



A Rose By Any Other Name: The Necessity Of Background Checks

By: Ron Marden and **Dwayne McSwain**

Abstract

Rose Smith was a divorced soccer mom who worked as a decently paid vault teller at one of the regional banks in a small town in the foothills of North Carolina. She was employed by the bank for several years and liked by everyone because of her winning personality and her ability to be a team player at work whenever she was needed, even though she was a full-time working mother with three grade school children. Unfortunately, her likeability was the main reason why no one suspected that she was slowly "borrowing" from the bags of money she handled in the vault. The bank managers and other employees were simply shocked to find that the total amount she had pilfered reached nearly \$50,000 over a two-year period. She was subsequently investigated by the FBI and eventually charged with embezzlement. Because of a backlog of cases in the district court system and appeals from her lawyer, she was not scheduled to face trial for somewhere between six and seven months. By and large, when someone is accused of embezzling large amounts of money like this from a financial institution, one would think that the scandal and humiliation would follow that person around, making it somewhat difficult to find new employment, particularly in an occupation that involves the handling of money. Guess what - think again!

Marden, R. and **McSwain, D.** (2010). A Rose By Any Other Name: The Necessity of Background Checks. *Internal Auditing*, March/April 2010. Vol. 25, No. 2, 10-15. NC Docks permission to re-print granted by author(s).

A ROSE BY ANY OTHER NAME:

Thorough background checks are a necessary, but sometimes overlooked, audit procedure. It should be part of every company's system of quality control and monitored by someone who is independent of that function, such as an internal auditor.

THE NECESSITY OF BACKGROUND CHECKS

RON MARDEN AND DWAYNE MCSWAIN

Rose Smith was a divorced soccer mom who worked as a decently paid vault teller at one of the regional banks in a small town in the foothills of North Carolina. She was employed by the bank for several years and liked by everyone because of her winning personality and her ability to be a team player at work whenever she was needed, even though she was a full-time working mother with three grade school children. Unfortunately, her likeability was the main reason why no one suspected that she was slowly "borrowing" from the bags of money she handled in the vault. The bank managers and other employees were simply shocked to find that the total amount she had pilfered reached nearly \$50,000 over a two-year period. She was

subsequently investigated by the FBI and eventually charged with embezzlement. Because of a backlog of cases in the district court system and appeals from her lawyer, she was not scheduled to face trial for somewhere between six and seven months.

By and large, when someone is accused of embezzling large amounts of money like this from a financial institution, one would think that the scandal and humiliation would follow that person around, making it somewhat difficult to find new employment, particularly in an occupation that involves the handling of money. Guess what—think again!

Rose and the Coalition

Needing to feed and care for her children, less than three weeks after she was fired and charged with the bank crime, Rose Smith landed a job several counties away in the high mountains of North Carolina as the head of payroll for the Stone Mountain Christmas Tree Coalition. The Coalition comprised more than a dozen individual tree businesses and employed more than 400 employees, though about 325

RON MARDEN, Ph.D., CIA, CPA, is the Cherry Bekaert Holland Research Fellow in the Department of Accounting at Appalachian State University in Boone, NC. He is a member of the Institute of Internal Auditors and has taught auditing, internal auditing, and fraud classes.

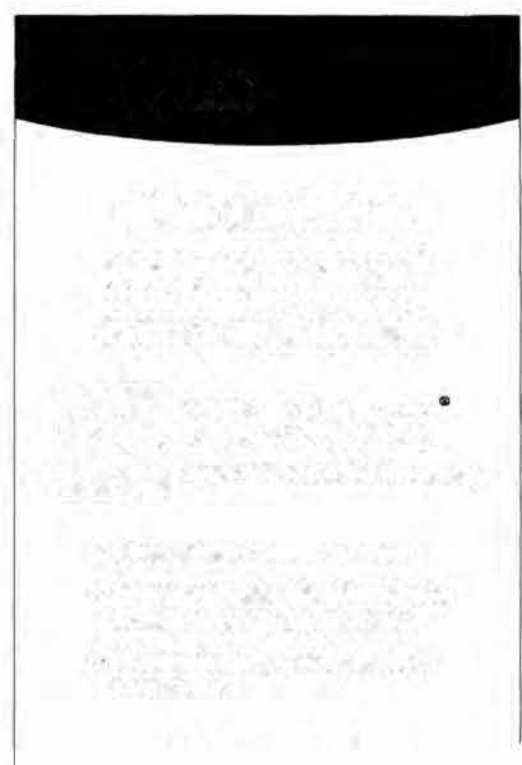
DWAYNE MCSWAIN, Ph.D., CPA is an Assistant Professor at Appalachian State University in Boone, NC. He has taught internal auditing for a number of years and has worked as an internal auditor as well.

were only used seasonally. The seasonal employees were used mainly in the fall to harvest the trees for wholesale to large chains such as Wal-Mart, K-Mart, and others. Within several weeks of starting her new job, Rose managed to launch a scheme that netted her almost an additional \$135,000 by simply cutting checks to herself as a seasonal employee under her maiden name *Rose Martin*. The Coalition was obviously not aware of her previous activities, and Rose did her best to make sure they would never find out by providing them with false information regarding her references and previous employment.

How could this happen and how did she eventually get caught—again? Apparently, it happened because anyone who applied for a job with the Coalition was first sent to the personnel office located in the county's largest town. After a cursory approval of an application and a process lacking any type of internal controls, the employee was instructed to take the papers over to the payroll office located on the other side of town where the employee and pay rate information was entered into the system. For all practical purposes, Rose "was" the payroll department. With virtually no system of checks and balances, Rose Smith found it quite easy to input *Rose Martin* into the system as a fictitious seasonal employee.

The Coalition was very successful, with more than a quarter of a million trees cut and sold annually to the large chains that would contract tens of thousands of trees at a time and a huge number of smaller independent retailers, churches, schools, scouts, assorted not-for-profits, and entrepreneurs who might each buy hundreds of trees at a time. It takes a lot of labor to cut and harvest that many trees given that it must be done in a very short time period. This is because the harvest cannot be gathered too early or it will dry out before needed, turn brown, and lose needles.

The necessity for a quick turnaround requires a large number of seasonal help, willing to work under sometimes very extreme weather conditions, that must be available on a moment's notice. In other words, for a short period of time, the Coalition will take almost any able body



as long as he or she can handle the work. Documentable resumes and background checks were rarely requested. In fact, most of the seasonal employees traveled from Mexico and Central America, migrating between the citrus harvests in Florida and the Christmas tree harvests in North Carolina. Not surprisingly, most of them did not have bank accounts and were paid in cash. Foremen, who were full time Coalition employees, oversaw groups of 20 to 30 seasonal workers at a time and reported the laborers' hours to payroll each week. The payroll department took this information to prepare the registers. Unfortunately, payroll also prepared and supplied

the envelopes of cash to the foremen to distribute to the seasonal workers.

Knowing how the system worked, Rose Smith grew even more confident and took the liberty of inputting several more fictitious seasonal employees. She simply made up false application papers for her files, which were obviously not shared with personnel, and entered them into the payroll system. She figured that if anyone even cared to reconcile the number of files she had compared to personnel, she would claim that personnel must have misplaced or lost them. This seemed reasonable given the lack of internal controls and the overall Coalition control environment. Consequently, with each passing week as she prepared envelopes of cash for the seasonal employees, she would set aside the false envelopes and take the cash home.

The internal auditor's expertise

Rob Norris had been elected CEO of the Coalition and had just started three months before Rose. As he looked at the quarterly financial statements that were put together by the Coalition's part-time accountant, he was puzzled. Although Rob's expertise was in forestry, he had taken a few accounting courses in college and could not understand why the payroll expense seemed unreasonable compared to prior periods. Rob asked the Coalition accountant, Barry Holder, if there was a plausible explanation for the increase. Barry was a CIA and a CPA and worked full-time as an internal auditor for one of the largest furniture manufacturers in North Carolina. He supplemented his income by working part-time for the Coalition by putting together compilations of its financial statements. Responding to Rob's request, Barry applied his internal audit training by starting with some basic analytics and quickly realized that Rob was on to something. He found out how many seasonal employees were supposedly employed from the personnel department, took into consideration how much they should be getting paid, and concluded that there was more than a reasonable possibility of a material overstatement in payroll expense. Barry followed the instincts developed from his internal audit experiences. He knew that

Rose had only recently started the job as head of payroll, so he figured that was a good place to start. He went to personnel and inspected her application form.

Not surprisingly, no one in personnel had performed a background check on Rose Smith; they simply assumed that all her references were reliable. Barry made inquiries regarding the listed references and soon found that none of them were legitimate, which quickly set his professional skepticism level at red alert. He then went to several databases available on the Internet that covered names, addresses, phone numbers and even e-mail addresses, and did some cross referencing. He soon suspected that Rose Smith and *Rose Martin* appeared to be one and the same person. Barry then compared the employee names on the payroll with the personnel files of authorized employees and found that Rose had not only used the name *Martin* as a pseudonym but had also added three other fictitious employees to the register.

Upon further investigation, Barry also found out that Rose was soon to be due in court on federal charges of embezzlement. Barry remembered the elements of the fraud triangle he learned about in his internal audit training. Rose certainly had the *opportunity* to input fictitious employees. She was fired from her last job and might easily *rationalize* that life was not fair and this money was owed to her. She might also be under some *pressure* in order to make ends meet, given that she had three young children and was no longer making the salary she once made as a vault teller with the bank. These factors do not necessarily prove fraud is involved, but they certainly made Barry uneasy. A quick call to the local authorities and FBI corroborated his suspicions. Barry went to Rob with his conclusion. Rose had been using a false identity to misappropriate cash assets for her own use. Barry and Rob provided this information to the sheriff's office which, in turn, took the information to the district attorney. Rose was subsequently picked up and whisked away in handcuffs and is now awaiting two separate court dates.

Rob sat down with Barry and asked for some advice. What could the Coalition do to prevent and detect this kind of fias-

co from happening again? Barry thought about the control activities his full-time employer (the furniture company) had in place and why the internal auditors spent time testing them for compliance and monitoring them over time for continued effectiveness. He soon realized that the Coalition had several material weaknesses in controls in personnel and payroll. He needed to explain the importance of the right control environment to Rob.

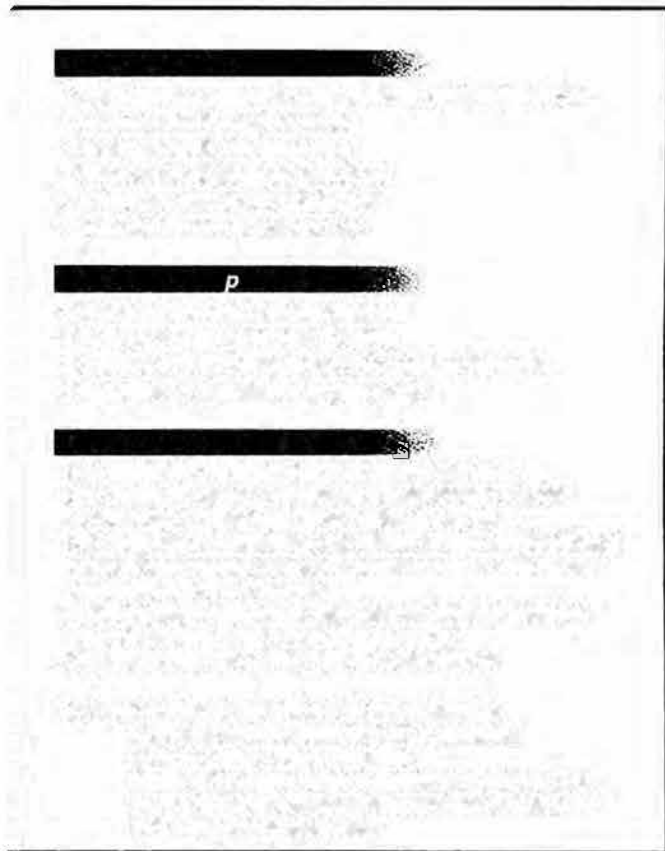
Rob quickly understood what Barry was saying and made it clear that he would establish the correct "tone at the top" and asked Barry to start working on the day-to-day control deficiencies. To start with, Barry said the company needed to do a much better job on background checks before hiring someone in inherently risky areas such as accounting and finance, particularly in payroll when there are so many cash payments involved. Further, both Rob and Barry agreed that, while possible, it would not be practical

and cost efficient to try to do this with all the seasonal workers.

The necessity of background checks

Thorough background checks are a necessary, but sometimes overlooked, audit procedure. It should be part of every company's system of quality control and monitored by someone who is independent of that function, such as an internal auditor. If someone is capable of stealing, it should not come as a surprise that he or she might be equally capable of lying and cheating. Barry put together some information for Rob and the Coalition to consider, and a number of possible procedures to put in place to strengthen the controls over any susceptible employment areas.

According to Barry, background reports can range from a verification of an applicant's Social Security number to a detailed account of the potential employee's history and acquaintances. Some employers



were even searching popular social networking Web sites such as MySpace and Facebook for the profiles of applicants. The following are some of the pieces of information that Barry thought might be included in a background check (with many being public records created by various government agencies):

- Driving records.
- Vehicle registration.
- Credit records.
- Criminal records.
- Social Security number.
- Education records.
- Court records.
- Workers' compensation.
- Bankruptcy.
- Character references.
- Neighbor interviews.
- Medical records.
- Property ownership.
- Military records.
- State licensing records.
- Drug test records.
- Past employers.
- Personal references.
- Incarceration records.
- Sex offender lists.

Barry also cautioned Rob that certain information may not be allowed in a background check. For example, the federal Fair Credit Reporting Act (FCRA) sets national standards for employment screening. However, the law only applies to background checks performed by an outside company, called a "consumer reporting agency" under the FCRA. The law does not apply in situations where the employer conducts in-house background checks. Under the FCRA, a background check report is called a "consumer report." According to the FCRA, the following cannot be reported, although this does not apply to jobs with an annual salary of \$75,000 or more a year:

- Bankruptcies after 10 years.
- Civil suits, civil judgments, and records of arrest, from date of entry, after seven years.
- Paid tax liens after seven years.
- Accounts placed for collection after seven years.
- Any other negative information (except criminal convictions) after seven years.¹

Barry added that recent changes to the FCRA made criminal convictions reportable indefinitely, though he noted that even though arrest record information is public record, in some states, employers cannot seek from any source the arrest record of a potential employee. If an arrest resulted in a conviction, or if the applicant is out of jail but pending trial, that information can be used. In California, criminal histories or "rap sheets" compiled by law enforcement agencies are not public record. Only certain employers such as public utilities, law enforcement, security guard firms, and child care facilities have access to this information. With the advent of computerized court records and arrest information, however, there are private companies that compile virtual "rap sheets."

Barry told Rob that the Coalition needed to use good sense in checking criminal records. Information offered to the public by web-based information brokers may not always be accurate or up to date. This is particularly true for investigations conducted online where the information obtained from web-based information brokers might not be verified for accuracy or completeness. For example, even though Rose had been arrested but subsequently never convicted, a data search could reveal the arrest, but not that she was acquitted or the charges were dropped. Barry told Rob that if the Coalition were to use an employment screening company, to make sure it always verifies negative information obtained from database searches against the actual public records filed at the courthouse. Further, Barry said that even if Rose had provided the name of her legitimate former boss at the bank, most employers have a policy to only confirm dates of employment, final salary, and other limited information, because intentionally interfering with former employees' attempts to find jobs by giving out false or misleading references could lead to legal action.

Rob was then surprised to hear Barry tell him that the FCRA does not prohibit the employer from asking questions in an employment application that may not necessarily be reported in a screening company search. In fact, if the Coalition did

not use a third-party screening company but conducted the background check itself, it would not be subject to the provisions of the FCRA. For example, an employment application might ask if someone had "ever" been arrested. The FCRA says a consumer reporting agency cannot *report* an arrest that *from date of entry* was more than seven years ago. However, it *does not* say the employer cannot ask the question. Of course there are certain other questions such as age and marital status that employers are not supposed to ask when interviewing. Rob and Barry both quietly laughed when they realized that they may have a hard time finding enough qualified seasonal laborers that could pass that type of scrutiny.

A job that never ends

Barry sat down with Rob and told him that there were a number of other internal

control issues that needed to be addressed and that this would take some time. Barry also explained to Rob the importance of using an internal auditor to monitor the Coalition's controls, someone who could apprise them of potential risks that might be avoided or at least mitigated before they become serious problems. Rob began to realize the true value of internal auditing and thanked Barry for his help.

This article was based on an actual case. The names of the people, places, company, and crimes have been altered. For a more thorough discussion on Background Check Resources, go to: *The Privacy Rights Clearinghouse* <http://www.privacyrights.org/fs/fs16-bck.htm> and the Federal Fair Credit Reporting Act, 15 U.S.C. §1681, www.ftc.gov/os/statutes/fcra.htm. ■

NOTES

¹ 15 U.S.C. §1681c.