Winter 2010

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Guarding Against Fraud

Lessons Learned from 2009

As we begin the new year, we look back on 2009 and the lessons learned from the cases Holtz Rubenstein Reminick investigated. While fraud can be devastating to any organization, it was troubling to see that many of the frauds in the last year have involved those organizations that could least afford it – charitable organizations.

The mission of many of these organizations is to improve the lives of those less fortunate. At a time of substantial declines in donations as a result of a struggling economy, their financial difficulties are compounded by the greed of individuals who spotted an opportunity and exploited it for their own benefit.

Dealing with fraud is always a delicate process. Management is faced with the realization that one of their own, a person they trusted and worked with side-by-side, has betrayed them. By the time the investigation is complete, it may show that other individuals were involved and that the ultimate loss is much worse than initially expected. Although we have had some recent success, it is a sad reality that in most cases there is nothing left to recover from the fraud perpetrator.

While the initial objective typically is to identify everyone involved in the scheme and quantify the fraud loss, the most important goals are to identify how the fraud occurred and how the organization can reduce its risk in the future. Thus, here are some lessons learned in 2009.

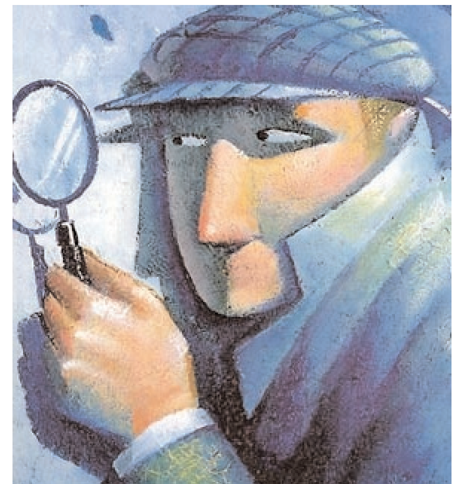
The CFO

In one case, a CFO used the company credit card as his personal bank account. Hundreds of thousands of dollars in personal expenses were charged to the company credit card. The controller, who was responsible for monitoring and paying the company credit cards, was overcompensated by the CFO – effectively a payoff for the controller's cooperation.

Although this organization had procedures in place for the review and approval of expenses, the controls were overridden. This fraud could have been detected much sooner if the company had an individual, independent of the process, perform surprise reviews of expenses.

The CFO also placed ghost employees on the payroll with the controller's assistance. This organization had multiple locations and many employees who worked at more than one location. The organization did not have a good system of tracking where employees were working and the CFO was able to exploit this weakness. This scheme could have been detected much sooner if the company performed periodic surprise payroll audits that required employees to show identification in order to receive their paycheck or direct deposit voucher.

This case is an example of a company that had controls in place, but did not monitor the effectiveness of those controls.



The A/P Clerk

Another case involved a company that became a victim of a poorly designed internal control system. This company had an accounts payable clerk who was forging the owner's signature and ultimately stole several hundred thousand dollars.

Although there was a control in place that required the preparation of bank reconciliations on a monthly basis, no one was looking at the cancelled checks. When performing a bank reconciliation, cancelled checks should be reviewed to verify the payee on the check matches the payee recorded in the cash disbursements ledger.

Many of the other cases we investigated in 2009 bear a striking resemblance to these two. In some situations, internal controls are ineffective; in others, internal controls are poorly designed. The latter can be just as bad as not having any internal controls at all. In either case, it is simply a matter of time before someone spots the weakness and capitalizes on it.

(continued)

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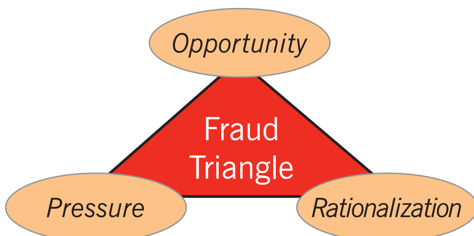
Fraud Triangle

So why does fraud occur? This is often illustrated using what is known as the fraud triangle. Each side of the triangle represents an element that must be present in order for fraud to occur.



Incentive or pressure. "I need to do it." This could be financial difficulties caused by a gambling or substance abuse problem. It could also be as simple as someone being passed over for a raise or promotion.

Rationalization. "I should do it." This it is how an otherwise honest person decides to do something they know is wrong. Examples of rationalizations could be, "I don't get paid enough." "I am smarter/work harder than my co-worker and *deserve* this."

Opportunity. "I can do it." Unlike the others, an organization can control this third side. Opportunity is the weakness in the internal control system that an individual identifies and exploits. An organization that reduces opportunities has significantly reduced their susceptibility to fraud.

In each of the cases we investigated in 2009, organizations had internal controls in place. The problem was that the controls were ineffective and, in some cases, easily circumvented.

Business owners and management must take measures to reduce their organization's risk, such as:

1. Providing fraud training for staff, management, and executives
2. Establishing an anonymous fraud hotline
3. Performing surprise audits including tests of internal controls

Certainly this list is not all-inclusive. But it is interesting to note that, while these are some of the least often implemented controls, they are the most effective at reducing the duration and amount of fraud losses. Recent studies show that the 25% of companies that performed surprise audits suffered losses that were 66% less than those that did not.

Fraud on the Rise

In 1996, 2002, and every two years since, the Association of Certified Fraud Examiners ("ACFE") has issued its "Report to the Nation on Occupational Fraud and Abuse." Between 2006 and 2008, this report reflected a clear increase in fraud. The table below shows the average annual revenues lost by an organization due to fraud and how that percentage translates to the U.S. Gross Domestic Product:

	% of Revenue Lost Due to Fraud	U.S. GDP Lost Due to Fraud
1996	6%	$400
2002	6%	$600
2004	6%	$660
2006	5%	$652
2008	7%	$994
2010	??	??

(in billions)

As you can see, while the number was fairly stable from 1996 to 2006, there was a significant increase in 2008, bringing fraud losses in the U.S. to almost $1 trillion. The 2010 report will almost certainly show a further increase. Whatever the results, it is clear that business owners have to remain vigilant in combating fraud.

Shortcuts, Short-Sighted?

Over time, controls erode. People find shortcuts to performing their jobs and eventually controls are ignored. Just as companies evolve, the controls of yesterday may not be appropriate for today's business environment.

In this economy, it is even more critical to make a proactive effort against fraud. As business owners make the difficult decision about eliminating jobs, they often evaluate factors such as whether the job elimination will save the company money or if the company can provide its customers the same level of service. What they often fail to consider is how the particular position fits into their internal control structure. Ultimately, an eliminated position may have played a vital role in internal controls and previously prevented someone from taking advantage.

In 2010 and beyond, management must constantly challenge themselves to make sure they don't become the victims in our next case.

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To view other litigation and valuation-related articles, visit http://www.holtzrubenstein.com/lvc/lvc.php

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