

The 60 Second “Circle of Safety”

A Newsletter for Friends of PDCM Insurance
“Protecting What Matters Most”

To: Our Valued Client

September 2005

6 Steps You Can Take NOW To Recognize And Prevent Potential Employee Dishonesty Claims

Written By:
PDCM Insurance



When assessing risk, many organizations tend to focus on sudden, high-profile disruptions such as fires and product liability. But equally costly threats to an organization may come from its own employees - the computer warehouse clerk who diverts thousands or even millions of dollars in stock, or the department head who submits construction and maintenance costs on his vacation home as a company expense. All are forms of employee dishonesty. According to the *Report to the Nation on Occupational Fraud and Abuse*, Association of

Certified Fraud Examiners, crooked employees cost American businesses six cents on the dollar!!

Employees are often in an ideal situation to defraud their employer. They have specific, detailed knowledge about an organization's systems, procedures and vulnerabilities. This knowledge, when combined with the trust of coworkers, makes it far easier for an employee to defraud an organization than it is for most outsiders. According to a 1999 Computer Security Institute/FBI Security Survey, the average loss due to theft from an outsider was \$56,000, versus \$2,700,000 for an employee, a striking difference.

Reasons For Having A Fraud Policy

A diligently written and communicated fraud policy helps to prevent fraud by establishing a culture in which fraud is openly condemned. Management must strive to avoid not only the reality, but the appearance of sanctioning employee theft. A good fraud policy encourages employees to report suspected wrongdoing, and makes those tempted by easy pickings to be aware that there are severe consequences for their crimes.

Here are the six risk steps you and your organization must take NOW to recognize and prevent employee dishonesty claims.

Step #1 - Create A Fraud Policy

Simply having a fraud policy in place raises fraud awareness among managers and establishes a hierarchy of responsibility for the detection and investigation of wrongdoing. There are several important provisions that fraud policies must include:

1. A statement making managers responsible for knowledge of the exposures and the symptoms of fraud in their departments;
2. Guidelines for properly handling suspected theft to avoid charges of malicious prosecution, slander, libel and false imprisonment;
3. Assignment of responsibility for investigation, internal notification and communication, insurance claims, and coordination with law enforcement;
4. A written reporting procedure so that employees can confidentially report suspicious conduct to those responsible for investigations.

Step #2 - Establish Internal Controls

Internal controls are necessary to monitor the objectives of any organization. Internal controls cover such diverse areas as human resources, manufacturing goals, accounting records, and compliance with government regulations. In the opinion of many auditors, sound internal controls can prevent most occupational offenses.

But internal controls can provide only reasonable - not absolute - assurance that their company's goals are being met. Most internal control mechanisms can be defeated by one or more employees sufficiently motivated. To maximize the effectiveness of internal controls three conditions are absolutely necessary.

1. Oversight and supervision of employees and their activities;
2. Careful division of employee responsibilities so that no one employee can handle a financial transaction from "cradle to grave."
3. Require countersignatures on all checks, as well as a separation of duties for sensitive transactions, such as purchasing inventory, writing checks and balancing accounts.

Step #3 - Obtain Periodic, Independent Audits

To assure objectivity, an outside CPA should perform both internal and external audits. Some organizations will even audit the auditor to ensure he or she is not committing fraud. Many organizations employ outside security consulting firms to test procedural controls and offer suggestions for their improvement.

Step #4 - Don't Forget About Your Computer System Controls

It is critical to restrict access to sensitive transactions and information to only employees with legitimate need for such access. This can be accomplished by:

1. Tracking who requests access to the network or sensitive transactions;
2. Ensuring that passwords are difficult to guess and changed frequently;
3. Install a "firewall" between the private corporate network and the internet or outside network;
4. Encrypting confidential information;
5. Using software that detects suspicious or threatening activity.

Step #5 - Take Appropriate Loss Prevention & Detection Measures

Because internal controls are not completely foolproof, especially when there is collusion, it is impossible to prevent employee dishonesty entirely. But by taking these few simple steps, organizations can make it difficult and time-consuming for employees and others to defraud the organization.

1. Establish standardized internal controls that provide both the consistency and uniformity throughout the organization;
2. Conduct pre-employment checks;
3. Educate employees on how strong ethics benefit the individual worker (i.e., avoid the financial impact on company profits, raises and promotions);
4. Management should set an example of ethical behavior;
5. Set a decisive policy to investigate and, where warranted, prosecute wrongdoing.

Step #6 - Completely Evaluate And Monitor The Adequacy Of Your Employee Dishonesty Coverage

Even with all the above steps taken, occasionally any employee, or group of employees, can successfully defraud your company. The last line of defense to prevent the financial impact of such events is a properly designed employee dishonesty policy. Take a close look at coverage adequacy. Not all employee dishonesty policies are alike, and there are many gaps that can exist if not properly designed. For that reason we strongly recommend an annual review of these coverage's in light of existing company exposures and make adjustments where necessary.

How We Can Help

Understanding and properly insuring your employee dishonesty exposure takes careful risk management analysis and guidance. This should be provided to you at least once a year, normally as part of your renewal review, and also any time when you add a new addition to your building.

PDCM Insurance has the expertise to identify these important exposures and design the employee dishonesty policy that is right for you and your organization.

For more information on our services, or how we can help you fix the problem identified in our risk management survey, please contact:

PDCM Insurance
3927 University Avenue
Waterloo, Iowa 50701
319-234-8888
FAX 319-234-7702
PDCM@PDCM.com
PDCM.com