1

Profiles of Fraud in the Business World

In responding to an *Accounts Payable Now & Tomorrow* Fraud Survey, one savvy professional wrote, "I hope to find out if fraud is generally internal or external to an organization. Can we trust our employees? Or is it someone from the outside that we need to be wary of?" She brings up a very good point. Where should executives focus their resources when it comes to protecting their organization from fraud? By the end of this chapter, you will have the answer to this question.

Without a doubt, everyone reading this is at some risk for employee fraud, also referred to as occupational fraud. When you think about it, the explanation is simple. Who better than your employees know where the weaknesses are in your processes? And even if your processes are iron tight, your employees will know how to get around the controls you've worked so hard to put in place. Now, some reading this may be scratching their heads, thinking I'm making a mountain out of a molehill. Before we dive into the statistics that demonstrate just how common fraud is in the corporate world, let's look at some of the myths that surround fraud in the corporate world.

THREE BIG MYTHS

When it comes to fraud, there are a number of misconceptions. The three biggies are:

1. It could never happen here.
2. My employees would never steal from me.
3. We have good segregation of duties, except for a few long-time, trusted employees who would never steal from us.

As you will see after reading this chapter, all three are false. It could happen in your shop and, in fact, has in almost every organization; sadly, a few of your employees will steal from you given the opportunity; and saddest of all, if an employee does steal from you, the odds are high that it will be one of your long-term, trusted employees.

FRAUD STATISTICS

Generally speaking, reported fraud statistics understate the problem. The reason is twofold:

1. People can report only what has been discovered. Undetected fraud can never be included in the statistics.
2. People are sometimes embarrassed to admit they have been the victim of fraud, especially when it demonstrates a shortcoming on their part. However, given the numbers you are about to see, it is not clear that this is still as strong a factor as it once was.

Throughout this book, you'll see reference to three sources of statistics. They all have different target audiences, yet they all tell a similar, chilling story. The sources are:

1. The Association of Certified Fraud Examiners' (ACFE's) *Report to the Nation*
2. PricewaterhouseCoopers (PwC) Global Economic Survey
3. *Accounts Payable Now & Tomorrow*'s (APN&T's) Fraud Survey

We should also point out that the surveys do not ask the same questions, but, again, the conclusions that can be drawn from the numbers are similar. PwC asked its survey respondents about "significant" crime. It was left to the respondent to decide what was significant and what wasn't. In this case, over 43 percent responded that their organization had suffered one or more significant economic crimes within the prior two years.

The APN&T respondents were asked if any organization the respondent had worked for in the past ten years had been a victim of any sort of fraud. In that instance, a whopping 86 percent responded affirmatively.

While the time frames are clearly different and the questions are not identical, the conclusion cannot be denied. Every organization must be concerned about fraud and take the necessary steps to guard against it.

In providing commentary to the APN&T survey, one of the respondents questioned whether the threat to her organization was internal or external. As the rest of the numbers will illustrate, the threat is dual. No organization can afford to let its guard down on either front.

OCCUPATIONAL FRAUD: IT'S A *BIG* PROBLEM

Occupational fraud is just as ugly as it sounds. Every two years, in a widely awaited "*Report to the Nation*," the ACFE provides an update on this topic. The 2006 report contains some fascinating information that is especially relevant to those concerned about accounts payable (AP). Why? Because it examines three of the most common frauds related to AP:

1. Check tampering
2. Billing schemes
3. Expense reimbursements

DEFINITIONS AND FREQUENCY

The ACFE describes occupational fraud as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets." Of those cases reported, 91.5 percent involve asset misappropriations, with a median loss of $150,000.

Billing schemes, the most common, are described as "any scheme in which a person causes his or her employer to issue a payment by submitting invoices for fictitious goods or services, inflated invoices, or invoices for personal purchases." This can be done by the employee's creating a shell company and billing the employer for nonexistent services or the employee's submitting invoices for personal items. A whopping 28.3 percent of the cases of misappropriated assets were of this type, and the median loss was a mind-boggling $130,000.

Check tampering is defined as "any scheme in which a person steals his or her employer's funds by forging or altering a check on one of the organization's bank accounts, or steals a check the organization has legitimately issued to another payee." This can be done by the employee's either stealing a blank company check or taking a check made out to a vendor and depositing it into his or her own bank account. A little over 17 percent of the asset misappropriation frauds were related to check tampering, with a median loss of $120,000 associated with this type of fraud.

And then there is expense reimbursement fraud, defined as "any scheme in which an employee makes a claim for reimbursement of fictitious or inflated business expenses." Readers of this book have probably seen more than their share of this type of fraud, which accounts for 19.5 percent of asset misappropriations. The median loss related to expense reimbursement fraud is $25,000.

WHO GETS HIT THE HARDEST?

Regrettably, small businesses continue to suffer a disproportionate share of fraud losses. The median loss suffered by organizations with fewer than 100 employees was $190,000 per scheme. This was higher than the median loss in even the largest organizations.

The most common occupational frauds in small businesses involve employees fraudulently writing company checks, skimming revenues, and processing fraudulent invoices.

HOW FRAUD IS DETECTED

As much as I would like to report that internal processes uncover most fraud, that is just not the case. By far, the largest number of cases is discovered because of a tip, and the second-largest number comes to light by accident. Here is a rundown of how frauds are initially discovered:

Tips	34.9%
By accident	25.4
Internal audit	20.2
Internal controls	19.2
External audit	12.0
Notified by police	3.8

(If you do the math, you will note that occasionally two methods are credited for the discovery.)

What this demonstrates is that organizations are not doing a good job at either preventing or detecting fraud. What is truly disheartening is the fact that over half the frauds are detected through methods that have nothing to do with the controls put in place by the organization. In fact, the tips often come about because the crook couldn't keep his or her big mouth shut and bragged about their "accomplishments," resulting in the tip. It is also why anonymous hotlines are such an important component in discovering fraud.

WHO COMMITS OCCUPATIONAL FRAUD?

According to the ACFE, long-term, trusted employees continue to have a stranglehold on this type of crime. Larger losses are associated with employees in higher positions as well as those who have been employed for a longer time. There is a direct correlation between the size of the loss and these two factors.

Men are over one-and-a-half times more likely than women to commit this type of fraud, and when they do, the losses are two-and-a-half times as large. Is this tied to the fact that in most organizations men tend to hold higher positions than women?

Since readers of this book are most apt to run into check tampering and expense reimbursement schemes, I thought I would take a look at the biggest perpetrators of each. If you are thinking sales and/or purchasing, think again.

While sales is the third-largest abuser on the expense reimbursement side, they fall far behind executive/upper management, who account for over one-third of all this type of crime, and accounting, who commit just under 32 percent of it. When it comes to check tampering, accounting (probably because of its familiarity with the issues) is responsible for a whopping 57.4 percent of the cases, with executive/upper management responsible for another 26.4 percent of the cases.

TO PROSECUTE OR NOT

While there is lingering reluctance to prosecute offenders, just over 70 percent of the cases included in this study were referred to law enforcement. The median loss in the referred cases was $200,000, about double that of the cases that were not referred. Fear of adverse publicity continues to be the primary reason for not prosecuting. Almost 44 percent indicated that this was their motivation for declining to take legal action.

Another third of the respondents said that they felt internal discipline was sufficient and a slightly lower number indicated that they had come to a private settlement with the perpetrator. A little over 21 percent believed that it would be too costly to take action. This probably accounts for the lower median loss on nonreported cases. The remaining reasons include:

- Lack of evidence
- Civil suit
- Disappearance of the perpetrator

The other reason that organizations may be reluctant to take legal action is that their chances of recovering a reasonable amount of the loss are not very good. Only 16.4 percent recovered 100 percent of their loss, while 42 percent received nothing.

However, it should be noted that a well-publicized prosecution can do wonders for stopping other potential internal thieves, and we are not necessarily talking about the media. Making sure that everyone within the company is aware that legal action was taken should do the trick.

This report is just one of the many resources available from the ACFE (www.acfe.com).

IS FRAUD AN EQUAL OPPORTUNITY CRIME?

Do you have a preconceived notion as to whether fraudsters are more likely to be male or female? This is one area where the numbers do not tell the same story.

According to the ACFE, 61 percent of the frauds were committed by men. However, the PwC data show that 85 percent of the perpetrators were male. This is a bit of a difference. The explanation probably lies in the makeup of the people interviewed. The PwC respondents tended to be very high-level executives who were asked about "significant" crime, while the ACFE respondents were fraud examiners and did not differentiate between frauds where the losses were big and those where it wasn't.

FRAUD IN THE EYES OF THE BEHOLDER

As we sift through the mountains of data related to fraud, one of the issues is the way an organization views fraud, especially if committed by insiders. One organization might consider it a firing offense, another might only give an employee a warning, and still others might ignore it completely.

Thus, if an organization is serious about preventing fraud, it is crucial that the message is sent from the top. In reality, what we observe is that one organization will fire (and possibly even prosecute) an employee for a relatively minor infraction, while another will completely ignore it.

Take the example of two travelers putting in for the same meal, splitting the profit. In most organizations, if this deed were discovered, the employees would be given a reprimand and asked to reimburse the company for the excess charges. In reality, at the organization where this happened, the two employees were fired and given no references. The organization was serious about fraud, and in its eyes, the employees stole from the company—which, technically, they did. However, there is the concept of letting the punishment fit the crime.

Clearly, in the case of petty theft, there are arguments on both sides of the fence regarding the proper action to be taken when it is uncovered.

EFFECT OF STATUS OF FRAUDSTER

Rank does apparently have its privileges when it comes to fraud. The PwC study found that many did not refer fraudsters from the rank of senior management for criminal prosecution. It also noted that there was a significant difference in the way companies dealt with senior managers involved in a fraud as compared with other employees. In fact, the survey pointed out that when it comes to senior management, the corporate response appears to be limited to warnings or reprimands.

While this is clearly not fair, it is a fact of life, at least for the present time. Needless to say, at the organizations where this occurs, the effect on morale is not positive.

BIG BOSS ISSUE

The numbers highlight another issue, especially when it comes to expense reimbursement fraud. Few employees, especially those at lower levels, are likely to feel comfortable questioning an expense report of an executive at the vice president level or higher. Yet, as the numbers above demonstrate, that's where a good portion of certain types of fraud happen.

At the end of Chapter 7, there is a story of an executive's putting in for a pocketbook costing $3,000. The processor was then put in an awkward position: do they question the clearly inappropriate expense and risk the wrath of that employee and possible career damage, or do they say nothing and process the expense report, which has been approved by the traveler's supervisor? Many of the accounts payable processors I have run into would question the charge, and I admire them for their gumption.

The responsibility for this, as will be discussed in greater detail in the chapter on travel and entertainment (Chapter 7), should be with the person who approved the expense report. However, as will also be discussed in greater detail in Chapter 7, most approvers don't look at the report, they merely scribble their signature on it without ever looking at what is included.

By insisting that people review what they are signing and then holding approvers responsible for losses associated with their own careless review, some steps may be taken against the frauds that are perpetrated due to the hasty reviews.

Along this line, you might want to consider giving every employee in the review chain the right to question any expense on a report or invoice.

WHY DO INSIDERS STEAL?

While you may be thinking the reason employees steal from their employers is they need the money, you would be correct only part of the time. PwC analyzed the data and found the following reasons for the theft (you will note that some thefts had multiple reasons; hence, the numbers exceed 100 percent):

Financial incentive (greed!)	57%
Low temptation threshold	44
Lack of awareness of wrongdoing	40
Expensive lifestyle	36
Denial of financial consequences	26
Career disappointment	12
Potential job loss	8

CONDITIONS THAT PERMIT FRAUDS TO OCCUR

PwC also analyzed the data to pinpoint the shortfalls within the organizations that permitted the fraud to occur. As above, they often assigned blame to several issues, and thus the numbers, if added together, will exceed 100 percent. The main reasons were:

Low commitment to the brand	34%
Insufficient controls	34
Ability to override controls	19
Too great staff anonymity	17
High company targets	13
Corporate ethics unclear	14

These are areas you can do something about. Tight internal controls are well within the bounds of what every organization can establish.

The ability to override controls is a serious matter. While there are times it may be required, the approvals needed should go up the chain of command several levels, and there should be regular reporting any time it is done. It should be a rarity used only when no other approach will work. Require documentation and approvals.

WHY AREN'T MORE FRAUDSTERS PROSECUTED?

The answer to this question is simple. The most common reason fraud isn't prosecuted is that the very act of prosecuting makes the fraud public. And this is something that many organizations loathe. They believe the fact that the fraud occurred demonstrates a lack of appropriate controls on their part. And, in many cases they are correct.

In fact, the ACFE figures show that fear of bad publicity is the number one reason why companies decline to prosecute.

FRAUD IN THE REAL WORLD

A husband and wife "team" created two nonexistent corporations, letterhead, and invoices. Post office boxes and bank accounts were opened for the fictitious corporations. The invoices were sent to the husband's place of employment for maintenance supplies. In his position as building and maintenance manager, the husband would approve the invoices for payment. Once the checks arrived, the wife would deposit them and write checks to herself or cash. Before the scam was uncovered, the pair had netted $400,000.

How were they discovered? Not content with the money they were stealing through their ingenious scheme, the husband succumbed to the allure of easy money and began putting personal charges on his corporate account. An audit of the credit card uncovered the fraudulent charges and triggered the larger investigation, which uncovered the ongoing fraud.

This couple had a good thing going. They had avoided some of the more common mistakes employees make when stealing from their employers. However, like many other thieves, they got greedy. It is not clear if their fraud would have ever been uncovered had it not been for the credit card charges.

By the way, the organization where this occurred lacked the appropriate internal controls and segregation of duties that in the normal course of affairs would have prevented this. Use of a purchase order (PO) process and three-way match would have uncovered this fraud early on. While we do not recommend POs for every purchase, purchases of this magnitude should be done under the auspices of a PO process.

The husband pled guilty, but his now ex-wife did not, claiming she was an innocent participant. She was prosecuted and convicted, and at the time of this writing was requesting a new trial and a new lawyer.

CONCLUDING THOUGHTS

By now, you probably realize you are at risk both internally and externally. In fact, the PwC study asked respondents about this issue, and 76 percent of them reported that the crimes were committed by external parties. However, they were asked only about significant frauds. We believe that most travel and entertainment fraud would not be considered significant, and had it been included, the numbers would be more equal. Even if this is not the case, there still appears to be significant risk from insiders.

This is not to say that every employee is out to defraud his or her employer. Just the opposite is true. Probably less than 1 in 1,000 or even 10,000 eyes their employer's coffers as a target for extra income. The problem, as the preceding statistics hopefully demonstrate, is that it is virtually impossible to tell which one of your employees is the potential bad apple. Hence, executives must institute the appropriate internal controls and segregation of duties within their operations so no employee can take advantage—even your long-term, trusted staff.

At the same time, implementing safeguards against fraud from outsiders is crucial. As the rest of the book will demonstrate, no one is exempt. The excuse of “we’re too small,” or the reverse, “we’re too big,” holds no water when it comes to thieves. They will take whatever they can from whomever makes it the easiest for them. Your job: to make sure it is difficult to steal from your organization so they set their sights on someone else.