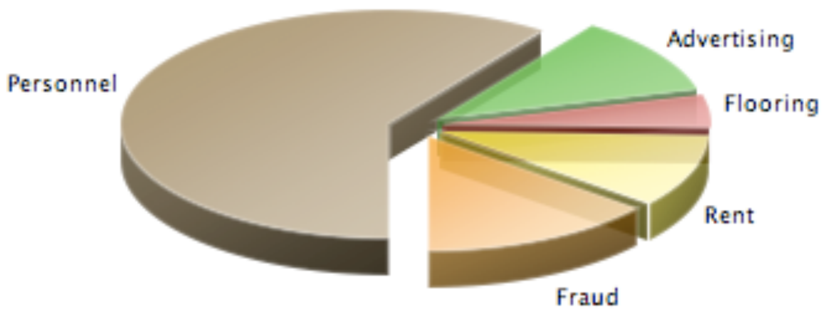
Occupational Fraud Inside the Dealership

Jeffrey B. Forsberg, CPA PS

Missing on the Dealer Financial Statement

The Association of Certified Fraud Examiners concluded that "the typical organization loses 5% of its annual revenues to occupational fraud" in its 2006 report to the nation. This is a staggering result. If fraud were given its own line on dealership financial statements, it would rank as the second largest expense as a percentage of sales. Although technically fraud is a loss and not an expense, fraud pulls insidiously to many accounts on the financials, further concealing it. Even at 1.5% of sales --as is more often quoted inside the auto industry—the magnitude of fraud can be seen in the form of a pie chart:



Fraud can potentially be higher than rent, advertising or flooring expense

Occupational fraud is best introduced by categorizing it:

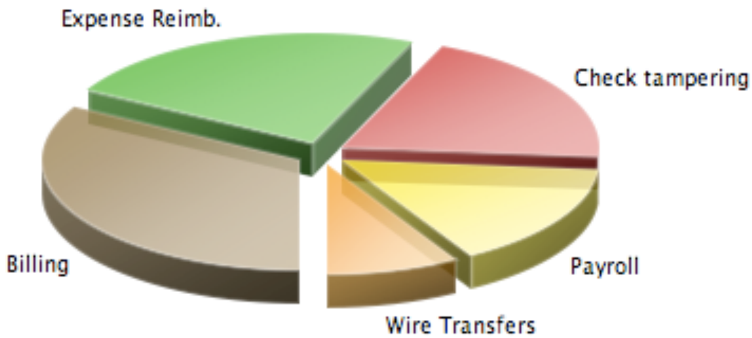
- Asset Misappropriation: Phony invoicing, payroll schemes and skimming revenues (unrecorded sales): The study found that over 90% of all fraud occurred this way.
- Corruption: Bribes, kickbacks and "under the table" type transactions
- Fraudulent Statements: Improper reporting of sales and expense

The report studied and surveyed all types of business and industries, including non-profit and government entities. Because dealerships operate in the retail, service, finance and wholesale environments, drawing hard-and-fast conclusions specific to dealerships is difficult. Despite this challenge, it is worth learning more about the How, Who, and What in order to shrink the fraud slice of the expense pie.

How Is Theft Occurring?

The report indicated that 88% of all asset misappropriations involved cash. In addition, cash disbursements was cited as the overwhelming choice among thieves, utilizing the below methods:

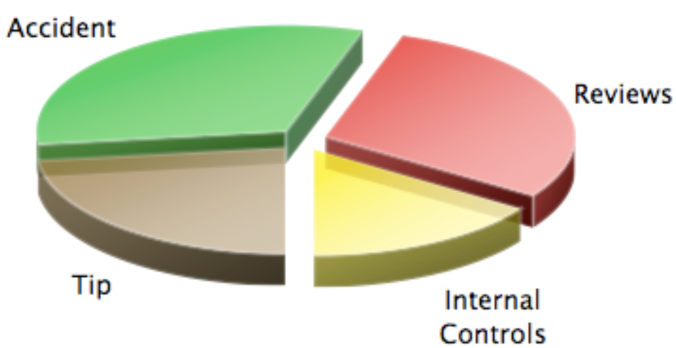
- Billing Schemes: Fictitious invoices are paid to a shell company controlled by an employee
- Expense Reimbursements: Fraudulent expense reports are submitted by employee
- Check Tampering: Employee either alters outgoing checks or steals blank checks and forges them
- Payroll: False overtime claimed or "ghost employees" are used to divert payroll to employees (I highly recommend that dealers review Form W2's annually)
- Wire Transfers: Improper electronic payments are made to a personal account of an employee



To Catch a Thief: The Who

Although there is marketing software named "who's calling" there is, alas, no software for "who's stealing?" However, there are proactive steps one can take against fraud, helped by an understanding of who's perpetuating it. In any "thief profile" the report noted that although theft was more prevalent among non-management personnel, the amount of the theft was three times greater when it involved management. Additionally, in 40% of the fraud cases, collusion involving two or more employees was present, and significantly, the theft amount was five times greater than that of a single individual.

Employee background checks should not be singularly relied upon as an effective fraud prevention measure; the report said that 92% of employees perpetuating fraud had no prior conviction of fraud (That doesn't mean you shouldn't perform background checks because you should). The report cited four ways fraud is uncovered, as illustrated below:



It is disappointing to learn that theft is most often discovered by accident. This isn't surprising because most dealerships do not have internal audit departments nor do they typically have anonymous fraud reporting systems. Among the proactive steps I recommend are (1) increasing the frequency of financial reviews **and** (2) strengthening the Company's internal controls. In my experience, the risk of theft is at its **highest** in the presence of poor accounting records. In fact, it is the perfect environment in which theft occurs, because the financial statements and computer schedules can't be relied upon to spot irregularities because everything looks unusual and suspicious.

Tips from other employees were a frequent means of unmasking theft in the report. To this end, you should consider utilizing online resources for anonymous reporting through hot lines (here's your chance to reclaim a portion of your profits from the internet). Tips from customers, vendors and others can also help catch a thief, but employees are the most common source of tips.

Additional steps on What You Can Do

The financial statements can be a road map to fraud. Unusual balances and/or trends should prompt further inquiry and investigation, and the following are some examples of what to look at in your statements and schedules:

- Cash is overstated (Bank statements not reconciled can conceal cash theft)
- Inventory is overstated (Monthly used inventory valuations, vehicle counts, and annual parts physical counts should be performed)
- Receivables (Write-offs should be reviewed for authorization and monthly statements should be sent to all customer accounts)
- Fixed Assets (A physical count may reveal missing property)
- Liabilities are understated (Review for reasonableness and inquire if factory and vendor statements are reconciled to ensure all expenses are recorded)
- Revenues are understated (Review for trends and patterns that may lead you to skimming, improper voids and/or unauthorized credit memos)
- Expenses are out-of-line with industry benchmarks or historical levels

Finally, a thorough review of the dealership's financial statements and computer schedules should be performed at least twice a year. A CPA friend of mine likened an auto dealership to a colander, along with a recommendation: Plug up the holes, and it will fill up with money.