

FRAUD – WHAT EVERY BUSINESS PERSON SHOULD KNOW

“The risk of fraudulent financial reporting is inherent in doing business for all sizes of business. The risk of financial fraud can be reduced through a concentrated and integrated effort of all those involved in the financial reporting cycle – owners, management, auditors, enforcement agencies and educators” – The Treadway Report

Fraud has been a fact of life since the beginning of time. While most of us are aware of the large financial frauds that have received so much attention the past ten years, we tend to discount the possibility that we will personally be victims. The reason for this is simple. We are comfortable with and trust our employees and vendors. As a result, we do not always take the most prudent business steps to reduce the risk of becoming a victim of fraud.

FRAUD FACTS:

- Businesses are defrauded by insiders: officers creating false financial reports, managers inflating expense reports, other employees embezzling cash and other assets.
- Businesses are defrauded by outsiders: suppliers submitting false invoices or duplicate invoices, competitors engaging in price fixing or industrial espionage, con artists utilizing schemes involving products, services or investment opportunities that will never materialize.
- Fraud is estimated at approximately 5% of our GDP – approximately \$600 billion per year, or approximately equivalent to a \$5,000 per year, per employee loss.
- Approximately ¼ of fraud losses are under \$45,000 each, and approximately ¼ of fraud losses exceed \$1,000,000 each.
- Approximately 1/3 of all fraud losses are incurred by businesses with under 100 employees. The average fraud loss for companies with less than 100 employees is approximately \$185,000, whereas the average fraud loss for companies with over 10,000 employees is approximately \$150,000.

HOW DOES FRAUD OCCUR?

There are three broad categories of fraud, all of which possess the same common characteristics being reason, opportunity and rationalization. These categories are:

- Misappropriation of assets,
- Corruption (abuse of position to influence transactions) and
- Fraudulent financial statement reporting.

WHO COMMITS FRAUD?

Virtually all fraud is committed by individuals; not companies, not committees, not departments and not groups. Quite often those individuals are highly intelligent, and surprisingly have high levels of integrity and high moral standards.

The largest frauds dollar wise are committed by business owners and executives. Fraud committed by managers against their employers average approximately \$200,000 per occurrence, and fraud committed by rank and file employees averages approximately \$80,000 per occurrence. The longer a person works for a company the larger the fraud. Likewise, the older the perpetrator and the more highly educated the perpetrator, the larger the fraud.

Finally, organizations can foster an environment conducive to fraud. A Yale University study sites a characteristic of “group think” (illusion of invulnerability, illusion of unanimity, personal doubts are suppressed by the group, “mind guards” are self appointed, and an atmosphere of docility is promoted by the leader) as a culture in which financial fraud of the highest dollar levels can occur.

HOW DOES A BUSINESS PROTECT AGAINST FRAUD?

Two behaviors significantly contribute to the level of fraud in America: individuals are reluctant to be whistle blowers and most of us take little active responsibility for reducing our own chances of becoming a victim of fraud.

To reduce our risk of becoming a victim of fraud we need to have expectations:

- As to behavior,
- Expectations as to performance and
- We should have a very clear idea of what we have that is at risk.

We should also be aware of who is in a position to commit fraud against us. In addition, we need to observe changes in our assets, as well as changes in the behaviors and lives of those individuals who have the ability to commit fraud against us.

THE ROLL OF INTERNAL CONTROLS IN REDUCING OUR RISK OF FRAUD:

There are seven components to an organization's risk management system:

- Internal environment,
- Objective setting (i.e. the organization's mission and values),
- Potential fraud identification,
- Risk assessment of those events,
- Risk response,
- Control activities,
- Information/communication and monitoring, that is setting policies to control behavior, continue education and measure performance.

Fraud can never be completely eliminated. However, we can all take steps to protect ourselves and our businesses from it. We can have a significant impact on our chances of avoiding fraud

by knowing how fraud happens, knowing who is apt to commit fraud, leading our organizations from a position of honesty and integrity, setting up controls that we hold our organizations and ourselves accountable to, communicating expectations and consistently and vigilantly monitoring our organizations performance.