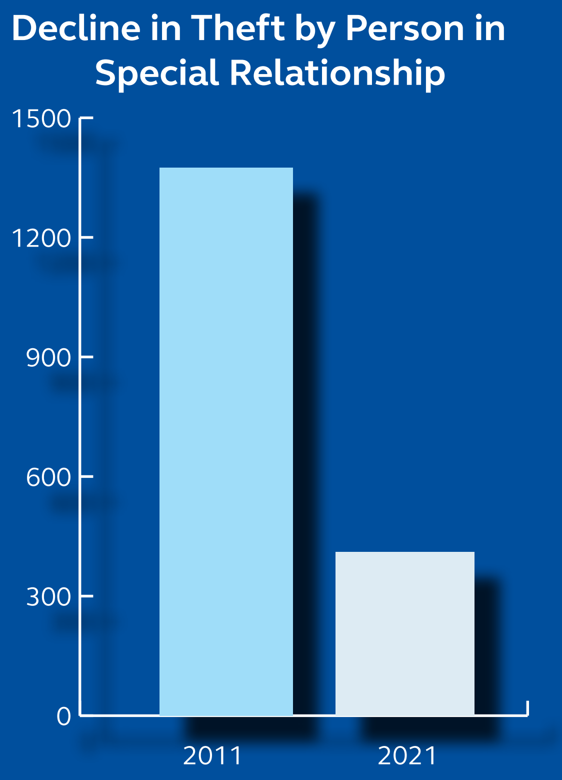
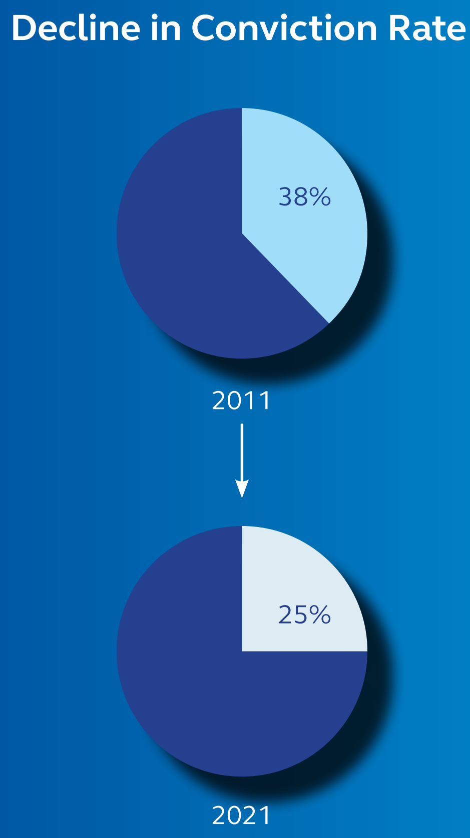
McLarens

Clipping the wings of the devil you know

Fidelity Guarantee Claim Trends and Mitigation

mclarens.co.nz





Charges for Theft by Person in Special Relationship under section 220 of the Crimes Act 1961 have declined over the last decade.

Conviction rates steadily declined to 38%, and currently only 25% of charges result in successful prosecution.

Although charges and conviction rates have been decreasing, at McLarens, we noticed increases in the discovery of employee theft over the last 24 months.

We've seen a sharp increase in fidelity claims in April 2020 and again in August 2021. Whilst we'd love to attribute this to successful marketing campaigns, anecdotally, we have identified the following contributors:

- Pressures arising from increased costs of living
- Opportunities introduced by the advent of the Covid-19 pandemic (and lockdowns)
- An overall rise in crime rates

Table 1: Ministry of Justice statistics on charges and convictions for Theft by Person in Special Relationship 2011-2021

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Charges	745	1,375	1,209	776	787	705	561	745	730	395	411
Convictions	437	802	513	487	464	327	249	426	575	210	158
% of Charges that Resulted in Convictions	59%	58%	42%	63%	59%	46%	44%	57%	79%	53%	38%

Discovery and Methodology Trends

In relation to the claims escalation in April 2020 and August 2021, we can confirm that the majority of the claims investigated by McLarens, featured scenarios where Covid-19 isolation enforcements were instrumental to discovery.

These months highlight times when New Zealand, or parts thereof, were in lockdown and most businesses were forced to operate using e-commerce only or cease trading entirely.

As a result, businesses saw their accounting and reconciliation systems come to a halt, allowing ready identification of fraud involving teeming and lading. To explain: this method of theft is one of the most common modus operandi used by perpetrators in fidelity guarantee claims, followed closely by falsifying supplier invoices.

Teeming and lading is a bookkeeping fraud, also known as:

- Short banking
- Delayed accounting
- Lapping

It involves the allocation of one customer's payment to another customer's account to make the books balance, often to hide a shortfall or theft. The traditional teeming and lading is a method by which a person takes payment, uses the money elsewhere, and posts the transaction later. In lay terms, this is robbing Peter to pay Paul.

When lockdowns were declared unexpectedly, perpetrators found themselves having 'robbed Peter' and 'owing Paul', the shortfall becoming clear when executive personnel reconciled the accounts to take stock of their companies' financial positions.

Another trend noted, is the near disappearance of cash theft in traditional store based retail businesses, due to the advancement of e-commerce and a move toward cashless / contactless payment necessitated by public health requirements.

Motives

Whilst our observations are in relation to the modi operandi, we have also tracked the motives behind these claims.

Fidelity Guarantee refers to the fiduciary relationship between the Insured and its employees - a relationship of trust. To understand motivations to jeopardise those relationships by betraying the employment relationship, we need to understand the level of trust involved.

These relationships, like many other types of relationships, are based on calculated trust; the employer can trust that the employee would not betray the relationship on the basis that this would result in the loss of the relationship (and therefore remuneration) for the employee.

But what happens when intervening forces cause imbalance to that calculation?

Typically, we find that that intervening cause to unbalance the relationship falls into one of three categories:

1. Opportunity
2. The relationship itself
3. Hardship

The first of these is fairly common and arises when there is not enough at risk for the employee (chance of being caught, the value of the relationship from their perspective) to pass up on an opportunity to take advantage of a vulnerability in the Insured's systems and processes for personal financial gain.

The second includes motives linked to a disgruntlement such as perceived entitlement

(taking from the business to supplement a wage that is perceived as being insufficient remuneration) or retribution.

The third is the larger category and features the most common motives and the primary motives for employee thefts investigated by McLarens in the past 24 months. This includes being unable to meet rising costs of living, medical expenses, childcare expenses, and addictions (gambling, substance abuse, and, with the accelerated advancement of e-commerce…online shopping). These factors, increasingly experienced by New Zealanders in the current economic climate, along with the upheaval Covid-19 has brought to many households, the employment relationship can quickly be thrown out of balance. The need of the immediate financial wellbeing of the employee becomes more important than the long-term benefit of maintaining the relationship i.e. present desperation trumps un-appraised benefits of employment.

These factors are commonplace. Increasing the benefits of the relationship to outweigh the hardships appear to be the only solution. Unfortunately, it is less achievable with business owners feeling the impact of the slowing economic growth.

Insured's can take steps to decrease the reliance on calculated trust in their fiduciary relationships.

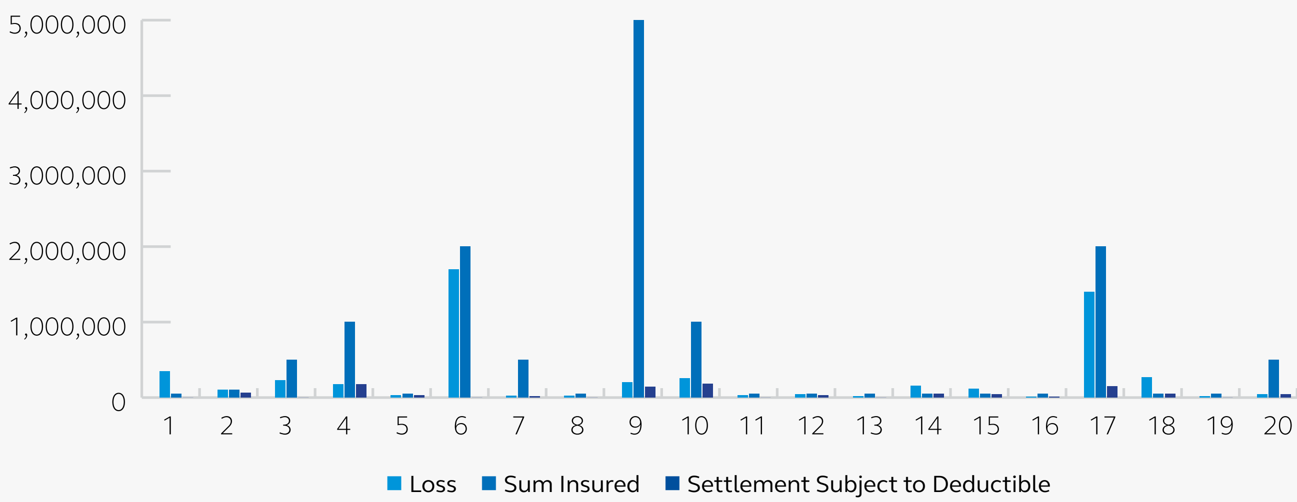
Extent of Loss Trends and Prevention/Mitigation

McLarens has extracted data from its bespoke practice management system, Centric, for a representative sample of 20 fidelity guarantee claims adjusted over 24 months, beginning 1 April 2020.

Table 2 below depicts the data extracted. In the first instance no particular trends are identified, however upon examination of the adjacent data depicting type and size of businesses and the modi operandi, we can present a key observation:

SMEs notifying fidelity guarantee claims are incurring losses exceeding their sums insured and this is often due to the period of theft extending from 18 months to 10 years.

Table 2: Sample of Fidelity Guarantee Claims adjusted by McLarens 1 April 2020 to 31 March 2022



When we interrogate why the theft has continued for extended lengths of time without detection, the answer is consistent. We have found contributing factors to be a lack of:

- Robust accounting and reconciliation processes
- Diligent use of record keeping systems

From our experience, we can see that with such an array of business types, accounting processes, and varying degrees of vulnerability to theft, there is no panacea to prevent employee theft.

In order to mitigate employee theft, however, the most effective steps Insureds can take are:

- Build robust systems and processes that include automated transaction logging
- Implement protocols that feature dual responsibility for releasing payments, receipt of funds and recording of funds inwards, outwards or transfers (i.e. the credits)
- Utilise the bookkeeping system subscribed to by the business to the best advantage

With these steps, the Insured can replace calculated trust as the backbone of the fiduciary relationships with their employees and be better assured that its systems will identify a betrayal of trust at the time it occurs.

Jon Stagg
CHARTERED LOSS ADJUSTER
MCLARENS SPECIALIST SERVICES

About the author:

Jon holds a Bachelor of Arts majoring in Conflict Resolution as well as a certificate in Financial Services and Diploma of Loss Adjusting. As a Senior Associate of ANZIIF, professional member of the Resolution Institute, and Chartered Loss Adjuster (ACLA), Jon has been adjusting Fidelity Guarantee claims since 2012 and works alongside the McLarens Forensic Accounting Services team to deliver pragmatic and result-oriented investigations whilst working with NZ Police and Insureds' accounting personnel to advance quantification and recovery of losses.