Fraud: Do You Know It When You See It?

The subject of employee dishonesty is a delicate one. Owners generally want to trust their employees, and given all the other battles owners fight on a daily basis, they are often not as vigilant as they can or should be. Vigilance requires an investment of time and money in return for an uncertain payoff.

Here's one example of a typical fraud scenario:

Lou Spencer's CFO, Marty Jacks, had been with Lou's company for 15 years. While Lou reviewed company financial reports and often the accounts receivable aging report, he let Marty handle the day-to-day financial operations. To say that Lou was surprised when one of his vendors mentioned that he'd run into Marty on the floor of a Las Vegas casino at 4:00 a.m. would be an understatement. As far as Lou knew, Marty spent every weekend at home or camping with his family.

Rather than confront Marty immediately, Lou casually asked his golf partner (a CPA who also happened to be a Certified Fraud Examiner) about employee theft.

The CPA listed more ways to steal than Lou could imagine, but Lou did remember:

- *Creating fictitious vendors or employees.*
- *Stealing inventory.*
- *Giving oneself undisclosed and unauthorized pay raises.*
- *"Lapping" or taking payment from one customer and applying it to another's account.*

The CPA explained to Lou the three conditions present in any fraud situation: motive, opportunity and rationalization.

"Has anyone run into financial difficulties?" he asked. "Maybe a sick kid? The unemployment of a spouse or even the readjustment of payments on a home loan?" Lou could not think of anyone in those situations.

Lou understood the "opportunity" factor immediately. He admitted that because he trusted Marty implicitly he was not reviewing every report carefully. Marty certainly had opportunity.

Rationalization: Lou was fairly confident that his employees—including Marty—were satisfied with their salary and benefit packages. Except for an occasional afternoon of golf, Lou believed he worked as hard as any of them.

The CPA suggested that before acting, Lou retain a fraud analyst to conduct a fraud audit. At a minimum, Lou should review his financial statements and this time, rather than focus on the decline in revenues, look for any anomaly or anything that "bucks the trend." Lou returned to an empty office to do exactly that.

What Lou discovered caused him to call his golf buddy to schedule a meeting about a Fraud Deterrence Audit. Lou swallowed hard as he signed an engagement letter for an audit that would cost his $20M company between $20,000 and $25,000.

After several weeks of review, the CPA laid out the situation for Lou. Marty had a gambling habit (motive). Over the past 18 months, Marty had set up numerous bogus vendor accounts and had siphoned off almost $1 million to these accounts (opportunity). When Marty started pulling small amounts of cash out without Lou noticing, Marty decided that since Lou didn't miss the cash, Lou could do without it (rationalization).

Armed with the facts, Lou fired Marty. There was no way to recover the money, so Lou and the Fraud Examiner concentrated instead on ways to prevent this scenario from reoccurring.

There are sub-specialties in accounting that include the Certified Fraud Deterrence Analyst and Certified Financial and Forensic Accountant. These advisors have knowledge and expertise that go beyond financial statement review. They have a unique way of looking at your business operations and activities.

These fraud detection professionals might suggest that you first look for any anomalies in the company's financial reports. Are there exceptions to trends over time? To do this, prepare two spreadsheets.

- On the first spreadsheet, enter the last five years' income statements expressed both in dollars and as a percentage of gross revenues. Using that report, investigate any significant changes in income as well as significant changes in the expenses as a percentage of income.
- On a second spreadsheet enter your company's balance sheets for the past five years. Using this report, compute the accounts receivable turnover and collection days for each year as well as inventory turnover. Again, investigate any significant changes.

Next, a professional might recommend that you change the schedule for running and reviewing reports. Lou's new CFO (hired only after a thorough background check) should provide Lou with reports on a weekly, rather than monthly, basis, and occasionally on days that she is not expecting to have to deliver reports.

A third suggestion might be that owners should carve out time to carefully review those reports without distraction. Give them the attention they deserve.

Lastly, a professional may advise that owners ask their CPAs to conduct a quick Financial Statement Overview. Many owners think they know how to read these Statements, but CPAs can teach owners what to look for and what the numbers mean.

A qualified Fraud Examiner will propose a number of changes tailored to your particular company and they should follow up on an agreed upon schedule to make sure that all changes have been implemented and that there are no new opportunities for fraud.

Internal forensic reviews, systems of checks and balances and a watchful owner are not signs of mistrust – they are signs of a healthy strong company. You may sleep better at night and position yourself and your business for a successful future if you take some of these steps. Do you need to have a conversation about detecting or preventing fraud in your business? Contact us to get help accessing the resources and information that you need.

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