

Wealth Protection for Private Business Owners
RUSS ALAN PRINCE & HANNAH SHAW GROVE

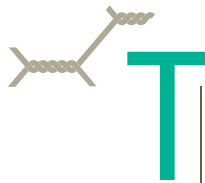
Inside Job: Employee-Driven Fraud On The Rise In Private Businesses

A growing number of small and medium size companies are suffering from the corrosive effects of employee-driven fraud as the economic environment remains uncertain. Concern among business owners has escalated during this time but controls to prevent fraud are practiced more by professional managers than family-run businesses.

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FOREWORD



ABOUT INC. BUSINESS OWNERS COUNCIL

Inc. Business Owners Council (www.inc.net) is *Inc.* magazine's membership organization for top entrepreneurs and family business owners. **The Council** brings thought leaders together with council members to explore best practices and develop insight that help members make smarter business decisions.

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These unprecedented economic times have led some to do things they ordinarily wouldn't do. In the case of this revealing research essay, the authors observe that fraud, embezzlement and corporate theft are on the rise. Each year, billions of dollars slip through the fingers of American businesses from malfeasance and criminal activity, dollars that could go to salaries, innovation and expansion.

Any business owner knows that the difference between a "good year" and a "bad year" isn't always determined by gross sales—it's also guided by how well the business is run and how well management keeps the business under control.

The intelligence in this research can go a long way towards helping business owners regain that control. By eliminating resources wasted by a few, owners can grow and develop their firms which could improve the circumstances for the many people whose lives are touched by that business.

Inc. Business Owners Council is designed to help its members make smarter decisions about their businesses. Original and actionable research like this is one way that we can do that for our members and for the larger *Inc.* community of innovators and entrepreneurs. We hope you find this research valuable.

Sincerely,

Lewis Schiff
Chairman, Executive Director
Inc. Business Owners Council

KEY THEMES

- Employee-driven fraud at small and medium size businesses has increased in the past three years
- The escalation is largely attributed to the economic crisis, which is expected to spawn additional fraud in the coming years
- Fraudulent activities are more likely to be detected within traditional corporate structures than in family-run businesses
- Concern about occupational fraud doubled among all firms between 2006 and 2009
- Very few small and medium size firms, regardless of ownership structure, have the internal controls in place to identify and manage such concerns
- Despite the increase in illegal activities and the heightened concern among senior management at middle market companies, just a small percentage plan to institute more measures to deter such activities

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ABOUT HERALD NATIONAL BANK

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ABOUT THE AUTHORS

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Ms. Grove is a respected author, columnist and speaker and a leading authority on the mindset, behavior, concerns, preferences and finances of high-net-worth individuals. She is the executive editor of *Private Wealth*, the first and only magazine for professionals with ultra-affluent clients, and the author of nine books and numerous reports on private wealth and related topics. She co-authors columns for *Elite Traveler* and *Robb Report China* and is widely quoted in the national, trade and online press.

She spent nearly 20 years in the financial services industry where she worked closely with institutional and high-net-worth investors to develop sophisticated financial, planning and servicing solutions. Grove is the principal of HSGrove Private Wealth Consultancy, and a long-time partner of Russ Alan Prince, the president and founder of Prince & Associates, Inc.

RUSS ALAN PRINCE



President
Prince and Associates, Inc.

Mr. Prince is the president of Prince & Associates, Inc., the leading market research firm specializing in private wealth. He is one of the most prolific authors on the topic of high-net-worth individuals and has completed work on more than 40 books covering subjects ranging from investor psychology to luxury spending, from prospecting in the mass-affluent segment to the political philosophies of the super-rich. His body of work is regularly consulted by family offices, private bankers, wealth managers, estate planning specialists, elite advisors and producers, academia, the press — even the wealthy themselves. Collectively, the cache of research-based insights within Prince's publications is the most complete longitudinal data and the largest, most comprehensive database on the topic.

Mr. Prince consults to high-net-worth families on accessing various family office and wealth management services. He also works with financial and legal experts who provide cutting-edge strategies and concepts to families with exceptional wealth. He is a highly sought consultant to the ultra-high-net-worth and elite advisors, and is regularly cited in the worldwide press.



In addition to the typical management challenges facing the owners and executives of businesses with annual revenues between \$2 million and \$50 million, fraudulent activities are on the rise, which can have far-reaching and damaging effects on a company while compromising smooth and profitable operations.

Occupational fraud takes many forms, though most activities are typically initiated by an employee (acting alone or in partnership with co-workers) to exploit his or her firm's resources for personal gain. Common examples of illegal and unethical business-oriented fraud include:

- Asset theft such as larceny, skimming, payroll schemes (i.e., ghost employees, falsified wages) and check tampering
- Financial statement manipulation such as incorrect or inflated asset valuations
- Corruption such as bribery and economic extortion

Broadly speaking, there was less evidence of occupational fraud among middle market businesses during 2006 than in 2009. The increase in fraudulent and criminal activities is generally attributed to the economic impact of the credit crisis and the ongoing recession, conditions that have negatively affected all types of people and professionals in myriad ways.

THE RESEARCH

To understand some specific challenges facing business owners we conducted two studies the first in 2006 and the second in 2009 with senior executives of small- and mid-size businesses about their experiences and concerns regarding employee-related fraud.

The companies represented in the research fell into two categories:

- Those owned or controlled by a family.
- Those with a traditional corporate structure run by unaffiliated employees.

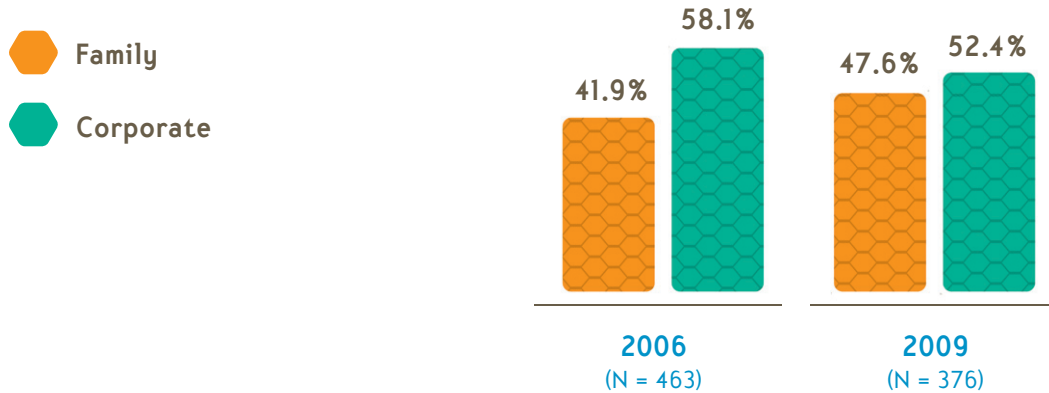
Roughly half of the family-owned businesses in our research initiative were spearheaded by a single family (Exhibit 1). In both studies, the respondents were the CEO, president or chairman of their respective organizations.

Other research findings indicate that fraudulent activities are most damaging to small- and mid-size companies that are often in a critical stage of growth and do not yet have the experience or resources to identify and manage such situations. As a result, our research focused on companies with annual sales between \$2M to \$50 million.

In 2006, corporate organizations dominated the sample of respondents. By 2009 the two types of ownership structures were more equally weighted.

exhibit #1

TYPE OF OWNERSHIP



While fraudulent activities increased on average 167.5% between 2006 and 2009 among the enterprises represented in our survey, the overall ratio of firms that reported such crimes is less than one in five (Exhibit 2).

exhibit #2

FRAUD COMMITTED IN THE PREVIOUS YEAR

	2006 (N=463)	2009 (N=376)	3-Year Change
Family	6.2%	14.5%	+133.9%
Corporate	15.2%	23.4%	+54.0%
Weighted Average	11.4%	19.1%	+67.5%

Among the companies that cited such activities, the most common grievance was asset theft (Exhibit 3). Roughly two-thirds of firms experienced some form of thievery in 2006, a figure that grew by nearly 45% percent by 2009 to 87.5% of all businesses surveyed. Falsified financial statements doubled, from nearly 30 percent to 60 percent, a 111% rise, in the same timeframe while corruption remained mercifully low by comparison and even dropped during the 3 year interval.

exhibit #3

TYPES OF OCCUPATIONAL FRAUD

	2006 (N=53)	2009 (N=72)	3-Year Change
Asset thievery	60.4%	87.5%	+44.9%
Financial statement manipulation	28.3%	59.7%	+111.0%
Corruption	15.1%	12.5%	-17.22%

The number of executives expressing concern about fraud originating at their firms more than doubled over the past three years, likely a response to personal or anecdotal experience and enhanced media coverage (Exhibit 4).

exhibit #4

CONCERNED ABOUT OCCUPATIONAL FRAUD

	2006 (N=463)	2009 (N=376)	3-Year Change
Family	27.3%	66.5%	+143.6%
Corporate	30.1%	61.9%	+105.7%
Weighted Average	28.9%	64.1%	+121.8%

Family-owned organizations are less likely than firms run by professional managers to have processes and procedures in place to deal with fraudulent activities (Exhibit 5).

exhibit #5 INTERNAL CONTROLS IN PLACE

	2006 (N=463)	2009 (N=376)	3-Year Change
Family	16.0%	16.5%	+3.1%
Corporate	38.3%	42.1%	+9.9%
Weighted Average	28.9%	30.6%	+5.9%

Despite the heightened concern, especially among corporate businesses, very few plan to augment the internal programs designed to deter or minimize fraudulent activities in their firms (Exhibit 6).

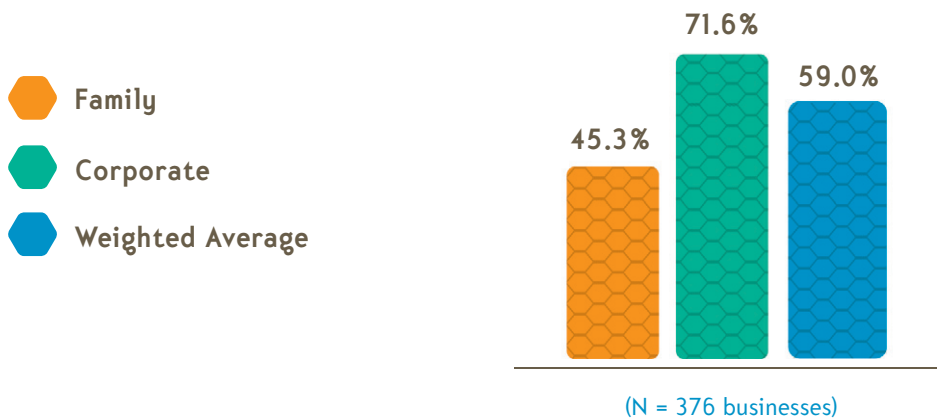
exhibit #6 PLANS TO ENHANCE INTERNAL CONTROLS

	2006 (N=463)	2009 (N=376)	3-Year Change
Family	9.8%	13.4%	+36.7%
Corporate	7.8%	8.1%	+3.9%
Weighted Average	8.6%	11.2%	+30.2%

It's important to note that the economic downturn has colored the outlook of most business leaders. About 60 percent of the executives surveyed in 2009 believe the climate will lead to more fraudulent activity as employees struggle with personal and professional setbacks (Exhibit 7).

exhibit #7

EXPECT THE DOWNTURN TO RESULT IN MORE FRAUD



CONCLUSION

A growing number of small and medium size companies are already experiencing fraudulent activities that threaten various aspects of their operations, and our research indicates that the majority of owners and senior executives believe the incidence of such crime will increase in tandem with the economic downturn. Fortunately, corporate-owned companies are already taking steps to control the damage and instill a 'no tolerance' policy among their employees. Privately-owned and family-run businesses must adopt stronger measures to limit fraud and its effects within their organizations, efforts that will ultimately prepare them to benefit more fully from the end of the recession and a more stabile market environment.



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