$1.50 VOL. 37 NO. 7 www.ocbj.com FEBRUARY 17-23, 2014

ORANGE COUNTY BUSINESS JOURNAL

RAMIREZ JIMENEZ INTERNATIONAL
CERTIFIED PUBLIC ACCOUNTANTS

How Much Money Are You Losing?

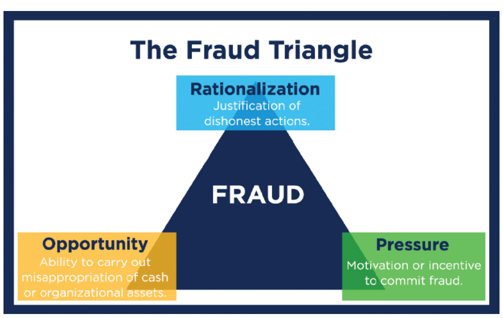
Is your company exposed to or at risk of fraud? Are you losing money without even realizing it?

The typical U.S. business loses almost 5 percent of its revenue each year due to corporate and employee fraud. Of these losses, small businesses rank the highest in fraud frequency at a rate in excess of 30 percent. Private companies, which include small businesses, have an even higher frequency which is in excess of 40 percent. Public companies, governmental entities and nonprofit entities are not immune from corporate fraud. While the overall frequencies are lower than those of small businesses at approximately 30 percent, 15 percent and 19 percent, respectively, fraud still exists and costs business owners and shareholders approximately $3.5 trillion dollars annually.

In a recent study conducted by the Association of Certified Fraud Examiners (ACFE), the median financial loss caused by occupational fraud was $140,000. Twenty percent (20 percent) of these cases exceeded $1 million! The statistics reveal that the small business owner does not have the proper tools or training to prevent fraud from occurring in their workplace. Corporate fraud can cripple an organization and can be catastrophic at times. In the ACFE study, the smallest companies suffered the largest median losses. These small entrepreneurial companies typically do not have the anti-fraud controls of larger businesses which increase their vulnerability to fraud.

Occupational fraud transcends an individual's position within a company. Owners and top management also commit fraud. Fraud committed by these owners and executives are three times as costly as fraud committed by managers, and almost 10 times as costly as fraud committed by employees. Owner and executive fraud averaged almost $600,000, while the median loss caused by managers was $180,000, compared to $60,000 for employees. In the ACFE study, executive-level fraud takes much longer to detect, and consequently is more expensive to the organization. The longer an employee has worked for a company, the higher the fraud losses tend to be. Fraud committed by an employee with more than 10 years experience with that company had a median loss of almost $230,000, while the median loss committed by some in their first year on the job was only $25,000.

To more fully understand fraud and some of the general characteristics of those who perpetrate fraud, it is important to understand the driving forces. The following chart is commonly referred to as the "Fraud Triangle," and was first identified by Sociologist Donald Cressey.



The Fraud Triangle highlights ***three factors which are present*** for fraud to occur:

1. Incentive/Pressure: A financial need or difficulty can be one of the motives for committing fraud. Examples include, an employee with a gambling problem or an employee going through a divorce.

2. Attitude/Rationalization: The individual or employee perpetuating the fraud will frequently rationalize the fraud. Such rationalization includes the idea that: a) the funds will be repaid, b) the owners make enough money and they will never miss the amount or, c) he/she is not paid enough, so it is deserved based on years of hard work and dedication.

3. Opportunity: The employee committing the crime identifies an internal control weakness and believes no one will notice if money or merchandise is taken. Often times, fraud will begin with a small amount. If it goes undetected or if no one notices, the amount will usually grow larger and the frequency will increase.

How is fraud identified?

Most corporate fraud is likely to be detected internally by individual tips from employees working at the company. Management reviews and internal audits are common forms of detection, but many small businesses do not have an internal audit function. In most cases, the time lag for detecting fraud is in excess of 12 months from when the initial fraud occurred.

In over 75 percent of the fraud cases studied in the ACFE survey, fraud is most commonly committed by individuals working in the following departments: accounting, operations, sales, executive or upper management, purchasing and customer service. As you can see, this covers most areas in a typical business.

In businesses with less than 100 employees, an alarming 13 percent of fraud is detected by accident. This indicates a clear lack of resources allocated to fraud prevention and detection. Considering the number of smaller businesses, coupled with a general lack of resources in this area, it is no surprise that these organizations have the most fraud instances reported year after year.

What can you do as a business owner or finance executive to reduce the level of fraud in your organization?

Knowing that fraud ***can occur and is occurring*** in your business is one thing, but what can you do to mitigate the consequences?

Here are a few suggestions: Protect yourself at the front end by conducting a thorough recruiting/hiring process which includes a formal background check. Improve your internal control structure. Ensure that you have proper segregation of duties and well-defined policies and procedures, such as mandatory vacation for all employees. Keep an eye on your employees and their habits. Some of the common "red flags" include employees living beyond their means, experiencing financial difficulties, unusually close association with customers or vendors, and excessive control issues.

It was Benjamin Franklin who said, "*An ounce of prevention is worth a pound of cure.*" This is no more evident than in occupational fraud.

Establish an anonymous fraud hotline. This can increase the frequency of internal employee tips. Statistics reveal that companies with fraud hotlines experience lower fraud occurrences. Fraud hotlines are generally inexpensive to implement and can be a strong deterrent. Offering individuals an anonymous way to report suspicious or unusual activity is a key element to any anti-fraud program.

Conducting employee roundtables and instilling a proper "tone at the top" mentality goes a long way. In these roundtable sessions, it is important to emphasize an anti-retaliation policy for those identifying and bringing attention to the fraud occurrence.

Fraud awareness training for all levels within an organization is essential to well-structured programs. Training programs should cover educational materials on what constitutes fraud, the harmful effects of fraud, how to report suspicious activity within your company and common behavioral traits of fraud. For companies that have implemented such programs, losses have generally been lower than those with no programs in place.

Involve your CPA or accounting firm. Auditors are not required to seek out fraud, but CPA professional standards require that auditors obtain an understanding of the internal control environment during each audit. External audits and financial statement reviews serve important purposes to a company and offer a strong preventative measure, but uncovering actual fraud is not the main goal. If you know that fraud is being perpetuated within your business, you need to act immediately to reduce the impact.

Undoubtedly, smaller companies lack the resources for some of the more complex fraud prevention and detection measures. However, simply involving an objective third party CPA can be an excellent resource in the area of fraud detection and prevention. CPAs with experience in this area can provide services to assist an organization of any size in its fraud prevention and detection efforts. Implementing anti-fraud measures such as a company code of conduct, required anti-fraud training and periodic review of controls and processes can greatly increase a smaller company's ability to prevent and detect fraud. This can often be done at a marginal cost, especially when considering the potential financial impact of a fraud scheme.

About RJI

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Gordon S. MacLean, CPA

Gordon MacLean is a Partner and the Director of Audit Services at RJI. He has 28 years of experience, including 20 years at a Big 4 firm. In addition to heading the audit practice at RJI, MacLean has performed numerous internal control evaluations, Sarbanes-Oxley engagements, in additional to various forensic and litigation support projects. MacLean can be reached at 949.852.1600 or at gmaclean@rjicpas.com.

Sam Lahham, CPA, MBA, CFE

Sam Lahham is an Audit Senior Manager at RJI. In addition to his CPA and MBA designations, Lahham is a Certified Fraud Examiner and has conducted numerous forensic, fraud and litigation support engagements. Lahham can be reached at 949.852.1600 or at slahham@rjicpas.com.