



ACCOUNTING MATTERS

Fraud risk management: A small business perspective



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KEYWORDS

Small business;
Organizational ethics;
Fraud;
Misconduct;
Risk management

Abstract Small businesses face big challenges when it comes to managing fraud risks. Financial strain, rapid growth, and a lack of resources and expertise create ample opportunity for motivated fraudsters to take advantage of small businesses. In this article, we draw upon insights from our years as fraud investigators to offer seven practical recommendations to help small business leaders prevent and detect fraud in this unique environment. These strategies can help even the smallest company make a big difference when it comes to fraud risk management.

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1. Introduction

Small businesses provide the backbone of the American economy. According to a 2014 report by the U.S. Small Business Administration, businesses with fewer than 500 employees employ 48.5% of private-sector workers, provide 63% of net new private-sector jobs, and produce 16 times more patents per employee than large firms (SBA, 2014). Unfortunately, this important segment of our economy is also one of its most vulnerable. According to a 2014 survey by the University of Cincinnati, 64% of small businesses have been victimized by fraud (Kennedy, 2014). What is even more concerning than

the rate of fraud in small business is its far-reaching impact. Recent research suggests that companies lose roughly 5% of their revenues to fraud each year, and fraud is a significant contributing factor to small business failure (Association of Certified Fraud Examiners, n.d.). The total cost of fraud, however, cannot be measured in dollars alone. Fraud also takes an emotional toll on its victims, diminishing worker productivity and morale.

Making small businesses more resilient to fraud could provide real benefits to their owners and to the overall economy, but small businesses frequently lack the resources and the expertise to fight fraud. In this article, we explore the unique challenges and opportunities facing small businesses when it comes to fraud risk management. As fraud investigators, we have seen these struggles firsthand, and we empathize with small business owners' despair when they unwittingly find themselves a victim of a fraud. Drawing on our experiences in the

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field, we offer seven practical recommendations for small business leaders to help them strengthen their defenses against fraud risk and build more ethical organizations.

2. The small firm perspective on fraud risks: Unique challenges and opportunities

Small businesses may find themselves victimized by fraud in myriad ways, but the most pervasive threats come from four sources: customers, vendors, employees, and the Internet. In the following paragraphs, we describe the typical fraud schemes associated with these four threats to help small business leaders become more aware of their fraud risks. While these examples are not an exhaustive list of fraud threats, they provide a framework and a launching point for small business leaders to begin to evaluate their own vulnerabilities.

Customers victimize small businesses by stealing inventory (shoplifting), passing bad checks, or making false claims for refunds, returns, and warranties. Customer-related fraud threats are especially pervasive in the retail industry. In fact, a 2013 study by *Business Insider* estimates that American retailers lose \$45 billion each year to retail theft. Small businesses across all industries can also be hurt by customers who take advantage of small businesses by being 'slow payers' or who require unreasonably high levels of service. While not necessarily frauds, such unethical customer behavior can put undue strain on the business's scarce resources.

Vendors, often with the assistance of an insider, can orchestrate large scale, difficult to detect frauds against small businesses by using shell companies, overbilling for services, and paying bribes to secure contracts. Vendors can also take advantage of small businesses by stealing their intellectual property, their customers, and their top talent. Because small businesses often lack the resources and the expertise to install the necessary security and legal protections to deter these customer- and vendor-related frauds, criminals take advantage of the opportunity to exploit what they see as an easy target.

Employees, on the other hand, may find very different motivations for committing fraud. While some may steal from their employers out of greed or need, they may rationalize their behavior as a right that they have earned through their hard work and sacrifice on behalf of the business. Small business employees may feel a sense of entitlement to the company's assets when they have played such a prominent role in building them up. Employees

may also rationalize stealing as merely a temporary loan and justify their actions with the good intentions to pay everything back before it is missed. Employee-related frauds may take on many forms ranging from the theft of company assets to revenue skimming, purchasing card and expense reimbursement abuse, time theft and other forms of payroll fraud, and even complex schemes to divert company funds through shell companies or kickback arrangements with vendors. Unfortunately for small businesses, employee-related frauds are on the rise. A 2009 survey by PriceWaterhouseCoopers reports that 76% of economic crimes against U.S. businesses were committed by insiders.

Increasingly, criminals are also exploiting weak cyber security measures at businesses both large and small to steal vast amounts of confidential customer information through the Internet. Data breaches sometimes occur through sophisticated software hacks, but criminals can also lure small business employees into voluntarily sharing this lucrative information through phishing scams. Criminals have also been known to sift through the trash ('dumpster diving') or to pose as a customer, vendor, or government official to steal business account records and other private information. Internet fraud and other threats to data privacy are especially worrisome for small businesses now that 45 states have passed laws that hold businesses accountable for data breaches perpetrated by third parties.

All of these sources of fraud risk have one element in common—exploiting opportunity. How can small businesses reduce this opportunity and build up their defenses against fraud? To start, small business leaders need to become more aware of the unique challenges and the unique advantages facing their particular operation. In addition to the many fraud risks elaborated here, small business leaders should gather a diverse group of trusted advisors to help them brainstorm other ways that their business may be vulnerable and to help them discuss ways to mitigate these threats. While the task may seem overwhelming from the outset, small business leaders should take heart that despite these many challenges and vulnerabilities, small businesses also present a unique opportunity when it comes to building a more ethical organization. Large, established companies often struggle to maintain a cohesive ethical culture. Small businesses, on the other hand, may use their smaller size to an advantage by enjoying more clarity in their messaging and values. Small businesses also excel at community engagement; indeed, small business leaders provide the backbone for local philanthropy, civic leadership, and community development. These local ties may allow small business leaders to work together to

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