

# Lake County Contractors Association Professional Practice Report

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## EMPLOYEE THEFT

By: Jim Drost & Dennis O'Brien

### PROTECTING YOURSELF

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If there is any doubt that employee theft is alive and well, you've only to read the statistics published by the Association of Certified Fraud Examiners:

- Fraud cost U.S. organizations more than \$400 billion annually
- Average organization loses about 6% of its annual revenue to fraud by its own employees
- Most costly abuses occur in organizations with less than 100 employees

What factors contribute to the possibility of a financial fraud?

1. First, a person must have a need.
2. Second, the person committing the fraud has to rationalize the crime.
3. The third is opportunity. This is the only area a company can control.

Do not let yourself get caught up in the false security that the person who is in charge of your books is a trusted long time employee; they are usually the guilty party. Why are they the guilty party, because you gave them the opportunity? So what do you do to remove the opportunity? The mantra of the accounting profession has always been "Segregation of Duties" – this is the best way to eliminate the opportunity. Divide and conquer, if one person cannot perpetrate the embezzlement, the odds of it happening are greatly reduced.

Since a company's cash functions are especially vulnerable to theft, this is where the segregation of duties is the most important. Here are some simple cost effective steps to achieve a high level of security:

- The person who prepares checks cannot be an authorized check signer. The controller, president or owner should sign the checks and do not sign checks without supporting documents. A check-signing machine does not remove the owner's responsibility.
- Require two signatures on all checks over a certain dollar amount. The amount should be high enough so it is not disruptive to the normal bill paying process.
- Require all bank accounts to be reconciled every month and have them reviewed by the preparer's supervisor.
- Financial statements should be prepared at least quarterly. The financial statements should include explanations for major variances in income and expenses as compared to the budget or the prior year.

These are a few simple steps that can help deter theft. You, the owner, need to be involved, what you don't know can hurt you.

### THEFT INSURANCE COVERAGE

by Jim Drost, T.J. Adams Group LLC

Who ever thought that Enron, Comdisco, Kmart, Lucent Technologies, Motorola, the telephone industry and the list goes on, would have the financial difficulties they have encountered. The economy just seemed to be invincible to any downward trend. The nation was what we thought to be a safe place to live, and nobody could touch the country. Who would have thought that the FBI or CIA with all of their investigative resources wouldn't detect a few pilots that didn't want to learn how to land airplanes, but only wanted to take off? This opened our eyes to the worst reality anyone could imagine. Employee dishonesty is a similar occurrence. No one expects it to happen to them. It's not something people want to admit

can occur. When it comes to employees stealing from their employer, it's hard to admit that a trusted, dedicated employee, who started with the company in the beginning, could ever steal from the hand that fed them. Unfortunately this is the typical alias of the person that is the most likely to commit fraudulent activities and steal from their employer.

Employee Fraud and Dishonesty costs businesses billions of dollars each year. Many losses go undetected and not all are made public due to the negative press.

One third of all employees admit to stealing at least once during their employment. The estimated losses are hard to estimate with certainty, however, the U. S. Chamber of Commerce calculates the loss to be a minimum \$40 billion annually. The federal government's General Accounting Office estimates the loss to be \$100 billion a year. What is not calculated is the soft cost associated with loss of time and resources resulting from management's investigation of each occurrence.

The average loss resulting from employee fraud is larger than \$300,000, and the damage this could do to a business is enough to put the entity out of business. A recent study by the Association of Certified Fraud Examiners (ACFE), estimates that businesses on average lose about 6 % of their total revenue to employee fraud. Embezzlement is the cause for 30 % of all business failures due to the financial strain that it puts on the business.

Although embezzlement of funds is the most common type of loss to an owner, dishonest employees also misappropriate other kinds of property, such as securities and inventory. Check and credit card fraud, as well as falsifying invoices, are other common offenses committed. These types of fraud usually occur over a long period of time and at all levels in the corporate structure. This in turn tends to complicate the size and nature of the claims. Closely held companies that feel they have a trust-worthy employment history and think that they control their accounts are most at risk. They feel it won't ever happen to them and that it's the other guy's problem. With the advent of computers and high quality printers, check fraud in particular is becoming very easy to accomplish.

Virtually every contractor needs crime coverage of some type. Employee Dishonesty coverage that protects the company against internal theft of company assets is probably the most important. Other types of available coverage may be considered, but could be less necessary depending on the specific internal controls and business practices. Many times the main reason that contractors

put the coverage in place is to fulfill the Employee Retirement Insurance & Securities Act (ERISA) requirements. This requires that pension plans have coverage from theft of assets by the trustees. In Enron's case they also needed Fiduciary coverage, but that's another story.

Employee Fraud can take many different forms, so coverage may be considered for several areas. These areas include: forgery & alteration, theft, disappearance and destruction coverage; robbery and safe burglary coverage, (other than money and securities) or (money and securities) coverage; premises burglary coverage; safe deposit box coverage; computer fraud coverage; extortion or (kidnap & ransom) coverage and separate securities deposited with others coverage. Limits can be tailored as required. A thorough analysis of your crime exposures may warrant the purchase of such coverages. The most common coverage is employee dishonesty. This covers the theft of company assets by employees and is probably the most important coverage to buy.

Employee dishonesty coverage insures against property loss along with money or securities and any other property of intrinsic value, which results from the dishonest acts of an employee. Coverage can be secured on a blanket or scheduled basis. Neither is specifically better, but should be discussed with the provider. The primary difference between the two is that the limits of specific coverage apply separately to each scheduled person versus the blanket limit applying to the entire loss. No matter which approach is taken the most important consideration is sufficient limits. The Surety Association of America has developed a formula that serves as a guideline of how much coverage to buy. It takes into account the contractors current assets, goods on hand, and annual gross sales.

Employee dishonesty coverage carries a per occurrence deductible that applies to either a single act or a series of acts committed by one or more employees. This clause is unusual in that it requires that all employee dishonesty losses, even if they are under the deductible, be reported to the carrier.

There are many important provisions to the policy that will need to be discussed with your agent. They are as follows: "Cancellation as to an employee" provision. This provision states that once an insured, partner or officer of the insured, find out of a fraudulent or dishonest act the coverage will not apply to any future or subsequent events. This unfortunately will include even the most minor acts. One must also be aware that if the insured hires an employee they know has a prior record,

or does not fire a dishonest employee (perhaps they are too valuable to fire), it will eliminate further coverage. It is imperative that if such a situation exists, it be communicated to the agent or underwriter. It might be negotiable.

Forgery & Alteration coverage may also be an important coverage to consider. It will protect against loss due to forgery or alteration of checks, bank drafts and other financial instruments drawn on the bank account. Some may regard this coverage as unnecessary, due to the fact that the bank may be considered liable. However there are instances in which this may be untrue, and the liability issues continue to change in the favor of banks. Another reason contractors may want to consider the coverage is if they enjoy a good relationship with their financial institution, and they do not want to rock the boat.

There are typically six general exclusions to any crime policy. Several of them may be modified to some extent. The main considerations are "loss resulting from any dishonest or criminal acts committed by the insured or any partner while acting alone or in collusion with others" and indirect or consequential loss resulting from any covered act or occurrence. Other include loss resulting from seizure of or destruction of property by order of governmental authority, expenses related to any legal action, loss resulting from nuclear reaction or war.

There are also several important provisions incorporated in all crime policies. Some of them are: Additional Employees or Premises, Discovery period, Loss sustained during prior insurance, duties in the event of loss, Subrogation, other insurance, valuation. If an insured buys or merges with another organization, thereby acquiring additional employees or premises, whatever crime coverage applied under the policy, is extended to the new employees or premises. The carrier must be notified within 30 days and pay the additional premium. The crime policy covers losses occurring while the policy is in force. Should a loss have occurred but not been detected until after the policy expired or had been canceled, the discovery period will extend one year after the cancellation or expiration. A loss sustained in a prior policy and after the discovery period will be covered through the "loss sustained during prior insurance" or "superceded surety ship provision". Policies must run concurrently, otherwise this provision will be void and no coverage will exist for prior acts discovered after such policy expired. The insured is required to report a loss or potential loss as soon as possible. They must file a sworn proof of loss within 120 days of discovery. Losses are

difficult to prove and deductibles should be considered accordingly to help eliminate the soft cost associated in the proof of loss. It must also be noted that once an employee dishonesty situation has been discovered the coverage ceases for that employee.

Many other endorsements and modifications are available for consideration. I have only touched on some of the more important provisions contained in the policy. If coverage has not been discussed with your agent, I encourage you to do so. An important reason for going through the underwriting process is to see how controls to detect and guard against claims have been implemented in your operation. Prevention is critical, and should be addressed by your accounting professional. It should be noted that any claims will be difficult and still result in lost resources. Resources that could have been better allocated elsewhere.

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