

Three Steps to Fraud Prevention in the Workplace

by Robert L. Kardell



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This past summer, the Association of Certified Fraud Examiners (ACFE)¹ released its bi-annual summary of fraud entitled “2006 ACFE Report to the Nation on Occupational Fraud and Abuse” (Report).² The Report summarizes 1,134 fraud cases reported by Certified Fraud Examiners³ and categorizes white collar crimes based on types of fraud, size of organization, size of fraud, detection methods that were in place, and the typical perpetrator of the fraud, also commonly referred to as the fraudster. ACFE defines Occupational Fraud and Abuse as:

The use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.⁴

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Some of the information provided in the Report is striking, not in what the companies did to prevent fraud, but for what the companies did not do to prevent fraud. There are several fraud prevention measures which companies could have implemented, but the majority of companies which were victims of fraud did not.

The cases in the Report involve companies of all sizes from the small, defined as having fewer than 100 employees, to the large organization having over 10,000 employees. The anti-fraud measures tested by the ACFE were equally applicable to organizations of all sizes.

The Report demonstrates that small companies are just as vulnerable as, if not more vulnerable than, large companies to fraud. The risk to a small company can be greater because smaller companies often have less ability to absorb the losses associated with fraud. Smaller companies are also at more risk than larger companies because they often do not have the resources for segregation of duties, external audits, computer programs, and other expensive fraud prevention measures. There are, however, three relatively inexpensive, anti-fraud measures which every company can implement to help reduce the possibility of fraud before it starts.

Most experts agree that preventing fraud is much easier and less expensive than actually detecting the fraudulent activities. Companies may be unaware of how expensive fraud can be until they become victims of fraud. There are two types of expenses incurred: the direct costs of the fraud itself and the indirect costs of the follow-up investigation and legal representation. The direct monetary loss associated with fraud



is the cost of the fraudulent activity itself, including the money taken, inventory stolen, or other asset loss due to the fraud. Calculating this expense can be a daunting task if the fraudster decides not to cooperate and identify the full extent of the fraudulent activity. Furthermore, recovery of the loss is rare. The ACFE reports that in 42.1% of the cases there was no loss recovered and in 23.4% of the cases, 25% or less of the loss was recovered.⁵

The indirect costs include the legal representation for the company against the perpetrator in civil actions. Companies can incur further legal expenses if the fraud becomes a criminal matter. Companies themselves may also become the subject of a civil or criminal action, and incur further expenses, if the fraud resulted in the loss of money to an outside entity or another individual such as another employee.

Discovery of the fraud should also trigger a review or investigation by the company's auditor or accountants, whether external or internal. The review or investigation often includes an investigation by an independent forensic accountant to determine the full extent of the fraudulent activity. An investigation triggered by fraud should also include a review of the internal controls of the company. The cost of the investigation for the company as well as the cost of legal representation can be expensive. It is even possible that the indirect costs associated with a fraud investigation will be greater than the fraud itself.

The monetary expenses of fraud can have a significant affect on the company, especially small companies. According to the ACFE, a typical organization will lose 5% of its annual gross revenue to fraud.⁶ A loss of any amount of revenue can be difficult for a small business to recover. The true cost of a fraud is never known until the fraud and the indirect costs are incurred. Businesses can save a substantial amount of money by investing in anti-fraud measures before a fraud takes place.

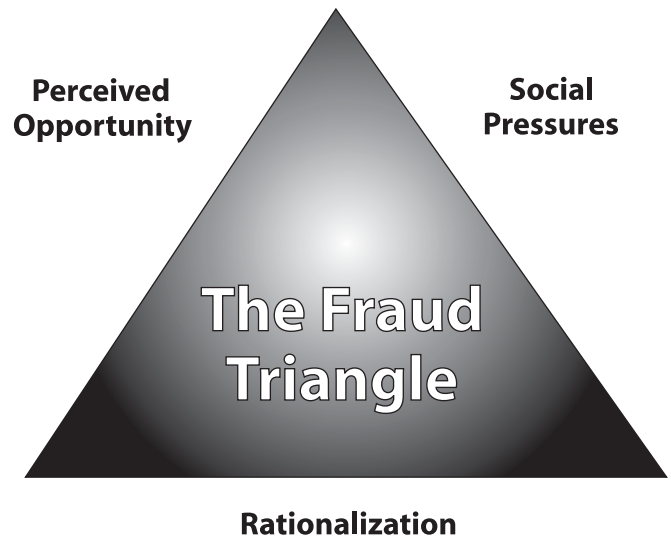
The greatest impact of a fraud investigation may not come from expenses incurred during the fraud investigation. The most destructive result of any fraud investigation may be the negative publicity that accompanies the discovery. As part of its survey, the ACFE inquired as to the reasons companies did not make referrals to law enforcement. In 43.8% of the cases, the companies did not want to refer the case for prosecution for fear of negative publicity.⁷ Negative publicity may affect small businesses to an even greater degree than it affects large businesses.

Basic Tenets of Fraud Prevention

A well-known criminologist, Donald R. Cressey, created a model that has been used often in the years since he first proposed it. Cressey created the Fraud Triangle in which each leg of the triangle represents a different component of what causes a white collar criminal to commit the crime.⁸ The three

sides of the triangle are 1) Rationalization; 2) Perceived Opportunities; and 3) Social Pressures facing the individual. According to Cressey, these three issues are present to some extent in all white collar crime cases. Although the triangle does not fit all cases of fraud, the model does help companies understand how anti-fraud measures work and how to implement such measures.

The three legs of the Fraud Triangle represent three approaches an organization could use to prevent fraud. Two legs, Rationalization and Social Pressures, are difficult for organizations to manage. These two legs of the fraud triangle are derived from individual attitudes and circumstances which are generally beyond the control of the organization. The last leg, Perceived Opportunities, can be managed by the organization quite effectively.



Hotlines and SOX Lessons

Congress passed the Sarbanes-Oxley Act⁹ (SOX) in the wake of the Enron and WorldCom failures. SOX requires large, publicly held companies to establish certain internal control procedures, among them a mechanism for the anonymous reporting of fraud:

Each audit committee shall establish procedures for:

(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and

(B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.¹⁰

Although hotlines were the only anonymous reporting mechanism included in the ACFE Report, the procedures required by SOX can include any method by which employees could file anonymous tips relating to fraud. An anonymous

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reporting system could include an anonymous email account, a drop-box outside the office door, a mail slot in the office door, a fillable form on the intra-office website or a number of other methods which employers could use to encourage the anonymous reporting of fraud.

The Report tested for five methods of fraud detection: external audits, internal audits, fraud training, hotlines, and surprise audits. The hotline is generally the least expensive option of fraud detection listed in the Report. Although the least expensive, the hotline was only used 45.2% of the time, and was fourth on the list of detection methods.¹¹

Furthermore, according to the ACFE, tips were by far the most common means by which a fraud was uncovered. In 34% of the cases overall and in 32.2% of the cases involving small business, the fraud was reportedly uncovered by a tip. Of all the tips received, 82% of the tips were reported by either employees or anonymously.¹²

Hotlines also reduce the amount of time it takes to uncover the fraud as well as the money that was lost to a fraudster. The average loss when a hotline was used was 50% lower. The total dollar loss to a company which had implemented a hotline was \$100,000 versus \$200,000 for cases in which a hotline was not used. Hotlines also reduced the number of months before the fraud was detected from 24 months to 15 months.¹³

What is striking about these numbers is that anonymous tips appear to be very effective in identifying and detecting fraud but only a minority of businesses chose to implement such an anonymous reporting mechanism. The Report suggests that the use of hotlines would serve as an effective anti-fraud measure to an organization of any size. While all companies may not be required to establish an anonymous reporting mechanism, all companies could benefit from implementing a simple method for employees or others to report fraud anonymously.

Surprise Audits

According to the Report, surprise audits were the least used method for detecting fraud. Only 29.2% of all cases reported that organizations used this method of detection. The data for surprise audits is remarkably similar to hotlines. The use of surprise audits resulted in median losses of 50% less. The loss to companies using surprise audits was only \$100,000 versus a \$200,000 loss to companies which did not use surprise audits. The number of months to detection was 15 months when using surprise audits and 24 months when not using surprise audits.¹⁴

Surprise audits can be of great use to a smaller company. Such an audit could be limited in scope and thus be very cost effective. An audit could be limited to a time period, certain

type of inventory, a susceptible account, or any other limiting factor. Surprise audits can be particularly beneficial if there is a suspected fraud regarding a single division or individual within the company. For instance, surprise audits can be very useful for auditing a teller drawer or a monthly expense report. Any limits on the audit would limit its overall cost and allow the company to control the cost of the anti-fraud measure. The use of a surprise audit can be limited to using the audit process as often or as little as necessary.

Employee Education

The third way in which companies can prevent fraud is through employee education on the topic of fraud, fraud awareness, or ethics. If company management is not able to review every transaction, which most cannot, then the next best thing is having other employees who are vigilant to fraud and fraud symptoms.

The ACFE reported that in organizations that used fraud awareness or ethics training the median loss to an organization due to fraud was reduced by \$100,000. Without any training, the losses averaged \$200,000 while with the fraud training the average loss was reduced to \$100,000. Fraud training also reduces the length of time it take a company to detect a fraud. Without fraud training, the average time in terms of months to detection was 24 months while with the training the average number of months to detection was 15 months.¹⁵

Employers can provide employees with fraud awareness or ethics training in many ways. Employees could be allowed to watch a video of corporate rules regarding accounting for expenses, attend a presentation from management or accounting on proper documentation procedures, monthly emails from management on firm policies and procedures, or reminders on message boards in the employee lunchroom. The overall costs for implementing such steps are small as well when compared to the costs of fraud.

Three Steps and the Fraud Triangle

Each of the three steps outlined above is intended to help identify the fraud if it exists within the organization. To a certain extent, the three steps can also be interpreted as methods by which an organization can manage the third leg of the Fraud Triangle, Perceived Opportunities. Each of the steps can serve to increase the awareness of the employees to the anti-fraud measures, especially through employee training and education.


Surprise audits work well at identifying fraud because the lack of foreknowledge of the investigation by the subject, but, they can work equally well to deter fraud before it begins if the employee were aware of such an anti-fraud measure. Making the employee aware of the existence of such an anti-

fraud measure would not diminish its effectiveness, and by virtue of the Fraud Triangle, the knowledge of the existence of a surprise audit may lead to a decrease in the perceived opportunity of a fraud. Decreasing perceived opportunities for fraud may, by itself, prevent fraud.

The same type of reasoning would apply to hotlines as well. If the potential fraudster has knowledge of an anonymous reporting mechanism, this knowledge alone may prevent a fraud from occurring.

The third step outlined above, Employee Training, takes on a new significance given the ideas behind the Fraud Triangle. Employee training and education can serve to increase the employee's awareness of the anti-fraud measures being taken by the organization and, at the same time, serve to decrease the perceived opportunities for fraud. The more employee education and training in fraud and ethics employees receive, the more they will become aware of the steps being taken by the organization to detect and prevent fraud and the less likely it is that a fraud will be committed.

This article should serve as a primer for business attorneys on the subject of anti-fraud measures. The three steps outlined are just three of many steps which can be implemented to prevent and detect fraud. Three basic steps to preventing fraud in the workplace are hotlines and/or other anonymous reporting mechanisms, surprise audits, and finally employee education and training. Of these, employee education may be

the most important for two reasons. First, the educational service will provide the training necessary for the employees. Second, employee education will serve to raise the awareness of employees to the anti-fraud measures being taken thus reducing the perceived opportunities for fraud. 

Endnotes

- ¹ For more information regarding the Association of Certified Fraud Examiners (ACFE) and fraud research please visit the website at www.acfe.com.
- ² The full text of the report can be reviewed and downloaded from www.acfe.com/documents/2006-rttn.pdf.
- ³ Certified Fraud Examiner (CFE) is a professional with expertise in fraud prevention, detection, deterrence and investigation.
- ⁴ *ACFE Report to the Nation of Occupational Fraud & Abuse*, p. 6.
- ⁵ *Ibid*, p. 59.
- ⁶ *Ibid* at p. 8.
- ⁷ *Ibid* at p. 57.
- ⁸ Donald R. Cressey, *Other People's Money: A Study in the Social Psychology of Embezzlement*, 1953
- ⁹ Sarbanes-Oxley Act of 2002 (SOX), PL 107-204, 116 Stat 745, Codified in Sections 11, 15, 18, 28, and 29 USC, July 2002.
- ¹⁰ 15 USC. § 78f(m)(4), (SOX § 301(4)).
- ¹¹ *ACFE Report to the Nation of Occupational Fraud & Abuse*, p. 35.
- ¹² *Ibid*, p. 28.
- ¹³ *Ibid*, p. 35.
- ¹⁴ *Ibid*, p. 37.
- ¹⁵ *Ibid*, p. 38.

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