

The red flags of fraud

What is your company's share of the estimated \$652 billion in fraud losses? **Interviewed by Steve Trusty**

United States organizations lose 5 percent of their annual revenues to fraud, according to a study by the Association of Certified Fraud Examiners, Inc. (ACFE).^{*} The report goes on to state that "applied to the estimated 2006 U.S. gross domestic product, this 5 percent figure would translate to approximately \$652 billion in fraud losses."

"Organizations can cut these losses by detecting fraud at its earliest stages," says John Schoendorf, partner and Litigation Support leader at Berenfeld Spritzer Shechter & Sheer LLP. "The study highlights how important it is for organizations to develop a system for anonymous fraud reporting. It is also important to have internal auditing procedures and to conduct surprise audits occasionally. Training on fraud detection and avoidance should be provided to employees and managers."

Smart Business asked Schoendorf for his insight into detecting occupational fraud and steps to take when it's discovered.

What are the common types of fraud?

The most prevalent is asset misappropriation, which includes fraudulent invoicing, payroll fraud and skimming revenues. According to the ACFE, this occurred in 91.5 percent of cases with a median loss of \$150,000. Corruption, including accepting or paying a bribe and engaging in business transactions where there is an undisclosed conflict of interest, occurred in 30.8 percent of the cases. The median loss in these cases was \$538,000. Financial statement fraud occurred in 10.6 percent of the cases but had a median loss of \$2 million. Financial statement fraud includes booking fictitious sales and recording expenses in the wrong period. Percentages exceed 100 percent because some cases involve schemes that fall into more than one category.

At what management level is fraud most prevalent?

According to the ACFE study, 30 percent of the fraud took place in the accounting department. Slightly more than 20 percent of the cases were committed by upper-level management or executive-level employees.



John Schoendorf
Partner
Litigation Support
Berenfeld Spritzer Shechter & Sheer LLP

Fourteen percent of the cases involved the sales department.

Fraud quite often occurs when trusted employees are financially pressured by changing personal circumstances. They see an opportunity to commit fraud, then justify their behavior by rationalizing it away. Look for common danger signals, such as medical issues within an employee's family, finding excuses for not taking a vacation or living beyond his or her means. In short, get to know your employees and recognize their lifestyles.

What steps should be taken to prevent occupational fraud?

Most fraud is detected accidentally or by tips from employees. Customers and vendors may also provide information that can lead to fraud detection. Because only a small fraction (8 percent in the study) of the perpetrators had convictions prior to committing their frauds, background checks aren't as useful as many think, at least in this area.

The most effective deterrent is open com-

munication. Make it easy for employees to provide tips, especially anonymously. Develop a system that encourages reporting actions that might indicate fraud. Tip hot lines can be very useful.

Another good tool is fraud training. Inform employees of what to watch for. Conducting surprise audits can prevent or limit losses. Involve as many people as possible in processes. For example, the person cutting checks should be different from the one approving invoices, and the person approving invoices should not be the one issuing purchase orders or checking in shipments. The more people involved, the less chance there is for fraud. In small businesses, where it might be difficult to segregate duties, one tool would be having the bank statement sent to the owner's home to allow independent comparison to the records.

What should be done if fraud is discovered or highly suspected?

The first thing is to contact your professional advisers, attorney and certified public accountant. You need to make sure that all the proper steps are taken to document any losses and their causes in ways that will hold up in court if that becomes necessary. In fact, you should proceed as though a court proceeding is a certainty. You can't undo procedures that might prevent valuable evidence from being admissible. You can't make accusations without adequate proof. Your attorney can help assure discovery is conducted properly.

Your accountant should refer you to a forensic accounting specialist, preferably a certified fraud examiner who has the training and experience to work with your attorney and the authorities to assure the best outcome for recouping any losses you may incur. <<

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JOHN SCHOENDORF is a partner in the Litigation Support practice of Berenfeld Spritzer Shechter & Sheer LLP. He specializes in forensic accounting, fraud examinations, commercial and civil damages, bankruptcy and restructuring. Reach him at (305) 669-7051 or jschoendorf@bsss-cpa.com.

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