

# **Fraud Isn't Just For Big Business: Understanding the Drivers, Consequences, and Prevention of Fraud in Small Business**

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## **ABSTRACT**

*Corporate corruption has dominated the business news over the last decade. While large businesses garner much of the attention, small businesses also face a distinct threat from fraudulent activities. In this article, we discuss the impact of fraud on small businesses. We present the classical theory of fraud and describe how pressure, opportunity and rationalization facilitate fraudulent activity. Finally, we propose clear practical steps that can be followed to help prevent fraud in small businesses and we offer future research opportunities.*

## **INTRODUCTION**

One need only look at the most recent archives of any business magazine or newspaper to find examples of fraudulent behavior in the business community. High-profile examples include Bernard Madoff, Fannie Mae, Enron, WorldCom, Tyco and many others. These ethical lapses have cost stakeholders billions of dollars and have left an indelible black eye on American business. In fact, the Association of Certified Fraud Examiners (ACFE, 2008) estimates that U.S. businesses lose approximately 7% of their annual revenues to fraud, which results in a staggering sum of almost a trillion dollars in losses across the economy. The ethical failures of the last decade have resulted in a backlash of investor scrutiny and government regulation and have inspired efforts to tighten corporate ethics standards and increase ethics education in business schools.

Researchers often classify fraud into two broad categories: financial statement fraud and occupational fraud. Financial statement fraud is typically perpetrated by unethical corporate executives attempting to make the company appear more profitable than it actually is. On the other hand, employees at any level of the organization may participate in occupational fraud. When occupational fraud takes place, money or other assets are stolen from the organization. When financial statement fraud takes place, money or other assets are manipulated on behalf of the organization.

The Association of Certified Fraud Examiners (ACFE, 2008) defines occupational fraud as “the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.” Although financial statement fraud at the corporate level may be more conspicuous and receive much more media attention, the effects of occupational fraud on small business can be even more debilitating to the organization. In the case of Page and Palette Incorporated, for example, a trusted bookkeeper was discovered using a company credit card to pay personal debt. The actions put the company in an extremely adverse position when the company was denied the additional credit it needed to restock popular books for the holiday season. The owner of Page and Palette estimates that the inability to order sufficient inventory cost the company as much as 20% in potential sales, in addition to the \$150,000 the bookkeeper skimmed over a two and a half year period (Covel, 2009).

From January 2006 through February 2008, fraudulent activities cost small businesses (defined as a business with fewer than 100 employees) an average of \$200,000 per fraud incident (U.S. Chamber of Commerce, 2009). No other category – including the largest firms – had so high a median loss (ACFE, 2008). As was the case with Page and Palette Incorporated, this type of loss can be particularly detrimental because of the inherent lack of resources that is characteristic of most small businesses.

Empirical evidence suggests that the perpetrators in many unethical and illegal acts (specifically theft and other forms of fraud) are, unfortunately, often the employees of small businesses. For example, one employee of a Nebraska pawnshop was apprehended after being seen loading merchandise into his truck after the store had closed for the night (Joseph, 2009). Although most employee theft is much less blatant, fraud is more prevalent than many employers realize. A study performed by the consultancy firm Jack L. Hayes International suggests that one out of every 28 employees was arrested for theft in 2007 alone (Sherr, 2009). Additionally, the U.S. Chamber of Commerce estimates that as much as 30 percent of small business failures can be attributed to employee theft (Still and Lehner, 2009).

However, employees are not the only initiators of unscrupulous actions. Business owners also fall prey to the enticements of fraud and, unfortunately, often seek to cheat creditors, suppliers and customers. The types of unethical behaviors in which owners of small businesses engage are generally quite different from those in which employees engage. Research has suggested that the most common fraud schemes in small business relate to finance – specifically, fraudulent billing and check tampering (ACFE, 2008, p. 5). The owners of a small auto dealership in Utah, for example, were recently accused of failing to deliver vehicle titles to customers who had purchased cars and trucks from the dealership (Jensen, 2010). The owners then used the stolen money for personal use instead of paying creditors for outstanding auto loans. The company is now out of business and the owners are facing multiple legal charges for unlawful business practices.

Such fraudulent behaviors can result in devastating consequences for small businesses. Some research even suggests that fraud is the *main* cause of small business failure – having a larger effect than any of the traditionally attributed causes (including a declining economy) (Carland, Carland, and Carland, 2001). While the consequences of fraud are extremely destructive to both small business owners and employees, deceitful business practices affect all stakeholders of the organization including the community, vendors, customers and others. Customers, for example, may be stuck with worthless products or empty promises; suppliers and creditors may go unpaid for their services, employees may lose their jobs, and communities often suffer damage to their tax base and reputation. Clearly, understanding the causes and consequences of fraudulent behavior and how to prevent it should be of the utmost importance to all small business owners.

## CLASSICAL FRAUD THEORY

Traditional fraud theory explains the motivation for fraud as having three key elements: pressure, opportunity, and rationalization (Cressey, 1953). Unfortunately, research has suggested that the perceived pressure felt by both small business owners and employees is often sufficient motivation for many individuals to indulge in unethical acts. These pressures are generally financially driven, but may also include non-financial pressures, such as a desire to falsely represent the success of the organization. Opportunities to act unethically may arise from the very structure of the organization. Alternatively, employees may engage in manipulating an organization's internal controls to provide opportunities for fraud. Rationalization creates a perception that although the action is not socially acceptable, some unique, extraneous circumstance justifies it. Understanding the role of pressure, opportunity, and rationalization is an important initial step toward fraud prevention.

### Pressure

By nature, the entrepreneur, or small business owner, is enterprising and driven by a strong desire to be successful. This zeal for achievement may lead the ethically weak to feel overwhelmed by the sometimes-ominous uncertainty that lies in the future. The financial pressure to succeed becomes even more prevalent when the livelihood of the small business owner and his family depends on the success of the business.

Pressure may also be the result of the unique methods by which many small business owners obtain funding. In addition to the use of personal assets, many small business owners fund their firms with money procured from venture capitalists, angel investors or family and friends. The requirements for the repayment of such investments may not be as strict as formal debt incurred through banks and other financial intermediaries. However, the benevolence of the

investment, or the intimate relationships between small business owners and their investors, may induce a level of repayment pressure, in addition to those already faced by small business owners.

### **Opportunity**

Permissive work environments and misplaced trust are strong indicators of occupational fraud (U.S. Chamber of Commerce Small Business Nation, 2009). It has been estimated that 5 percent of individuals would commit fraud in any situation, 10 percent would not commit fraud regardless of circumstances, and the remaining 85 percent of people would only commit fraud, given the right conditions (Lavery, Lindberg, & Razaki, 2000). In order for a perpetrator to engage in fraud, the person must perceive that that he will not get caught, or that, if he is caught, there will be little or no repercussion for his dishonest acts.

Small businesses, unfortunately, often lack the internal controls that larger organizations have. As a result, eliminating opportunities for fraud is extremely difficult. Furthermore, since many small businesses are privately owned they are subject to much less regulation and different reporting standards than are publicly owned corporations. As such, opportunities for fraud become more apparent.

In addition to fraudulent reporting, small businesses face a collection of other ethical dilemmas. Small businesses are especially susceptible to theft as they often lack the resources necessary to establish formalized systems intended to deter unscrupulous behavior and prevent fraud. It is estimated that 75 percent of employee theft is never discovered (Paulsell, 2007), suggesting that even if firms don't see fraud within their own organization, it may still be occurring. The ACFE reports that fraudulent conduct in small business is more likely to be discovered by accident than by an internal audit. The ACFE also found that, compared to all other sized businesses, fraud in small business is the least likely to be caught by internal operations (ACFE, 2008). Given the perceived vulnerability of small business, extra precautions should be taken to compensate for the absence of strong internal controls.

Another challenge that many small business owners face is the fact that employees are often required to fulfill various roles within the organization. This absence of separation of duties increases the opportunity for individuals (both the owner and employees) to act unethically without anyone else knowing. The owner of a small trucking company in Alabama, for example, thought that he had sufficient control of the organization since he was the only person with authority to write checks for the company. However, his bookkeeper was given all other financial and accounting responsibilities. These responsibilities included reconciling the checking account, authorizing wire transfers, and keeping track all of the records. With no one else auditing her work, she was able to embezzle \$550,000 from her employer before being discovered by a Certified Public Accountant, who was hired to investigate a small discrepancy in the firm's accounting records (Wells, 2003).

Finally, small business owners and their employees may lack the knowledge and training necessary to fully understand their firm's potential vulnerability to fraud and take the precautionary measures required to deter it. Many small business owners strive to maintain a family-like environment among their employees. This exaggeration of trust may discourage small business owners from offering important fraud prevention training.

### **Rationalization**

Even in the presence of pressure and opportunity, fraud will only exist if individuals are able to rationalize their dishonest acts as acceptable. If the potential perpetrator cannot find a way to justify his actions, it is unlikely that fraud will ever take place. The level to which an individual can comfortably justify unethical behavior is, in large part, directly proportional to the individual's level of personal ethics. Given constant levels of pressure and opportunity, some individuals have a greater proclivity toward unethical acts than others which leads to more "creative" justifications for their actions.

Rationalizations by small business owners include the idea that because their family and employees depend on the survival of the business—a just cause by any standard—some degree of fraud is acceptable. Another common rationalization is that success in business requires that owners bend the rules a little. An individual may rationalize, for example, that in such a competitive environment, any behavior that creates an advantage for the individual and creates a disadvantage for the competition is not only tolerable, but also encouraged. A similar idea is that individuals in small

business are justified in compromising their ethical standards because they are unfairly disadvantaged compared to larger firms. Similarly, many small business owners may justify their unethical behavior as a short-term solution to develop the business. These individuals assume that when the company is larger these actions will no longer be necessary and, therefore, will cease.

Employees of small business often rationalize their unethical acts in ways very similar to those of the owner. An employee, for example, may feel that the company has wronged him in some way. As a result, fraudulent actions are justified as being a necessary form of retaliation, either for the sake of revenge or to preclude any future instances of employee maltreatment. A similar justification occurs when an employee feels that his current wage is significantly less than his contribution to the organization. In this case, employee theft is justified as being the earned income unfairly withheld by the company. Through theft, the employee perceives that he is simply not allowing the company to forcibly steal labor from him. Employee fraud may also be motivated by the Robin Hood effect –stealing from the rich to give to the poor – especially in times of severe financial difficulties.

The self-rationalization that occurs within any organization can be largely attributed to the level of ethics fostered by the organization's environment. Unethical and dishonest behaviors are much less likely to occur in firms with an established code of ethics (Albrecht, Albrecht, & Dolan, 2007). Firms that maintain high ethical standards, supported by enforceable policies, often promote a general feeling of honesty and integrity that permeates throughout the entire organization.

### **PROTECTION AGAINST FRAUD**

All small business owners should take precautions to proactively prevent fraud within their organizations. Additionally, small business owners should be aware of the pressures that both they and their employees face. Business owners should also have a fraud plan that outlines, step by step, how they will respond to fraud if it is discovered within their organization. As such, if fraud is detected, the organization will have a set plan to both resolve the current incident and prevent future incidents from occurring.

Communication is another important aspect of fraud prevention. When small business owners are open and honest, and label appropriate behavior, the probability that fraud will occur is minimized. Understanding appropriate behavior makes rationalizing inappropriate behavior much more difficult compared to when confusion and inconsistencies exist within the organization. Finally, the last step to fraud prevention includes a no-tolerance policy for fraud throughout the organization.

Specific measures that all small business owners should implement in order to prevent fraud include the following. First, hire honest individuals by conducting background and reference checks on all potential hires. Second, establish a code of ethics that clearly communicates appropriate ethical behavior throughout the entire organization. Such a code should be the foundation for formal ethics training. Third, as previously mentioned, small business owners should model appropriate behavior by being an example of honesty and integrity. Fourth, establish a system of formal internal controls within the organization. Such a system should include complete separation of duties for any position that is directly associated with recording, counting, analyzing or depositing the company's assets. For inventory centric businesses, this would include periodic, unscheduled audits of the organization's inventory. Other fraud-prevention actions include making prompt bank deposits without cash withdrawals, using numbered receipts for all payments, locking cash and checkbooks in a secure area, and allowing the company's books to be regularly audited by a third party.

### **CONCLUSION**

Recent instances of fraud have been widespread across all industries. The societal costs incurred by such fraudulent behavior are enormous, affecting individual consumers and firms alike. The structure of small businesses makes them especially vulnerable to the devastating effects of fraud. Increased research that explores how preventive

measures directly alleviate the pressure, opportunity, and rationalization that contribute to fraud can pay big dividends for small business owners and the greater economy.

While much has been learned, there are still many questions that need to be answered about the fundamental drivers of fraud. Drawing on disparate literatures from psychology, sociology, and business will assist in the exploration of the effects of pressure on individuals from environmental influences, managers, or social groups. Experiments that test the perception of opportunities to commit fraud can enlighten our understanding of the mechanisms that can be used to change perceptions. There is a growing body of literature in the information systems field that investigates such questions. Increased emphasis on ethics in research and pedagogy will strike at the heart of the process of rationalization.

In an increasingly complex world, fraud perpetrators often develop new tools and opportunities to scheme and lie and cheat for gain. However, researchers and business leaders have the opportunity to also use new technology and knowledge to develop tools and processes that will assist in the fight against the debilitating effects of fraud.

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