

# NACVA QuickRead

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## Fraud Issues in the Hospitality Industry Post-COVID-19 Pandemic

The hospitality industry is already experiencing an increase in fraud, and everyone associated with the business—including operators, owners, managers, employees, and even guests—is at risk of being affected. In this article, the author identifies areas of fraud and provides recommendations to mitigate risk.

As a self-proclaimed foodie, I am excited that we will once again be able to go to restaurants and hotels. However, as a forensic accountant I am concerned for the hospitality establishments that, of necessity, focused on sustaining business and staff over back-office matters such as internal financial controls. This lack of attention to internal controls could lead to an increase in fraud as activity starts to ramp back up.

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In the summer of 2020, one of our clients asked Marcum to perform a forensic investigation at a hotel it owned, and which was being managed by a third-party management company. The management company also held a one percent interest in the hotel. After the site visit and forensic analysis, our assessment was that, while the contractual relationship (between our client and the management company) was standard to the hospitality industry, the management of the hotel and the related venues at the hotel was anything but standard to the industry.

Our investigation raised the following red flags:

1. **Inventory Theft**—Inventory mismanagement and skipping internal control processes led to large inventory thefts and losses of approximately \$750,000 over a two-year period.
  1. Both food and alcohol inventories were not accurately performed. The process did not include counting of several items, some of which were perishable and costly.
  2. Opened alcohol bottles were placed behind unopened bottles, leading to multiple open bottles; open bottles were not included in the inventory.
  3. Some food and alcohol items were not listed in the inventory sheets.
  4. Some non-food inventory, such as sheets and/or towels, were ordered at one venue but used at another, unrelated venue, without intercompany tracking or transfers.
  5. Physical inventories were not performed on a monthly basis as required by the internal controls process established by the management company. Several months were missed, with the excuse that the venue was not operational or did not have enough business or employees. This is a prime example of relaxed internal controls.
2. **Vendor Fraud**—Setting up of fictitious vendors, making payments to phony vendors, and kickbacks are some examples of how employees could perpetrate vendor fraud.

The forensic analysis revealed that there were several inventory orders placed for food, alcohol, and non-food items, without following the standard ordering process established by the management company. There were also several non-food items ordered multiple times within a short period, with no explanation. Both of these scenarios are indicators of kickbacks being received by employees of the management company.

3. **Fictitious/Former Employees**—Although not exclusive to the hospitality industry, fraud related to setting up fictitious employees or continuing to pay former employees is more common to the hospitality industry because of high employee turnover. The forensic analysis did not reveal any fictitious employees on the client's payroll, but there were several individuals no longer employed by the venue who were still on payroll and receiving weekly checks.

The perpetrator was forging the employees' signatures on these checks, cashing them at different check cashing locations, and not depositing them directly into a bank account. This avoided creating a pattern that could be easily identified, making it more challenging to catch the fraud.

4. **Complimentary or Void Transaction Fraud**—This type of fraud generally happens when transactions involve payment by cash. Employees have the authority to provide a complimentary product or service to a loyal customer or void transactions due to various reasons. However, if the customer pays in cash, an employee can code it as a complimentary transaction and pocket the cash or can void all or part of the transaction for guest complaint/customer dissatisfaction and pocket the cash.

The forensic analysis included a comparison of complimentary and voided transactions by employees. The analysis documented a handful of employees whose percentage of complimentary and/or voided transactions was much higher than others in comparable time periods. Calculation of the dollars that such employees comped/voided above the normal range equaled approximately \$200,000 over a five-year period.

5. **Underreporting of Expenses**—Underreporting of expenses generally leads to an increased net income. While underreporting of expenses is categorized under misstatement of financial statement, it could lead to fraud. Most commonly, if the net income or controlling of expenses under a threshold are triggers for a bonus, or additional management fees or higher profit percentage, manipulation of the financial statements could lead to fraud.

The forensic analysis revealed that the contract between the client and the management company included a clause where a higher net income margin would trigger a larger management fee. Analyses of expenses and several balance sheet accounts documented that several expenses were being recorded as a decrease to cash and increase to prepaid expenses. However, these prepaid expenses<sup>[1]</sup> were never decreased and expensed into the profit and loss statement. As a result, the net income was high enough to trigger the additional management fees clause in the contract. Therefore, the management company received approximately \$400,000 in additional management fees over a four-year period that it would have not paid had the financial statements not been manipulated.

Having identified several areas of fraudulent activity, Marcum recommended the following processes and procedures to help mitigate these risks going forward.

### **Mitigation of Fraudulent Activity**

Fraudulent activity can generally be mitigated by stronger internal controls and the segregation of duties among different employees. Below are some recommendations of such internal controls to minimize the forensic red flags described above.

## 1. **Inventory Theft**

1. Physical inventories should be performed on a timely basis. In this engagement, we specifically asked the management company to perform the physical inventory at the end of the month;
2. Inventory documents should include all items at the property, and any changes should be authorized by an appropriate member of management;
3. There should be a requisition policy to order new inventory. All requisitions should be supported and explained by inventory records, and any anomalies should be approved by an appropriate member of management;
4. There should be increased supervision in kitchen and at the bar which could lead to decrease in inventory theft; and
5. Periodically, the management of any hospitality entity should calculate cost margins and trend analysis of variations. This would help to recognize if there are any patterns that are indicative of theft of inventory and catch them early on so as to avoid any significant monetary damage to an entity.

## 2. **Vendor Fraud**

1. Proper authorization is needed to establish any new vendor;
2. There should be an approved vendor list and any additions or removals should be authorized by an appropriate member of management;
3. A threshold for payments should be established and any payments over this threshold should require two signatures/authorizations;
4. There should be segregation of duties for ordering inventory, assessing inventory received, approving vendor payments, and making vendor payments;
5. Certain internal control procedures including a cover sheet detailing the vendors being paid, the current amounts being paid, and year-to-date amounts paid should be implemented; and
6. Approval for payments to vendors should require supporting documentation including invoice, requisition form, etc.

## 3. **Fictitious and Former Employees**

1. Establishing a new employee in the payroll system should be performed by an employee in the HR department<sup>[2]</sup> and not the hiring manager;
2. All documents validating the new hire should be provided to the HR department;
3. Any changes in the personal information of the employee should be triggered by the employee, and all documentation should be provided to the HR department by such employee;
4. Preference should be given to making all payroll and expense reimbursement payments via direct deposit into the employee's verified bank account. If the employee requires a check, it should be either personally collected by the employee or sent to the employee's verified address on file;
5. There should be a policy in place for authorizing any increases in pay, bonuses, and any other payments to employees. There should be segregation of duties between individuals authorizing/approving payroll and individuals responsible for triggering the payment of such payroll;
6. The HR department should prepare the payroll register and seek approval from the supervising manager of the employees; and
7. There should be an expense reimbursement policy in place for any reimbursements made to any employee, which should include individual employee logins or in-person submissions for expense reimbursements.

#### 4. Complimentary or Voided Transaction Fraud

1. Calculate the percentage of complimentary and/or voided transactions by each employee each month and evaluate such calculations for variations and trends;
2. Complimentary and/or voided transactions above a certain threshold should require approval from a shift manager;
3. A detailed log of complimentary and/or voided transactions should be maintained, with a detailed reason for every transaction and supporting documents if any; and
4. An investigation policy should be put in place to address higher percentages of complimentary and/or voided transactions by any employee.

#### 5. Underreporting of Expenses

1. Monthly trend analysis of balance sheet and expense accounts should be performed for year-to-date data;
2. Perform further investigation of any unusual trends; and
3. Segregate duties related to the approval of certain types of accounting entries and the booking of these entries.

### Conclusion

Fraud generally ramps up when an industry or society goes through a significant event like the pandemic we are currently experiencing. There is especially an increased opportunity of fraud in industries with large transaction volumes and cash-paying customers, such as hospitality. As the hospitality industry gears up to serve the pent-up demand for travel and entertainment around the world, increased revenues should be supported by strengthened internal controls, proper processes, and vigilance. This will help ensure increased revenues translate into increased net margins.

[1] Prepaid expenses account is a transient account where the disbursement are recorded until it is appropriate to expense the expenses in the profit and loss statements. It also is used to allow the expense to be properly matched with the appropriate accounting period.

[2] Not all entities have HR departments; in that event, there should be segregation of duties between the hiring manager and the individual(s) who are authorized to setting up new employees and payment of payroll.

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