



Small Business Insights

How to Prevent Employee Fraud

Provided by: ToughComp

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Employee fraud—when an employee knowingly lies to, steals from or deceives their employer to make personal gains—occurs in approximately two-thirds of U.S. small businesses, according to the National Federation of Independent Business. In fact, small businesses face a higher risk of employee fraud than large corporations. This is often due to a lack of basic accounting controls and a higher degree of misplaced or assumed trust.

While employee fraud can take place in many forms, the following are the most common types:

- **Asset misappropriation**—This type of fraud accounts for the vast majority of fraud schemes and includes check forgery, theft of money, inventory theft, payroll fraud and theft of services.
- **Bribery and corruption**—These methods include kickbacks, shell company schemes, bribes to influence decision-making, manipulation of contracts or substitution of inferior goods.
- **Financial statement fraud**—This type of fraud is the rarest and costliest. It entails manipulating financial statements to create financial gains for an individual or entity.

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Organizations with the fewest employees have the highest median loss in employee fraud cases, according to the Association of Certified Fraud Examiners.

It can be difficult for employers to spot employee fraud. However, 40% of employees who steal from their work have experienced prior HR red flags, according to the Society for Human Resource Management. Therefore, it's important for small businesses to be able to identify employee behavior and other signs that may be indicative of fraud occurring within the organization. Employers should look out for the following:

- **An employee living beyond their means**—If an employee's lifestyle suddenly doesn't match their salary, this could indicate fraud.
- **An employee working longer hours than usual**—Coming in early, staying late, working on weekends, or not taking sick leave or annual paid time off could be signs of employee fraud. Fraudsters often avoid taking time off because they don't want people to review their work. In addition, fraudulent activities often occur outside of regular business hours, when the employee is less likely to get caught.
- **An employee experiencing financial difficulties or family issues**—An employee who is going through financial problems or experiencing family issues might be more inclined to commit fraud to lessen their stress.
- **An employee being secretive**—If an employee is reluctant to share their processes or have someone review their work, they may be committing employee fraud.
- **An employee who works in a position to commit fraud**—Oftentimes, employees who have worked at a business the longest are the most likely to commit fraud. This could be because they have more trust, know the company's weaknesses or can control what appears on paper.
- **Accounts receivable that are suspicious or inconsistent**—Excessive or unexplained cash transactions, unreconciled bank account statements, sudden activity in previously inactive accounts, or an unusual increase in expenses, supplies or employee reimbursements can all be indicative of employee fraud.

Employee fraud can be particularly devastating for small businesses, as they often have fewer resources available to help them recover from malicious acts. As such, it's important for small businesses to take the following action to prevent employee fraud:

- **Create a tip hotline.** Whistleblower tips are the most common way employee fraud is discovered. Therefore, employers should take tips seriously and set up a hotline to catch fraud earlier and minimize losses.
- **Conduct internal audits.** Internal audits and management reviews uncover over 25% of employee fraud schemes, according to Association of Certified Fraud Examiners. Conducting regular audits may not only allow employers to discover any misconduct but also deter employees from committing fraud in the first place.
- **Perform background checks.** Contacting references, performing background checks and conducting online research can help small businesses vet candidates before hiring them.



- **Implement internal controls.** While employees need a certain level of trust and authority to do their jobs, internal controls can help detect and hopefully deter fraudulent activities. Such controls can include clearly defining what constitutes fraud in the employee handbook, setting up an anonymous hotline and performing monthly bank reconciliations.
- **Create a culture of integrity.** Consistent controls and policies can create a culture that empowers staff to be accountable for their actions and minimize risk while driving compliance.
- **Purchase insurance.** Insurance, particularly commercial crime insurance, can help small businesses protect themselves from business-related financial losses.

By taking precautions and implementing internal controls, small businesses can effectively limit their risk of employee fraud.



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info@toughcomp.com
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