

Occupational



A PRODUCTIVE AREA FOR COUNSEL'S ATTENTION

By Susan Cheng, CPA, CFE, CA and Barry Jay Epstein, Ph.D., CPA

Corporate counsel may have, in the past, given too little attention to garden-variety fraud and abuse by employees of their employer companies or clients. However, in terms of adding value, occupational fraud often represents “low-hanging fruit” that, with a modest level of effort, may yield noteworthy savings and profit enhancements. That potential is one implication of a new study by the Association of Certified Fraud Examiners (ACFE), whose *2010 Report to the Nations on Occupational Fraud and Abuse* (“2010 Report”) was released in June.

Whereas five previous Reports dealt only with fraud at U.S. organizations, the *2010 Report* is a global fraud study¹. It finds patterns of fraud reported to be consistent across six continents, suggesting that occupational fraud is indeed universal in nature.

The cost of occupational fraud is alarming, running into the billions of dollars. On average, organizations lose 5% of annual revenue to fraud. Applying this percentage to the 2009 estimated Gross World Product of \$58.07 trillion, ACFE projects total global fraud losses of \$2.9 trillion.

In the U.S. alone, although the median loss from all occupational fraud was \$105,000, for the most serious category of fraud, *financial statement fraud*, the median loss was \$1.73 million. The other two principal categories—*asset misappropriation* (accounting for almost 90% of the reported U.S. cases), and *corruption*—had median losses of \$100,000 and \$175,000, respectively.

The cost of fraud goes beyond the monetary. Loss of reputation, both business and personal, decline in shareholder value, and the cost of defending lawsuits from shareholders, government agencies and other third parties, often follow from the revelation of fraud within an organization. Some companies, most notably Enron and WorldCom, paid the ultimate price for their fraudulent behavior.

The Case for Anti-Fraud Measures

Corporate counsel can and should play a key role in advising their clients (senior management, directors and, in particular, audit com-

mittee members) to increase fraud awareness and take steps to reduce its occurrence. No organization, especially in today's economic climate, can afford to lose 5% of its annual revenue to fraud. As such, organizations should be encouraged to dedicate resources towards anti-fraud efforts, to curtail occupational fraud and minimize the risk of catastrophic loss.

The *2010 Report* confirms that anti-fraud measures contribute to reducing the cost and duration of occupational fraud (eighteen months is the median time before detection). This finding is especially relevant to small organizations, typically those with fewer than 100 employees, that have fewer controls due to having limited resources, but which are disproportionately impacted by occupational fraud.

The Need for Fraud Training

Of the fifteen categories of anti-fraud measures in place at victim organizations at the time frauds were perpetuated, three measures—external audit of financial statements, code of conduct, and internal audit/fraud examination department—were most often cited. The *2010 Report* ranks external audits—traditionally relied upon as a top fraud deterrent – as relatively ineffective as a measure for detecting occupational fraud. Consistent with prior findings, tips from employees were overwhelmingly the single most notable contributor to initial detection of occupational fraud, followed distantly by management review and internal audit.

The significant role of employee tips in the detection of fraud underscores the importance of regular fraud training, which the study showed lowered fraud losses. Employees must be educated as to what fraud is, why they should care about fraud, and how it can negatively impact them. They should be trained to recognize and report possible fraudulent behavior, since behavioral red flags, e.g., displayed by those living beyond their means or experiencing financial difficulties, cannot be detected through traditional control mechanisms.

Perform a Fraud Health Check-Up

Certainly, fraud has severe monetary and other deleterious consequences. No organizations should underestimate the importance of imple-

menting anti-fraud measures. Organizations should regularly assess their fraud health so that needed corrective actions can be timely implemented. The ACFE's recently published *Fraud Prevention Check-Up* assesses an organization's preventive controls, identifying potential risk exposures. This seven-part self-scoring exercise evaluates the organization's fraud risk oversight, ownership, and assessment; tolerance and risk management policy; controls within processes and overall business environment; and proactive fraud detection.

Corporate counsel can add value to their existing client service by advocating that this check-up be performed under their direction, to protect their legal rights. It is imperative that organizations not ignore the findings of this exercise. A low score, if obtained, reflects vulnerabilities that should be proactively targeted. Knowledge of control gaps and deficiencies, but not taking appropriate remedial actions, could potentially subject the organizations to legal consequences.

Fraud Prevention is Smart Business

Organizations with strong fraud prevention measures in place will benefit from an improved image, and will find it less costly to attract and retain capital, including human resources. Corporate counsel, supported by qualified fraud experts, can provide valuable services to their clients by encouraging that such steps be taken. ■

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¹ According to ACFE, the *2010 Report* was based on 1,843 cases of occupational fraud from more than 100 countries, reported between January, 2008, and December, 2009. ACFE broadly defines 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.