2019

Fraud in Small Businesses: A Preliminary Study

Esther Bunn
Stephen F Austin State University, estherbunn@sfasu.edu

Jack Ethridge
Stephen F Austin State University

Kaili Crow
Stephen F Austin State University

Fraud in Small Businesses: A Preliminary Study

Esther Bunn
Stephen F. Austin State University

Jack Ethridge
Stephen F. Austin State University

Kaili Crow
Stephen F. Austin State University

This study investigates the attitudes small business owners and managers have towards fraud and internal controls. Commonly small businesses consist of long-term friends and relatives and tend to embody a culture of family, love, and trust. Four factors were identified that lend themselves to a lack of internal controls and a breeding ground for fraud. A survey was distributed to small business owners and management. The responses were analyzed and compared to the data in the 2016 American Certified Fraud Examiners Report to the Nations. Of the four expectations studied, only the anticipated results of Expectation 1 were confirmed.

INTRODUCTION

This exploratory paper investigates the attitudes small business owners and managers have towards fraud and internal controls. A background study was completed in May 2017 that focused on the data reported by the American Certified Fraud Examiners (ACFE) 2016 *Report to the Nations*. The background study investigated the statistics provided by the ACFE and theorized that fraud is common in the small business accounting environment because of a culture of family, love, and trust. Trust, combined with a lack of internal controls and management oversight, creates an environment for fraud. This paper investigates the theories presented in the background study through a pilot survey of small business owners and managers in rural and urban settings.

BACKGROUND INFORMATION

According to the ACFE, small organizations, defined as businesses with fewer than 100 employees, are the number one victim of fraud with three out of ten, or 30%, of small businesses being affected (*Report to the Nations*, 2016). Data presented by the ACFE's report determined that small businesses can expect to lose $150,000 due to fraud, which is the same monetary amount that large companies, defined as more than 10,000 employees, are expected to lose (*Report to the Nations*, 2016). Often, small businesses consist of long-term friends and relatives and naturally tend to embody a culture of family, love, and trust. This high level of family and trust present in a company's culture, combined with a lack of internal controls and management oversight, creates the perfect environment for fraud to flourish.

CATEGORIES OF FRAUD AND THE FRAUD TRIANGLE

Fraud falls into two basic categories: fraudulent financial reporting and asset misappropriation. This pilot study focuses on asset misappropriation, which occurs when a party misuses or steals a company's assets. According to Stephanie Laitala, president and owner of Owl Bookkeeping and CFO Services, asset misappropriation is present in 90% of all reported fraud cases (Laitala, 2014). The commonality in most fraud cases is not the demographics of the fraudster, but instead is the existence of three factors: opportunity, incentives/pressures, and rationalization. These three factors make up the Fraud Triangle and are present in most cases of asset misappropriation.

The opportunity element of the Fraud Triangle represents the ability a party has to commit fraud. The presence of opportunity is generally contributed to the lack of or weakness in internal controls and includes examples such as: inadequate separation of duties, lack of management oversight and poor system controls.

The incentives/pressures element represents the personal reasons that cause the individual to want or need to commit fraud. Frequent examples of incentives/pressures are personal financial problems, a recent divorce, or perceived inequities such as the individual believing they are underpaid or undervalued.

The final factor in the Fraud Triangle is rationalization which represents the process the individual undergoes to justify the fraudulent behavior. An example of rationalization could be someone thinking, I really need this money and I will pay it back when I am on my feet or the company does not need this money as much as I do. These three factors are present in most fraud cases and small business owners should be knowledgeable of the Fraud Triangle and deliberately act in ways to mitigate these factors.

FRAUD IN SMALL BUSINESSES VS. LARGE BUSINESSES

Every two years, the ACFE releases a *Report to the Nations* that includes numerous statistics that relate to fraud in business environments. Figures 1 and 2 were created with data presented in the ACFE 2016 *Report to the Nations* and demonstrates the frequency and median loss undertaken by both small and large organizations from 2010 to 2016.

FIGURE 1
SIZE OF VICTIM ORGANIZATION – FREQUENCY[1]

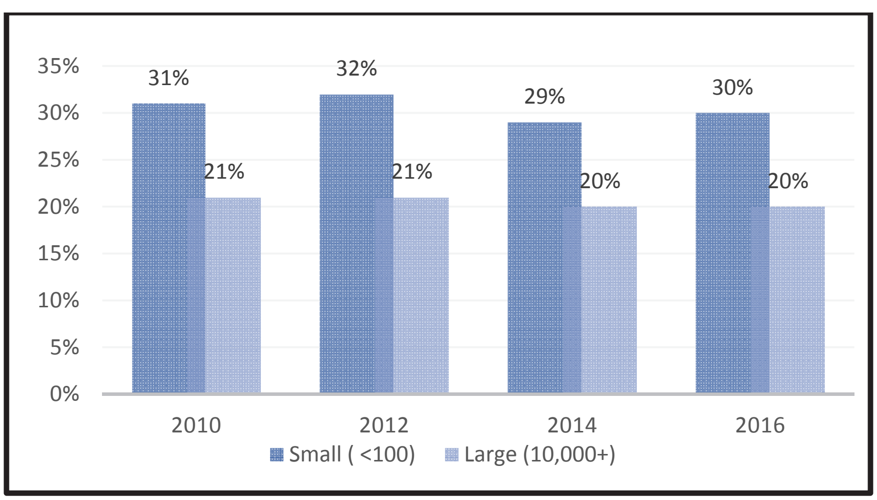
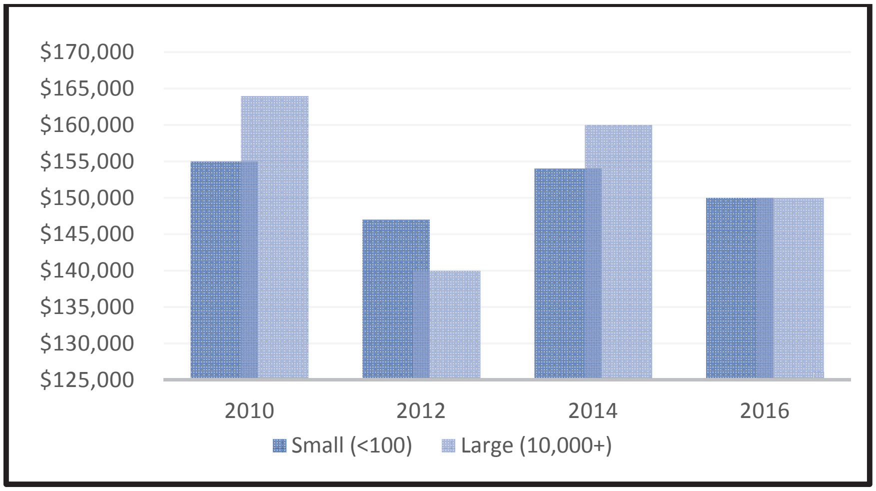


FIGURE 2
SIZE OF ORGANIZATION – MEDIAN LOSS[1]



Report to the Nations on Occupational Fraud and Abuse 2016 Global Fraud Study, 2016, p. 32
Report to the Nations on Occupational Fraud and Abuse 2014 Global Fraud Study, 2014, p. 25

As indicated in Figures 1 and 2, small businesses are victimized 10% higher, on average, than large businesses. During this period, small organizations lost only $2,000 less, on average, than large organizations. Since small businesses customarily produce less revenue than large businesses, the impact of these losses due to fraud would represent a higher proportion of revenue and would in turn be much more devastating. These losses are so catastrophic and common in the small business community that about one in three small business bankruptcies are attributed to embezzlement which leads to the conclusion that fraud in small businesses is not only frequent, but fatal (Laitala, 2014).

FACTORS THAT CONTRIBUTE TO FRAUD

According to the founder and chairman of the Association of Certified Fraud Examiners, Joseph T. Wells (2003), the three major factors that contribute to small business fraud are: inadequate employee prescreening, limited controls, and too much trust. There is evidence that limited controls and too much trust are dominant factors that contribute to small business fraud. However, since only 5% of occupational fraudsters have been convicted in a prior fraud related offense, it would be challenging to argue that inadequate employee prescreening plays a significant role in preventing fraudulent activity (*Report to the Nations*, 2016). Rather than employee prescreening, it can be argued that a lack of management oversight has a higher correlation to small business fraud. When an in-depth look is applied to the factors related to fraud, one can see that the trust factor could be the cause of limited controls, lack of oversight, and inadequate prescreening. This in turn leads to the theory that too much trust is the main contributor to occupational fraud in small businesses.

Small business owners regularly have a vast amount of technical skills and communication skills, which is likely the reason for their success. But unfortunately, many do not possess the financial expertise some would say is necessary to run a business effectively. To compensate for the lack of financial proficiency, many small business owners hire an employee to handle finances so that the owner is free to do what they enjoy, whether that be sales, production, or the innovation of new ideas. While this may appear as a logical solution, the problem is that the lack of knowledge demonstrated by the owner creates the opportunity for key employees to manipulate the financial records without the owners being capable to recognize any discrepancies or unusual transactions. Small business owners may feel that they would be able to recognize fraud, but it is unlikely that an owner or manager with little financial or accounting knowledge would be able to stumble upon fraud, as about 95% of perpetrators make efforts to conceal their crimes by creating or altering physical documents (Stover, 2016). When the commonality of cover up schemes is combined with the lack of accounting literacy demonstrated by many small business owners, it becomes clear how easily fraud could occur in the small business environment and remain unnoticed with a lack of separation of duties.

PURPOSE AND METHOD

Based on the information gathered in the background study, a survey was developed and given to small businesses owners and management in rural and urban settings with the purpose of identifying relationships between common attitudes and practices in small businesses. The survey inquired about the background of the company, presence of internal controls, attitude towards fraud and internal controls, and the culture of the company. The responses from the survey were intended to investigate the following four expectations: (1) element of family and trust present in a small business, (2) the relationship between family and trust and the level of oversight provided by owners and management, (3) the presence of internal controls, (4) and the prevalence of fraud in the small business community. Surveys were distributed via email or delivered in person to businesses in the surrounding areas of Houston, Texas, and Nacogdoches, Texas, with the guarantee of anonymity so that owners and managers would feel comfortable to be honest with their responses. Three-hundred surveys were distributed, and twenty useable surveys were returned. Criteria for a usable survey includes: a response to each question on the survey (excluding open responses) and a reported number of employees between 2 and 100. Characteristics of the survey participants are presented in Figure 3.

FIGURE 3
SURVEY CHARACTERISTICS OF SMALL BUSINESS PARTICIPANTS

	Low	High	Average
# of Employees*	3	100	19
# of Accounting Personnel Employed	1	3	1. 3
# of CPA's on Staff**	0	1	0. 2

*Two firms have 51 & 100 employees, remainder of all companies have less than 30 employees.

**Only four firms employed a CPA, several had outsourced accounting work to CPA firms.

RESULTS OF THE STUDY

Expectation 1: Family and Trust

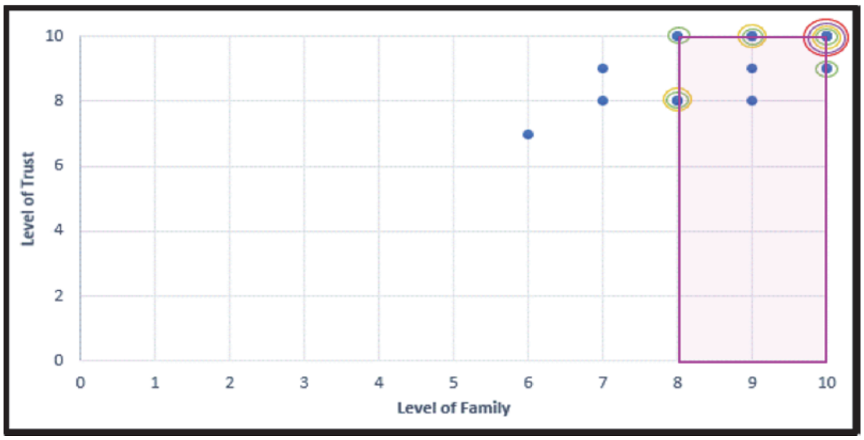
Expectation: It was expected that most small businesses surveyed would answer the following questions with a response of 8-10, with potential responses being each whole number between 1 and 10:

"How much do you trust your employees?"
"How much is the element of family and trust present in the culture of your company?"

It was expected that responses for the level of trust and element of family would demonstrate a high level of family and trust since the overarching theory presented in the background study is that fraud is common in small businesses because a high level of family and trust is present in the small business culture. Therefore, it is expected that most small business owners and managers will record a response that demonstrates that they trust their employees and have family present in the culture of their company.

As seen in Figure 4, the results were as expected, as seventeen out of twenty surveys, or 85%, responded with an element of family and level of trust between 8 and 10. Since small businesses are typically composed of family and long-time friends, it is not surprising that a high percentage of small businesses would claim that element of family and trust is at a high level for their businesses.

FIGURE 4
LEVEL OF FAMILY AND TRUST



Expectation 2: Family and Trust and Management Oversight

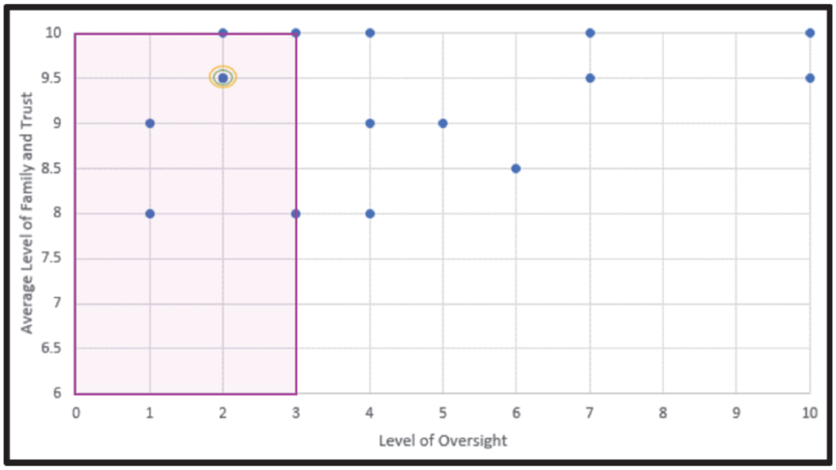
Expectation: The theory tested is that a high level of family and trust will lead to a low level of management oversight. For this to be true, it was expected that out of the seventeen surveys that recorded a positive response for Expectation 1, more than nine surveys (majority), would answer the following question with a response of 1-3, with potential responses being each whole number between 1 and 10:

"How much oversight does your company provide over its employees?"

The theory related to Expectation 2 was that the level of trust is most often inversely related to the level of management oversight. The reasoning behind this theory is the belief that the more owners and managers trust their employees, the less likely they are to monitor their employees closely.

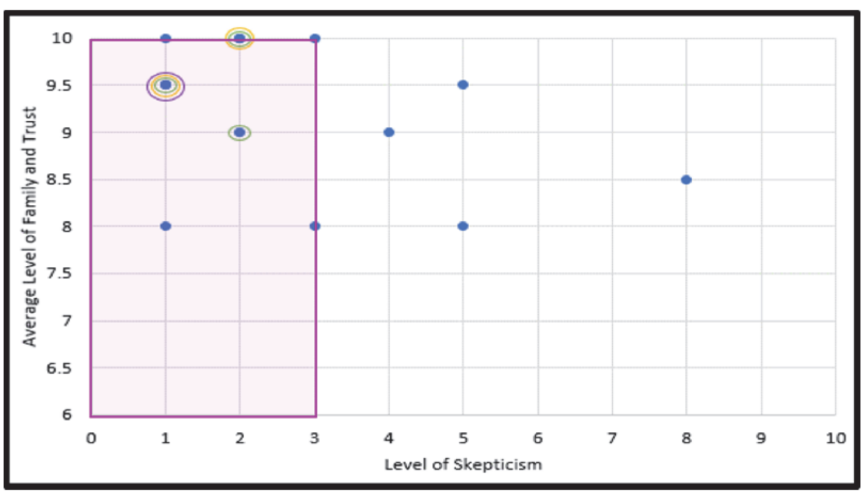
In Figure 4, the "Average Level of Family and Trust" values were calculated by taking an average of the responses from the two questions posed in Expectation 1 regarding the level of trust and the element of family present in the small business. The purpose of Expectation 2 was to evaluate whether an indirect relationship existed as it related to the level of family and trust present in a company's culture and the level of oversight provided by management. It was decided to average the levels of trust and the level of family to gain one value to represent each company's level of family and trust that is present in their company. Expectation 2 stated that out of seventeen companies that recorded a level of trust and family over 8, at least nine would record a level of oversight under 3. The positive responses for Expectation 2 are represented by the shaded area of Figure 5. Out of the seventeen surveys, only eight, or 47%, recorded expected responses for Expectation 2 by recording a level of oversight at a 3 or less. There does not appear to be significant evidence of clear inverse relationship between the level of family and trust and the level of oversight provided by management in the seventeen companies surveyed.

FIGURE 5
LEVEL OF FAMILY AND TRUST V. LEVEL OF OVERSIGHT



After failing to meet Expectation 2, an additional test was created to further evaluate the relationship of management oversight and the level of family and trust. For this test, the average level of family and trust was compared to responses from the survey question that asked, *"How skeptical are you of your employees?"* Following the same reasoning for the inverse relationship between the level of trust and family and management oversight, it is also reasonable to assume that a high level of family and trust present in a company's culture would lead to a low level of skepticism about employees. Therefore, it was expected that out of the seventeen surveys that recorded a positive response for Expectation 1, more than nine surveys (majority) would record a level of skepticism with a response of 1-3, with potential responses being each whole number between 1 and 10.

FIGURE 6
LEVEL OF FAMILY AND TRUST V. LEVEL OF SKEPTICISM



As indicated in Figure 6, out of the seventeen small businesses that recorded a level of trust between 8 and 10, thirteen companies, or about 77%, recorded a level of skepticism between 1 and 3. There is more support that a lack of skepticism about employees is more likely to be inversely related to the level of family and trust than the level of oversight provided by management.

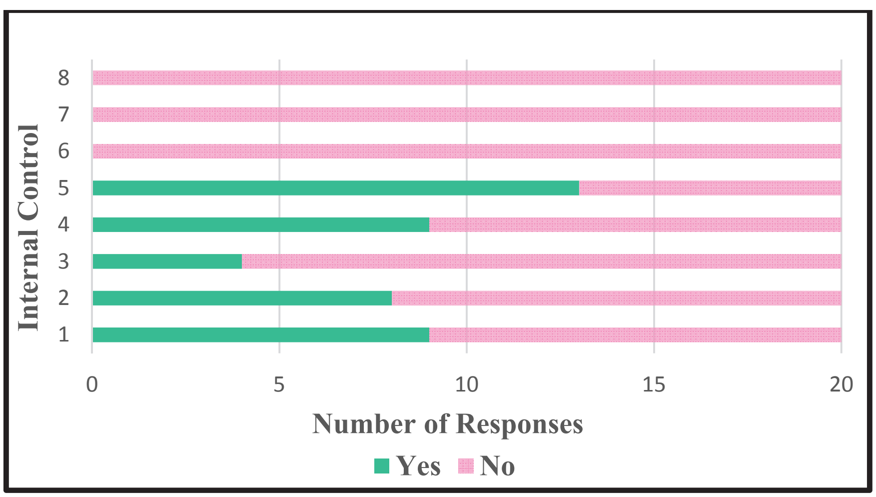
Expectation 3: Internal Controls

Expectation: It was expected that each survey that recorded a "Yes" when asked if internal controls were necessary for small businesses would record responses that demonstrated a reasonable number of internal controls in place. A reasonable number being defined as the presence of at least 50% (4 out of 8) of the internal controls inquired of in this pilot study. We expected at least 50% of internal controls to be in place in businesses that claimed internal controls were necessary because of the common and simple nature of the internal controls such as the performance of bank reconciliations and the existence of a code of conduct.

Out of the twenty small businesses surveyed, nineteen recorded a response that claimed internal controls were necessary for small businesses. To further investigate the validity of owner's or manager's claims that internal controls are necessary, the survey asked which of the following internal controls were in place:

1. "Do you have a Code of Conduct?"
2. "Does your company have systems in place that require more than one person to authorize checks or payments?"
3. "Does the same person that collects the cash or assets also keep record of what was received?"
4. "Does your company perform new employee background checks on individuals that will be directly handling cash or assets?"
5. "Does your company perform bank reconciliations?"
6. "Does your company participate in job-sharing or mandatory vacation time?"
7. "Does your company provide fraud training to managers?"
8. "Does your company provide fraud training to employees?"

FIGURE 7
PREVALENCE OF INTERNAL CONTROLS



In Figure 7, each internal control question posed in the survey was assigned a number 1 through 8, as shown previously in the listing of internal control questions. If an owner or manager recorded a response that showed the internal control was in place, a "Yes" was recorded, and if a response showed that the internal control was not in place, a "No" was recorded.

The results indicate the most common internal control in place is the performance of bank reconciliations (#5 in Figure 7) with 13 out of 20 (65%) responding "Yes." If a positive response was given, a second question was posed which asked if the bank reconciliations were checked or reviewed by anyone other than the preparer. Out of the thirteen companies that claimed to perform bank reconciliations, only one company has their bank reconciliations checked by someone other than the preparer. However, it should be noted that two surveys left comments to the side of the question claiming that the owner prepares the bank reconciliations.

Also notable, is that none of the companies surveyed claim to have mandatory vacation or job-sharing policies or provide fraud training to employees or managers. While discouraging, it is understandable that most small businesses would not provide fraud training to employees or managers because of the extra costs associated with training. But, the absence of any job-sharing policies is alarming. One of the largest internal control issues that surround the small business accounting environment is separation of duties. Some may claim that this is a direct result of small sized accounting departments, but it could also be argued that the size of the company is merely an excuse for small business owners to not act in bettering the internal control environments of their companies. Having a one-person accounting department is common, as indicated in the background information, and most likely appears like a sound and logical choice to small business owners because of the many advantages to only employing one accountant. One suggestion for small business owners would be to introduce mandatory vacation time for employees and hire a temporary placement service for that period. A less costly suggestion would be for small business owners to take on some of the duties themselves and actively participate in the verification of bookkeeping. This way, owners are more involved in the financial aspect of the business and in turn, make it more difficult for an employee to manipulate the books without being detected.

If the data in this pilot study was proven to be even somewhat representative of the accounting environments in all small businesses, then the average small business would only have two of the eight internal controls implemented in their operations. Out of the nineteen surveys that claimed internal controls were necessary, only two companies, or about 11%, had more than four of the eight internal controls implemented. Therefore, the expectation that if a company believed internal controls were necessary for small businesses, then they would of had at least four of the eight internal controls implemented.

Expectation 4: Prevalence of Fraud

Expectation: It was expected that out of the twenty companies surveyed, six, or 30%, would claim to have experienced fraud. This expectation was created from the ACFE's 2016 *Report to the Nations* claim that 30% of small businesses will be affected by fraud. Out of the twenty surveys, only three, or 15%, claimed to have experienced fraud. When compared to the 30% provided by the ACFE 2016 *Report to the Nations*, it appears that fraud was less prevalent in the companies that participated in the pilot study than the average small businesses.

It was also noted that four companies claimed to have personally known of fraud that has occurred at another small business. When the three companies who claimed to have experienced fraud are combined with the four companies who claimed to have personally known of fraud at another small business, it is shown that only 35% of the companies surveyed have had any experience with or known of any small business fraud. If the ACFE's claim is that 30% of all small businesses are affected by fraud, then it would be reasonable to assume that significantly more than 30% would be aware of *or* be affected by fraud.

CONCLUSION

The purpose of the paper was to investigate the attitudes of small business owners in two different regional areas by reviewing the data provided by the 2016 ACFE report and comparing its results to a survey of small business owners in the Houston, Texas, and Nacogdoches, Texas, areas. The paper established expectations for four areas: (1) element of family and trust present in a small business, (2) the relationship between family and trust and the level of oversight provided by owners and management, (3) the presence of internal controls, (4) and the prevalence of fraud in the small business community. The results of the survey provided support for the expectation concerning family and trust and did not provide adequate support for the other three expectations. The number of participants was not adequate to determine if the responses for the four expectations would be different in rural area (Nacogdoches) compared to an urban area (Houston). Future research should focus on revising the survey and investigating potential differences in rural and urban settings.

REFERENCES

Association of Certified Fraud Examiners (2014). *Report to the nations on occupational fraud and abuse 2014 global fraud study*.

Association of Certified Fraud Examiners (2016). *Report to the nations on occupational fraud and abuse 2016 global fraud study*.

Laitala, S. (2014, June 11). Big Concern for small businesses: Business fraud overview. Retrieved March 26, 2017, from http://jux. law/big-concern-for-small-businesses-business-fraud-overview/

Stover, F. (2016, May 17). Fraud awareness and the small business 2016. Retrieved March 26, 2017, from https://blog. atchleycpas.com/2016/05/17/fraud-awareness-and-the-small-business-2016/

Wells, J. T. (2003). Protect small business. *Journal of Accountancy*, 195(3), 26-32.