Fraud Detection and Prevention

Risk and Materiality are two concepts that are well known and understood by auditors. In the area of fraud these concepts apply to the risk of experiencing a fraud and the materiality of the losses to fraud. The assessment of the importance of these factors will, to some degree, determine how serious the company treats the prevention and detection of fraud. It will also affect the resources devoted to fraud related tasks by audit, so it is important for all auditors to given proper consideration to the risk and material of fraud in their organization.

What is the risk or likelihood of a fraud occurring in your organization? A more difficult question to answer than one might think. However, many studies have been performed - asking that very question. A 1997 study stated that 63% of companies had a least one fraud in the last two years; and a 1999 study has 57% of respondents reporting a fraud in their company in the last year. So the research indicates that the risk of experiencing a fraud is high. But, the studies point out another disturbing fact, not only is fraud likely, but the instances of fraud are increasing. Not surprising when you compare the risk, relatively small pay off gained, and the jail term associated with robbing a gas station with the fraudulent paying an invoice to you or your spouse. The gas station robber runs the risk of being shot and killed or a lengthy jail term - for a few hundred dollars. The person committing the fraud, however, is not as likely to be caught, if caught - may only get a mere slap on the wrist, and can easily obtain thousands of dollars.

So, if your company has at least one fraud in the past year, and that appears to be likely, is the loss still significant? Over the years many people have tried to size the materiality of fraud. One of the biggest problems in determining the amount of the losses is the undetected fraud. However, ignoring the undetected losses, the current figures still indicate that fraud is costly in financial terms. A KPMG study in Canada reported an average loss to fraud in 1998 of almost $1 Million. In the retail sector in the United States fraud has been estimated at rates of 6% of revenues; and a study by the American Certified Fraud Examiners (ACFE) states that financial losses in the US are a staggering $400B per year - some studies quote even higher figures. Add to this the intangible costs, such as, damage to the organization through loss of goodwill, negative publicity, reduced employee morale, stockholder confidence, etc. In some cases, the intangible costs may be even higher than the financial losses.

The following provides the median loss due to fraud for different types of fraud (Joseph Wells, 'Occupational Fraud and Abuse', Obsidian Publishing Co, Austin Tx, 1997).

- False Voids - Cash Registers $ 50,000 US
- Ghost Employees $ 275,000 US
- Commissions $ 200,000 US
- Skimming Receivables $ 52,000 US
- Kickbacks $ 250,000 US

As you can see the median losses are significant; and, if you include Fraudulent Reporting of Financial Statements, the figures for fraud are much higher. The median loss for Fraudulent Statements is $ 4 Million. While represents the size of the misstatement rather than an actual loss it is still considered to be fraud.

So, fraud happens in all types of organizations, private and government, and in all industries. In addition, the losses to fraud are significant.

What is Fraud?

There are many definitions for fraud and a number of possible criminal charges, including: fraud, theft, embezzlement, and larceny. The legal definition usually refers to a situation where:

- a person makes a material false statement;
- the victim relies on that statement; and
- the criminal benefits.

It should be noted that persons inside the organization or external to it could commit fraud. Further, it can be to the benefit of an individual; to part of an organization; or to the whole organization itself. However, the most expensive and most difficult fraud for auditors to deal with is one that is committed by senior management - particularly if it is 'for' the benefit of the organization.

Why Does Fraud Happen?

Interviews with persons who committed fraud have shown that most people do not originally set out to commit fraud. Often they simply took advantage of an opportunity; many times the first fraudulent act was an accident – perhaps they mistakenly processed the same invoice twice. But when they realized that it wasn't noticed, the fraudulent acts became deliberate and more frequent. Fraud investigators talk about the **10 - 80 - 10** law which states that 10% of people will never commit fraud; 80% of people will commit fraud under the right circumstances; and 10% actively seek out opportunities for fraud. So we need to be vigilant for the 10% who are out to get us and we should try to protect the 80% from making a mistake that could ruin their lives.

Generally, fraud occurs because of a combination of opportunity, pressure and rationalization. An opportunity arises, the person feels that the act is not entirely wrong, and has pressure pushing them to commit the fraud.

Opportunity. An opportunity is likely to occur when there are weaknesses in the internal control framework or when a person abuses a position of trust. For example:

- organizational expediency – 'it was a high profile rush project and we had to cut corners';

- downsizing meant that there were fewer people and separation of duties no longer existed; or
- business re-engineering brought in new application systems that changed the control framework, removing some of the key checks and balances.

Pressure. The pressures are usually financial in nature, but this is not always true. For example, unrealistic corporate targets can encourage a salesperson or production manager to commit fraud. The desire for revenge – to get back at the organization for some perceived wrong; or poor self-esteem - the need to be seen as the top salesman, at any cost; are also examples of non-financial pressures that can lead to fraud.

Rationalization. In the criminal's mind rationalization usually includes the belief that the activity is not criminal. The often feel that everyone else is doing it; or that no one will get hurt; or it's just a temporary loan, I'll pay it back, and so on.

Interestingly, studies have shown that the removal of the pressure is not sufficient to stop an ongoing fraud. Also, the first act of fraud requires more rationalization than the second act, and so on. But, as it becomes easier to justify, the acts occur more often and the amounts involved increase in value. This means that, left alone, fraud will continue and the losses will only increase. I have heard it said that 'There is no such thing as a fraud that has reached maturity'. Fraud, ultimately, is fed by greed, and greed is never satisfied.

Who is responsible for the prevention and detection of fraud?

There are two main views - one states that management has the responsibility for the prevention and for the detection of fraud. Management:

- is responsible for the day to day business operations;
- is responsible for developing and implementing controls;
- has authority over the people, systems, and records; and
- has the knowledge, and authority to make changes

therefore, fraud prevention and detection is their problem. Audit, on the other hand:

- has expertise in the evaluation and design of controls;
- reviews and evaluates operations and controls; and
- has a requirement to exercise 'Due Diligence'

therefore, fraud prevention and detection is audit's problem.

The reality is that both management and audit have roles to play in the prevention and detection of fraud. The best scenario is one where management, employees, and internal and external auditors work together to combat fraud. Furthermore, internal controls alone are not sufficient, corporate culture, the attitudes of senior management and all employees, must be such that the company is fraud resistant. Unfortunately, many

auditors feel that corporate culture is beyond their sphere of influence. However, audit can take steps to ensure that senior management is aware of the risk and materiality of fraud and that all instances of fraud are made known to all employees. Also audit cal also encourage management to develop Fraud Awareness Training and a Fraud Policy to help combat fraud. Finally, audit can review and comment on organizational goals and objectives to reduce the existence of unrealistic performance measures. So, there are a number of things auditors can do to help create a fraud resistant corporate culture.

> *Fraud Awareness Training is a critical step in deterring fraud. It emphasizes the role that all employees have in preventing and detecting fraud - not just auditors. Often it is tied to a corporate ethics program, laying the foundation for all aspects of employee behavior.*
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> *A Corporate Fraud Policy sets out what employees are to do when fraud is suspected. It defines a consistent course of action and sets the tone for how the company will deal with fraud. In particular, it must clearly convey the message that no one has the authority to commit illegal acts - even to the benefit of the company.*

Dave Coderre
Author of ‘The Fraud Toolkit; ‘Fraud Detection: Using Data Analysis Techniques to Detect Fraud’ and ‘CAATTs and Other BEASTs for Auditors’
Dave_Coderre@hotmail.com