Internal Fraud, By the Numbers

by Christopher Todd

Numbers sometimes speak louder than words. When we talk about fraud, here are three that stand out: 5, 713 and 18.

First, the 5. According to the Association of Certified Fraud Examiners (ACFE), the typical organization loses 5 percent of its annual revenues to occupational fraud and abuse.

If 5 percent doesn't seem like much, let's put it in big-picture context. As part of the United States' 2009 gross domestic product, 5 percent equals $713 billion. And how much is $713 billion? Enough to run the U.S. Department of Defense during 2008, that's how much.

And the 18? Well, that's the median length of time to uncover a typical case of occupational fraud. In other words, if someone just started stealing from inside your business, chances are you won't figure it out until the 2012 NCAA basketball champion is crowned.

Still, you're probably thinking, there's no way my business can be victimized by internal fraud. Our employees are loyal and trustworthy, they've been with the company for years. They're almost like family.

Here are a few more numbers, taken from ACFE's 2010 report on global fraud: about 50 percent of the identified frauds were perpetrated by employees who had been with the business for five years or more; 85 percent of the perpetrators had no criminal history, and 82 percent had no prior employment punishment or termination. In other words, the statistics indicate that fraud is most likely to be committed by the people you're least likely to suspect.

The ACFE often refers to the "fraud triangle," whose three legs are labeled Opportunity, Financial Pressure and Rationalization. Smaller workforces, breakdowns in internal checks and balances and changes in business models all can create opportunities for fraud. In the current economy, many more employees than usual are feeling financial pressure. When opportunity and financial pressure intersect, it's not hard to develop a rationalization to cheat your boss.

How, then, does a CEO make a business fraud-proof?

It starts with creating and maintaining a work environment based on uncompromising ethical standards. Management must adopt, implement and frequently communicate expectations and policies relating to managing fraud risk. If employees know what's expected, they're less likely to behave inappropriately and more likely to recognize signs of inappropriate behavior in their coworkers.

Employees must feel confident that they can alert management without fear of reprisal if they suspect inappropriate conduct by other members of the team. One of the best approaches is to subcontract to a third-party operator of an independent tip line. The

ACFE report notes that the most prevalent method of catching workplace fraud is through an independent tip line. In fact, about 40 percent of all internal frauds first came to light through a tip. Two-thirds of those tips came from employees; customers, vendors and competitors also provided leads that prompted successful investigations.

The owner or CEO must be personally involved in fraud prevention efforts — not because it looks good but because you're the company's best deterrent.

Take a hands-on approach with all mail from banks and financial institutions. Open them first, look them over, and then carry them back to whoever is responsible for reconciling the statements. Ask questions. Review your payroll logs and lists of vendor payments before checks are issued. Do you recognize all the names? Do the payment amounts appear accurate?

Also, watch out for possible conflicts of interest. Are there family and/or personal relationships linking employees within your business or linking your employees with employees of a supplier or subcontractor? That's not necessarily a problem, but it is something to watch.

The surprise, or random, audit is another effective tool in the antifraud arsenal. Knowing that their work can be checked at any time, without notice, can serve as a powerful deterrent to employees.

Also, make sure every employee takes an annual vacation. When substitutes fill in, it's often easier to spot irregularities that had gone undetected.

Your CPA can also be a valuable resource, providing on-site training in fraud detection and prevention. CPAs can train owners to spot red flags that signal asset misappropriation and corruption, and they can also educate businesses about fraud threats that originate outside the company.

Preventing fraud is hard work. And the businesses that succeed are the ones whose owners set the proper tone and pay attention to the details.