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THE JOURNAL REPORT: SMALL BUSINESS

Running the Show

Inside Jobs

Small-business owners need to trust their employees. Up to a point.

By ARDEN DALE
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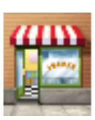
Diann Cattani is the face of small-business fraud.

Ms. Cattani spent 15 months in a federal prison in Florida from 2002 to 2004 for stealing on the job. A trusted employee at a small business owned by a husband and wife, she spent $500,000 of company money on personal items over four years, before turning herself in to her boss. Now, she speaks around the country in a fraud-prevention program called "Taking the Harder Right" -- a series of seminars conducted by Oliver G. Halle & Associates Inc., an Atlanta-based firm that specializes in corporate ethics and antifraud training.

There's a big audience out there for Ms. Cattani. Small businesses are victimized by fraud more often and lose more money than other companies. "It's not just that the frauds are larger relative to the size of the companies -- they're just larger in absolute terms," says Dana Hermanson, an accounting professor at Kennesaw State University in Kennesaw, Ga. "That's a profound result that speaks to the need for fraud prevention and internal controls at small companies."

THE JOURNAL REPORT



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Shared office space and virtual offices[2] allow small businesses to have a presence in any market they choose. Plus, there's a myth that franchising makes owning a small business easy. The truth is[3] that hundreds of franchisees fail each year.

• See the complete Small Business[4] report.

The reason small businesses make such inviting targets is that the same things that make a small business successful also open the door to trouble. Trust in the employees can become an invitation to steal. Entrepreneurial spirit may make it hard to delegate, depriving a business of the middle-management expertise that can be so useful in detecting fraudulent activity. And a small work force may keep a business nimble but also vulnerable, without staff to reconcile the books and exercise other controls.

"The entrepreneurial skills it takes to get a business off the ground aren't the same that allow you to run it over the long haul," says Wayne Rivers, co-founder and president of Family Business Institute Inc., a consulting firm based in Raleigh, N.C.

But there are several steps small-business owners can take to avoid being victimized, including demanding accountability from their employees, setting the right tone with their own behavior and instituting procedures that minimize the chances of fraud going undetected.

'You've Got to Ask'

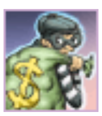
A 2006 report by the Association of Certified Fraud Examiners found that businesses with fewer than 100 employees tend to suffer the biggest losses from fraud. Their median loss that year was $190,000, higher than that in even the largest organizations. Median losses were $179,000 at companies with more than 1,000 employees and $150,000 at companies with more than 10,000 employees.

The most common frauds in small businesses involve employees writing company checks fraudulently, skimming revenue and processing fraudulent invoices, according to the ACFE, a trade organization based in Austin, Texas.

A big part of the problem at small businesses is too much trust. Small-business owners often extend so much trust to employees that they may even hold back from asking crucial questions for fear of destroying a relaxed atmosphere.

"When you communicate to people that you're really looking out for their welfare beyond your needs, there's a real chance they may begin to believe they can do what they want," says Joe Astrachan, director of the Cox Family Enterprise Center at Kennesaw State University and editor of the Family Business Review.

FRAUD ALERT



• **The Problem:** Fraud is more common and more costly at small businesses than at other companies.

• **The Background:** Some elements of small-business success can also invite fraud, like trust in employees and minimal staffing.

• **The Outlook:** Business owners can help protect themselves by demanding accountability, setting the right example and adopting formal controls.

In the case of Ms. Cattani, trust worked against her bosses. She was the first employee hired by the human-relations consulting firm she later defrauded, and was responsible for signing checks, overseeing the payroll and communicating with attorneys and accountants, among other duties. "I had complete autonomy," says Ms. Cattani.

Trouble started when her travel agent mistakenly put a personal holiday trip by Ms. Cattani and her family on the business account. Ms. Cattani spotted the mix-up and intended to mention it, but let the matter slip as holiday bills mounted.

"Once it got gray for me, I don't think I paid for another meal personally," Ms. Cattani says. "I was working out of the home and I expensed company furniture, but I wasn't honest about it. I got greedy."

Her bosses never questioned her.

"You've got to ask the questions," says Ms. Cattani. "Say, 'Show me -- show me the receipt that proves you were at dinner with these clients.' "

Being Too Small

Another problem comes down to size. Small businesses often don't have the staff to maintain important controls.

The most common fraud scheme perpetrated on small businesses is check tampering, according to the ACFE. Check tampering frequently occurs when a person with access to the company's checkbook also is responsible for recording payments and reconciling company bank statements.

"This scheme often arises when limited personnel make it difficult to segregate duties," the ACFE wrote in its 2006 report.

Small staffs also tend to lack a broad range of expertise. Business owners aren't "bankers and chief financial officers, they're entrepreneurs, and generally not very sophisticated on [financial] topics," says Mr. Rivers of the Family Business Institute. "They learn through on-the-job training, and usually only enough to minimize taxes; it's really easy to rip them off financially."

Experts tell small-business owners to watch for something they call the fraud triangle. The notion is that trouble arises when three elements are in play -- pressure or incentive, opportunity and rationalization. Owners are advised to watch for the employee who might be under financial pressure, have the opportunity to misappropriate funds and have a questionable frame of mind or character.

Business owners should also look at their own behavior carefully and set an example, Mr. Astrachan says. Making expenses transparent and justifying them to the group should be part of this, he adds.

For example, an owner requisitioning a company car, computer or bank account for personal use doesn't always hurt the firm if kept in check. But it can hurt the financial position and morale of the company if it gets out of hand.

"In my experience, if owners treat the business as a personal bank account, buying things not relevant to the business, they are encouraging employees to do so, too," Mr. Astrachan says.

Keeping compensation clean is important, too, according to Ira Bryck, director of the UMass Family Business Center in Hadley, Mass. Mr. Bryck advises small businesses that it's best for an owner to be paid separately for roles as owner and manager. As a manager, an owner "should be paid a salary that you would pay anyone for doing your job," says Mr. Bryck. Separately, he says, the owner is entitled to a dividend based on the company's financial performance.

Small-business owners should also think about adopting formal controls to prevent fraud.

Five common antifraud measures outlined by the ACFE are a fraud hot line or anonymous reporting mechanism, fraud awareness or ethics training for employees and managers, an internal audit department, surprise audits and external audits.

In addition, a small-business owner concerned about check tampering might take basic steps like insisting on signing all checks personally, or having an unopened copy of the bank statement sent to the owner's home so it can be reviewed independently and compared with the company's records.

Watch the Books

Proper accounting procedures also are critical. Joe Kennedy, who runs TSBOM, an accounting firm in Los Angeles, says employees often know where the vulnerable spots are in a company's bookkeeping. For instance, taxes often are one of the biggest expenses for a business, and small businesses often try to cut taxes by using the company credit-card account for personal expenses, Mr. Kennedy says. "A lot of owners just hand us their credit-card bill and say 'Just find a way to make them tax deductible,' " he says. "They end up shooting themselves in the foot," he says, because employees take advantage of this approach by using the company card for personal expenses.

Above all, business owners have one particularly powerful weapon against fraud, according to Jonny Frank, a partner at PricewaterhouseCoopers, where he is the fraud risk and controls national practice leader. Though they might not realize it, the intimate knowledge most owners have of their business gives them an inner sense of where things can go wrong, says Mr. Frank.

"They need to unlock from their own minds the various ways the company could get in trouble or be defrauded," Mr. Frank says. If they don't, someone like Ms. Cattani might find the opportunity impossible to resist.

--Ms. Dale is a special writer for Dow Jones Newswires in Jersey City, N.J.

Write to Arden Dale at arden.dale@dowjones.com[5]

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