

COLLAS DAY | DISPUTE RESOLUTION

Employee Fraud

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The Worm in the Bud

Fraud by employees is the fastest growing economic crime, accounting for between 60% and 85% of all fraud committed against businesses - depending whose figures you believe.

Under current economic conditions the incidence of fraud also appears to be rising steeply. The annual Fraud Barometer, published by KPMG, showed a 50% increase in the first half of 2008. Bank related fraud recorded its highest ever year-on-year rate of increase.

Some of that apparent increase may reflect a higher incidence of detection or reporting. As a current bon mot puts it, "when the tide goes out, you see who's been swimming without trunks". More formally put, the tighter attention to detail that tends to accompany tough economic conditions may identify previously undetected frauds.

It may also be that it suits firms at this time to draw attention to incidents of fraud which previously they would have dealt with as privately as possible.

However, even allowing for more detection or reporting of existing frauds, it is evident that economic difficulties - corporate and individual - create favourable circumstances for fraud to start. Employees are vulnerable, especially those in circumstances where actual or anticipated reduction in income creates immediate financial distress. That risk is not confined to one tier of employee - the lower paid, for example.

Other risks driven specifically by current economic conditions are likely to affect employees with more senior and responsible roles. There may be strong motives to falsify accounting information to mislead both internal and external parties - lenders, shareholders, auditors, suppliers - and the

opportunity to do this is greater for more senior staff. Fraud of this kind may not be motivated by personal greed, so some of the commonly cited 'flags' for detecting fraudulent behaviour may be missing.

A special case of this kind of fraud is where directors are responsible. Directors who are above normal authority represent a higher risk, with a lower likelihood of timely detection. In current circumstances, boards need to assert collective control to protect their own positions.

It is self-evident that major publicity is only accorded to white collar crimes, such as fraud, that are considered newsworthy - Lay and Skilling at Enron, Koslowski at Tyco; Leeson and Kerviel at Barings and SocGen; most recently Madoff and Stanford. Almost all frauds, even within financial services, are on a much smaller scale and attract limited attention. The practices involved may be very similar - the misappropriation of funds, false expense claims, the theft of cheques, the forging of signatures, the falsification of documents and reports and so on. However, the remedies may be rather different.

Fraud is not confined to direct theft of goods or money. The misappropriation of client data by an 'insider' employee and subsequent utilisation of that information by third parties is increasingly common. Vulnerable employees may be targeted by professional criminals for this purpose. In some instances, 'trojan horse' employees may seek work in a firm with the specific intention of acquiring sensitive information. According to KPMG, two-thirds of fraud by value is perpetrated by organised gangs.

An example of such 'employee espionage' occurred when an employee working at an Indian call centre for a well-known High Street Bank was charged with data theft. It was alleged that the employee, working as a data operator, had hacked into the

computer systems to obtain customers' details, which he passed on to fraudsters, leading to substantial sums of money being misappropriated from the accounts of UK customers.

Businesses in Guernsey need to recognise that fraudulent acts are not confined to other jurisdictions. They are a very real threat to local businesses too. Two prominent local cases in the last 18 months, in which sums of money were misappropriated by employees, have highlighted the need for vigilance.

Prevention. Better than cure

Prevention: In attempting to prevent fraudulent acts being committed by employees a great deal of emphasis is placed on employee screening ahead of employment, either by a firm's own HR professionals or through third parties, such as employment agencies.

Realistically, such measures cannot be relied on to do more than deter and filter out some applicants, with existing 'form'. Even if effective screening can be afforded at all levels of an organisation, the emphasis on new employees can be misleading. Fraud experts point out that individual fraud is often perpetrated by employees who have a significant length of service. According to the Workplace Law Network "90% of fraudulent employees have been with their employer for more than a year - and 20% for more than a decade"

Internal control systems and other preventative measures are also relied on a lot but regularly prove flawed. There is bound to be some tension between the latitude that established and influential employees enjoy and the maintenance of adequate oversight. However, periodic reviews of the balance between checks and controls on the one hand and operational flexibility on

the other; periodic alteration of procedures and responsibilities to combat complacency or collusion; and refusal to exempt anyone from key oversight measures will provide substantial protection and should be given high priority by management.

Detection: if you can't keep fraudsters out of your business, can you detect them in action?

A lot of advice is given about warning signs associated with commission of fraud. According to CIFAS, "the UK's Fraud Prevention Service" warning signs of potential employee fraud include:

- staff under stress without a high workload;
- marked personality changes;
- staff always working late;
- reluctance to take leave;
- reluctance to delegate work;
- unexplained wealth or living beyond apparent means;
- customer complaints of missing statements or unrecognised transactions;
- new staff resigning quickly;
- cosy relationships with suppliers / contractors;
- suppliers / contractors who insist on dealing with just one individual;
- rising costs with no explanation;
- key employees having too much control or authority without audit checks;
- employees with external business interests.

While these are helpful pointers, or starting points for careful enquiries, they are susceptible to a number of explanations - especially at a time when employees may be experiencing stress and uncertainty - and should be viewed and acted on with caution.

Robust internal controls will serve to detect as well as to deter.

Action: Should you suspect fraud in your business, it is important that you take action. Prompt, decisive action is needed in order to curtail the loss and to minimise the impact on the business and the reputation of the institution.

While it is necessary to act quickly, an element of caution is also required. Care must be taken not to breach employees' employment rights, whether allegations are proven or turn out to be unfounded.

If a director is suspected of fraud then the implications for other directors can be more complex and serious. Specific advice should be taken.

You may choose either to prosecute a fraudster or to deal with the matter privately. In order to secure a conviction against the perpetrator or to maximise the prospects of the recovery of funds, it is essential that evidence is gathered that proves all the elements of the offence. It is also imperative that the evidence obtained is admissible in court.

Legal advice is required to help you reconcile these competing demands.

The tracing and recovery of misappropriated assets can be an involved process, especially when dealing with an overseas jurisdiction. Here too, legal advice and assistance can help in respect of disclosure orders and freezing orders to recover evidence and any assets. Advice may also be required on various aspects of money laundering legislation.

Summary

Fraud is a substantial and growing problem to which all businesses are exposed. It is likely that current economic conditions will encourage new frauds and make it more likely that firms that have felt secure will be exposed. Preventative measures cannot be entirely effective, so Boards and senior management should develop policy designed to detect and investigate fraud and to anticipate the issues that may have to be addressed to deal with it.

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