fraud schemes are eventually uncovered when other employees report suspicious activity. So make it easy for them to do this by establishing a hotline through which employees can report suspected fraud anonymously.

Concluding Thoughts

It's critical that Los Angeles and Southern California CEOs and CFOs implement sound internal controls to help guard against employee fraud and embezzlement. The cost of fraud can be devastating to small and mid-sized businesses, which often don't have the financial resources to recover from a major fraud loss. An outsourced CFO services provider can offer valuable assistance by helping spot potential problem areas and implementing sound internal control measures.

About CFO Edge

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