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Use Poor Richard's Timeless Advice to Take on Fraud

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“An ounce of prevention is worth a pound of cure” is oft-quoted advice from Benjamin Franklin. It was actually related to firefighting, but whether its lon-gevity is due to Franklin’s influence on our young nation or the fact that it just makes sense, the expression has come to apply to many facets of life, including the business world. Perhaps no area of business is more suited to the application of this aphorism than fraud prevention.

Unfortunately, the spirit of another Franklin quote too often gets in the way of the prevention advice: “A penny saved is a penny earned.” Many companies acknowledge the need for fraud prevention, but the cost/benefit mindset often blocks the action from moving forward.

Fraud and its prevention, for some reason, create an odd juxtaposition of stances and ideas within the business community. Statistics consistently show the cost of fraud, but review, audit, and other proactive measures do not seem to be catching up with less scientific methods.

The Association of Certified Fraud Examiners’ (ACFE) *2012 Report to the Nations on Occupational Fraud and Abuse* notes that the typical organization loses 5 percent of its annual revenue to fraud. Potentially, this means somewhere in the neighborhood of $3.5 trillion could be lost to fraud, based on Gross World Product.

Consider this point, too: the survey indicates occupational frauds are more likely to be detected by tip than by other means – which has been consistently noted in the survey since this tracking started in 2002. The survey also notes that small companies are “disproportionately victimized by occupational fraud,” and that such companies typically lack anti-fraud controls. Apparently they consider themselves too small to justify the perceived cost of prevention, trading in one Franklin quote for the other.

The ACFE also says, “Anti-fraud controls appear to help reduce the cost and duration of occupational fraud schemes.” It does not say, however, that such controls prevented fraud. The survey notes that in more than 43 percent of cases, the initial detection of fraud was by tip, and another 7 percent was detected by accident. So, half the known cases were found by accident or tip. Reviews, audits, and other measures, therefore, accounted for the other half. Whether a systemic detection system works would depend upon whether you see the glass as half empty or half full.

In the June 2010 *Journal of Accountancy*,[1] the ACFE’s Joseph Wells noted the “remarkable evenness in these trends.” Wells also noted that looking for fraud “adds cost to the audit,” and that “fraud prevention is a joint effort between management and employees.” He added that fraud education and communication within each company is key, and that if workers realize fraud costs jobs and pay raises, the employees become “stakeholders in fraud prevention” – hence, a larger percentage of discovery by tip.

Employee education should be considered paramount in the assessment of fraud risk, and every size organization should make it a priority.

Certainly the expense of educating employees about the costs of fraud will be less than implementing controls, spending more on audits, and incurring the other perceived costs of fraud prevention. Perhaps we have found a balance between Franklin’s two mantras, in that a reasonable prevention program can save, and those savings in costs and fraud can add to earnings.

In an Institute of Internal Auditors blog, Norman Marks, a vice president with SAP, asks the question, “For how many companies is fraud and theft of assets in the top 10 risks?”[2] Marks noted, “I prefer to assess whether management has effective processes and controls to prevent or detect fraud. Those should include fraud risk assessment, as well as controls." This brings us back to the issue of employee education. Employee education should be considered paramount in the assessment of fraud risk, and organizations of all sizes should make it a priority.

One of the areas in which employees should be knowledgeable is the "fraud triangle." Essentially, for fraud to occur, three elements are typically present – pressure, opportunity, and rationalization. Pressure can arise due to financial problems, addiction, or financial need. Often, perpetrators do not feel they can share this pressure with others, hence the first point of the triangle is made.

Without opportunity, the second point in the triangle, fraud schemes have less of a chance of succeeding. Fraudsters have to believe they will not be caught or detected. That is why a company's failure to establish controls will increase the opportunity for the fraudster.

The third point of the fraud triangle is rationalization. Fraudsters tend to reconcile their behavior because they do not necessarily believe they are bad people – they are just "borrowing" from the company, or they are doing it in lieu of a salary increase that didn't come their way. In their minds, there is justification for their actions.

When it comes to fraud prevention, there is no generic program that fits all. There are numerous ways business owners can address the issue at varying levels of cost. In the lexicon of Franklin, there are many ounces of prevention to be found.

Employee education – First, explain to all employees the true cost of fraud, including the company's reputation and that their jobs could be affected. Letting everyone know the true cost of fraud is key. The fraud triangle includes the element of "rationalization," so nip any potential thoughts of "I'm not hurting anyone" or "it's just money" early. In the words of British Prime Minister David Cameron, "At a time when we're having to take such difficult decisions about how to cut back without damaging the things that matter the most, we should strain every sinew to cut error, waste and fraud."[3]

Employee reporting – Establish a method by which employees can anonymously report suspected fraud. Be sure to have one person investigate such claims and avoid the possibility of vendettas or other unscrupulous behavior. Make sure employees know how to communicate if they suspect something.

Surprise audits – Scheduled audits and other internal checks are always recommended, but an element of surprise will have the effect of keeping potential fraudsters thinking twice.

Hiring methods and background checks – Be sure to include criminal background checks, education verification, and credit checks in the hiring process. However, be mindful of the ACFE survey data that explains that more than 87 percent of fraudsters had never been charged with or convicted of a fraud-related offense. A credit check on someone handling cash should be your minimum action.

Employee support – A company should have a mechanism to help employees who are dealing with addiction, emotional issues, or financial problems. Remember the issue of "pressure" within the fraud triangle. If there is a way to gain an understanding of an employee's pressure, and possibly provide a path of assistance, you have measured another ounce of prevention.

For smaller firms and family businesses where the resources may not be available to have separate departments or a fraud tip line, there are several relatively low-cost procedures that can help reduce the risk of fraud by minimizing the opportunity side of the fraud triangle. For example, do not let the same person write the corporate checks, reconcile the bank statements, deposit the checks, and have access to the company's computer to record items in the general ledger. Break up these duties. Also, establish a basic policy for expense reports by explaining what is and what is not covered. Have all reports approved by the owner, and make sure these are supported with original documents and not copies.

The points above are recommended to soften the points of the fraud triangle. If an employee has an outlet for counseling, it may (emphasis on "may") alleviate some of the pressure that they felt they could not share. Surprise audits and internal checks should be designed to limit the opportunities that can fall the way of the potential fraudster. Perhaps the most difficult aspect to consider is how to deal with the rationalization issue. Certainly employee education and support are key, but everyone rationalizes things in different ways. It is this aspect that will test the employer's resolve as a good manager and emphasize the need to have a read on employee morale.

Consider the case of a company's CFO, who had progressed through the ranks from bookkeeper. Even as a CFO, he still performed the corporate bank reconciliations, he opened the bank statements, and he signed the checks. This is a classic breakdown in internal controls. His children were growing up, there were braces, there were school fees, and there was a bigger house – more financial pressures. However, moving up to CFO did not bring the financial rewards he was expecting. The management of the company was located in another state, and there was no one checking his work or watching over him. He began by padding his expense reports, then a false workers' compensation claim, and then kickbacks from vendors. After seven years, his fraudulent activities amounted to almost $700,000. It was only when he fired a secretary who "asked too many questions" that his schemes were uncovered. Pressure? Growing family, bigger house, college tuition. Opportunity? A CFO performed the same tasks he had as a bookkeeper. He signed the checks, he opened the bank statements, he performed the bank reconciliations. Rationalization? His deposition transcript said it all: "I worked long hours, no one seemed to appreciate it, and I never really was rewarded. All I did was work, work, work, and my family suffered. I thought

I could make them happy by buying things."

This case – a model of the fraud triangle in action – forced the company to drastically change its internal controls. All bank procedures were changed and management took greater control over day-to-day operations. The company recovered $500,000 from its insurance company, and the former CFO did not go to jail. An agreement was reached whereby he could seek nonfinancial employment and repay some of the money he stole. The company also drafted an internal fraud policy and changed the way it did business with its vendors.

In the *Wall Street Journal* article, "Small Businesses Face More Fraud in Downturn,"[4] Jim Ratley, president of the Association of Certified Fraud Examiners, said "A lot of times a small business will close its doors, and may never know it was defrauded – that the problem wasn't a declining economy, but that employees were stealing."

The advice that many CPAs have been giving clients over the years still holds true, and has become essential in an ailing economy. Pay careful attention to employees' expense reports, be mindful of employees who seem to be living beyond their means, and make sure employees take vacations. Also, business owners should open the bank statements for the business and look at them – that includes examining the back and front of check copies.

Forensic accountants freely admit to being professional skeptics, and we urge business owners to have the same mind-set. The wisdom of one of Franklin's contemporaries, Thomas Jefferson, has also aged well. Jefferson said, "The natural cause of the human mind is certainly from credulity to skepticism." Knowing the red flags and hearing some of the war stories of how fraud affects business is the quickest way for owners to become skeptics. Truly, many were affected by the economic downturn a few years ago, but there is a large group whose positions have weakened because of fraud within their organizations.

As CPAs, we must convince our clients that fraud exists and could occur in their businesses. They must also realize the importance of fraud awareness and deal with the human side of their business, their employees. For a businessperson, protecting the bottom line from fraud is always going to be an ongoing challenge. The statistics tell us that fraud will never be eradicated. However, the odds of avoiding it can be improved through the implementation of effective prevention and detection strategies.

Education and ongoing maintenance within a business will help owners understand why fraud is committed, minimize the factors that may motivate employees to commit fraud, identify and reduce the high-risk areas and opportunities for fraud, know the symptoms of fraud, and communicate expected behavior to employees.

There are many more fraud prevention methods that can be discussed, but they vary depending on the size of an organization and the time and money businesses are willing to spend. Many books have been written on the subject. This discussion is merely an alert to the reader regarding the reality of the problem. Despite the fact that fraud will likely never be eradicated, you cannot – must not – sit back and wait for something to happen or join the "It will never happen to me" club.

Again, we turn to the wise Benjamin Franklin, who summed up the issue best: "By failing to prepare, you are preparing to fail."

[1] Journal of Accountancy, *June 2010, AICPA*
[2] *http://www.theiia.org/blogs/Marks/index.cfm/post/Does%20Internal%20Auditing%20Spend%20Too%20Much%20Time%20Auditing%20for%20Fraud*
[3] Manchester Evening News, *Aug. 10, 2010*
[4] The Wall Street Journal, *Feb. 19, 2009*

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