◀ **CHAPTER ONE** ▶

Why No Organization Is Immune to Fraud

Did you know that:

- Organizations lose an average of 7 percent of gross revenue to fraud every year? In 2008 that represented approximately $994 billion.[1]

- The most common method by which fraud is detected is tips? Over 46 percent of cases that are detected are reported via a tip from an employee, vendor, or other whistle-blower.[2]

- Fraudulent financial reporting—the main form of management fraud, is twice as common in organizations as billing schemes—the most common form of employee-level fraud?[3]

- Organizations that implement entity-wide fraud awareness training cut fraud losses by 52 percent?[4]

- Seventy-four percent of employees report that they have observed or have firsthand knowledge of wrongdoing in their organization in the past 12 months?[5]

- The average fraudulent financial reporting fraud costs the victim organization $2 million, while the average loss per incident of billing fraud is only $100,000?[6]

- The majority of public companies investigated by the Securities and Exchange Commission (SEC) for fraud subsequently suffer a substantial decline in stock price (50 percent or more)?[7]

- It takes an average of 24 months for a fraud to be detected?[8]

- One-third of large-organization executives say they have no documented investigative policies or procedures for fraud, and one-half have no incident response plan?[9]

- One-quarter of companies consider themselves *highly vulnerable* to information theft, and 29 percent have experienced information theft, loss, or attack in the past three years?[10]

- The most common type of fraud affecting institutions, by far, is theft of assets—which can include money, services, or physical assets?[11]

Chapter 1 introduces the critical notion that you as a financial professional have considerable power to prevent, detect, and report fraud. The chapter also covers the following topics:

- The multiple definitions of fraud that make it critical to clarify the *real* meaning of the term in your mind
- A number of widespread myths about fraud and the realities that they misinterpret
- Management's role as the standard setter for an ethical and law-abiding institutional culture

It is not possible to compile a workbook on fraud fighting without relying to a considerable degree on the prodigious and wide-ranging research conducted by the Association of Certified Fraud Examiners (ACFE). However, in addition to this authoritative body, founded in 1988 in Austin, Texas, by Joseph T. Wells, the Big Daddy of the anti-fraud profession, there are other respected institutions whose research provides additional useful material for the study of institutional fraud.

As with the list of statistics that open the chapter, the following pages draw on key findings of numerous prominent consulting, research, and academic institutions that are active in supporting the fight against fraud in organizations of all kinds—corporations, both public and private, not-for-profit organizations, and governmental agencies. These carefully selected statistics provide a framework defining the vast scope of the fraud problem. With the perspective provided by these data, you will be equipped with a solid understanding of the magnitude of the fraud problem, along with key trends and patterns in major categories of fraud.
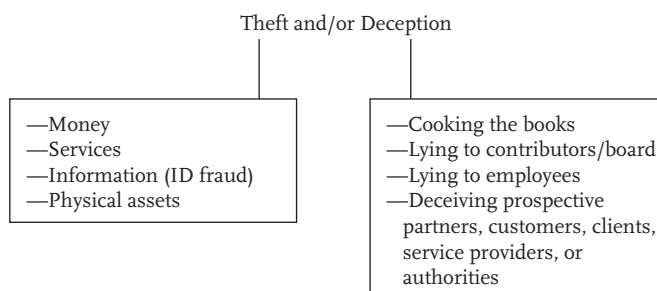
▶ What Is Fraud?

Most people involved in the fraud-fighting business have their own concept of what fraud is—and what it isn't. As a result we have a grab bag of definitions to choose from in guiding our day-to-day work. Some are legal definitions. Others are academic, while still others are based on personal experience. Out of the lot, the most useful definitions boil down to two.

According to the ACFE, fraud is:

> Any illegal acts characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the application of threat of violence or of physical force. Frauds are perpetrated by individuals and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage.[12]

According to the American Institute of Certified Public Accountants (AICPA), fraud is:

> A broad legal concept that is distinguished from error depending on whether the action is intentional or unintentional.[13]

Theft and/or Deception

—Money
—Services
—Information (ID fraud)
—Physical assets
	—Cooking the books
	—Lying to contributors/board
	—Lying to employees
	—Deceiving prospective
	  partners, customers, clients,
	  service providers, or
	  authorities

Exhibit 1.1   White-Collar Crime 101 Definition

The bottom line. Regardless of whose definition of fraud you accept, you will find that nearly all incidents of fraudulent activity—also called white-collar crime—fall into one or both of two categories: Theft and Deception. Exhibit 1.1 is a graphic illustration of this dual-category definition of fraud, as formulated by White-Collar Crime 101.

► Myths and Realities about Fraud

One of the key reasons for the astounding breadth and depth of the fraud problem is that management often operates under the false impression that its organization is immune to fraud.

More precisely, top executives like to think that because they have complied with rules and laws requiring them to put internal controls in place, they are adequately protected against attacks by white-collar criminals. In reality, *no* organization—no matter how well-designed its internal controls against fraud are—can ever be fully protected against determined fraudsters. The bad guys always find loopholes or weaknesses in your operations that they can exploit to steal cash, forge checks, collude with vendors, falsify financial reports, steal confidential data, or commit any of a million other crimes that cause either financial or reputational damage—or both.

In addition to this false sense of self-protection, other common yet potentially costly misconceptions that senior managers often have about fraud are illustrated in the following myths.

■ Myth #1: Ethics and Compliance Training "Has Us Covered"

This myth assumes that such training addresses key issues about fraud and instructs employees how to detect the red flags of fraud and how to report it. See Exhibit 1.2.

In fact, compliance and ethics typically have little to do with fraud. Nearly all organizations have a code of ethics on which this training is based. However the vast majority of such codes don't even contain the word "fraud."

In most organizations, such a code informs employees about issues like sexual harassment, antitrust issues, accepting gifts from vendors, and other ethical matters that are important—but are not related to fraud.

The important thing to remember is that while all fraud is unethical, not all unethical conduct is fraudulent. For example, accepting a generous gift from a

Exhibit 1.2 Fraud Training versus Ethics Training

vendor—such as a free vacation, tickets to professional sporting events, or other such items—is unethical and most likely in direct violation of your organization's ethics policy. However, such gifts are *not* necessarily illegal, and hence they often do not represent fraud.

■ Myth #2: Our Finance Staff Are Qualified to Protect Us Against Fraud

This notion is equally misconceived. Internal auditors, financial managers, accountants, treasurers, and other professionals in most organizations are usually *untrained* in fraud detection and prevention, and they most certainly are not trained—let alone expected—to be fraud investigators. However, in many organizations, there is growing pressure for internal auditors and other financial managers to focus more on fraud detection—which may be one reason you are reading this book!

■ Myth #3: We Have Very Little Fraud Here

The problem arises when this assumption is made without firm quantitative proof. In too many organizations, senior management believes there is little fraud because management *wants* to believe that. In the meantime, employees, vendors, or customers could be stealing huge amounts of money.

One of the most stunning examples of the "we-have-no-fraud-here" myth is the case of subprime mortgage fraud. Banks were lending money to unqualified mortgage borrowers by the billions in the 1990s and leading up to the housing crash that began in early 2007. Because housing prices were on a historic upward trend, top executives at large mortgage lenders were making money hand over fist as their

sales people, underwriters, and independent mortgage brokers essentially threw every standard for loan qualification out the window, confident that if a borrower ultimately proved unable to make the monthly payments, the bank could foreclose and sell the property at a profit.

What the bankers failed to address was the question of how much fraud was being perpetrated by brokers, appraisers, attorneys, and even their own underwriters in order to meet increasingly challenging quotas for loan closings.

The truth was that throughout the country, lenders were approving more and more so-called liar's loans, a colloquialism for "stated income" loans—which are approved by lenders without checking tax returns, employment history, credit history, or any other pertinent financial background on the applicant. Moreover, leading up to the subprime crisis, prospective borrowers were virtually *encouraged* by mortgage brokers to defraud lenders by filling out mortgage applications with completely fictitious income figures and making up numbers reflecting their assets and liabilities and so forth. But to shareholders, regulators, and the general public, bank executives claimed that their lending operations where completely professional and that no fraud was involved.

The truth only came out after the crash—when regulators, lenders, attorneys, and politicians started digging into the matter and discovered that as much as 90 percent of stated income loans were made despite at least *some* fraudulent application or tax return information.[14]

This example is only one of many that you could find to debunk the "no fraud here" myth that many senior executives *throughout* the U.S. business community continue to embrace.

In reality, *no* organization is immune to fraud. Some organizations have less than others. But anyone in the anti-fraud profession will tell you that if a company, not-for-profit, or government agency says they have no fraud, they are either outright lying or hopelessly naïve.

■ Myth #4: Fraud Is a Necessary Cost of Doing Business

Really? Can you imagine what the tens of thousands of former employees of Enron, WorldCom, Adelphia, Bear Stearns, and others would say to that?

You may say, "A large organization can afford a bit of fraud because they are financially sound, and it may cost more to catch the fraudsters than to write off the losses."

The problem with this reasoning is that when the fraudsters know that you do not take action against "small frauds," or educate their workforce about fraud, they are encouraged to attempt larger ones. If the organization has no firm policy for investigating and punishing known fraudsters, it is actually inviting dishonest people to steal. The eventual result will be that so-called small frauds eventually accumulate into major losses. And when that occurs and the news media find out about it, the reputational damage to the organization can be serious enough to drive away customers and incur scrutiny of government authorities that could seriously endanger the organization's financial health.

■ Myth #5: Implementing Controls and Training Is Costly

In reality, fraud losses are much costlier. If, as the ACFE has determined, your organization loses up to 7 percent of its revenue to fraud every year, you can do the math to calculate approximately how many actual dollars are lost to fraud each year. Even if the ACFE is off by, say, 25 percent for the sake of argument, your organization's fraud losses probably still amount to a disturbingly high number.

And here is an additional perspective: The price of implementing the most effective anti-fraud controls—including financial controls, operational controls, physical security of inventory, employee training, hotlines, detailed fraud assessments, audits, and the like—would never amount to more than one-tenth the amount of money lost to fraud in a given year.

Remember

It is highly risky to assume that your organization is adequately protected against fraud. Even with the best controls in place, clever criminals will always find ways around them.

▶ The Urgency of Detecting and Preventing Fraud

With your understanding about the enormity of the fraud threat, together with the above clarification of the definition of fraud, you now have a foundation for moving ahead into the nitty gritty of major types of fraud, as well as the motives of those who commit them and the proven techniques for detecting and reporting incidents of fraud.

As you can see from Exhibit 1.3, internal audits and controls play a key role in the detection of fraud. Unfortunately, because of their general lack of training in fraud detection, the role of internal auditors and other financial professionals in fraud detection is *not* as significant as it should be: detection by accident and by employee or outsider tip rank higher. That is one important reason why learning to detect and report fraud is among the overarching purposes of this workbook.

There is some good news. Many frauds *can* be prevented! There are *many* ways to detect and report fraud before it does serious damage to your organization's reputation and financial health.

To make significant progress in fraud reduction, internal financial staff *must* play a decisive role in fraud detection. This workbook will provide solid guidance in how to use audit and other detection methods to discover fraudulent activity in your organization and when and how to report it so that senior management can determine whether to launch investigations of incidents of fraud or take other measures to rid the organization of fraud.
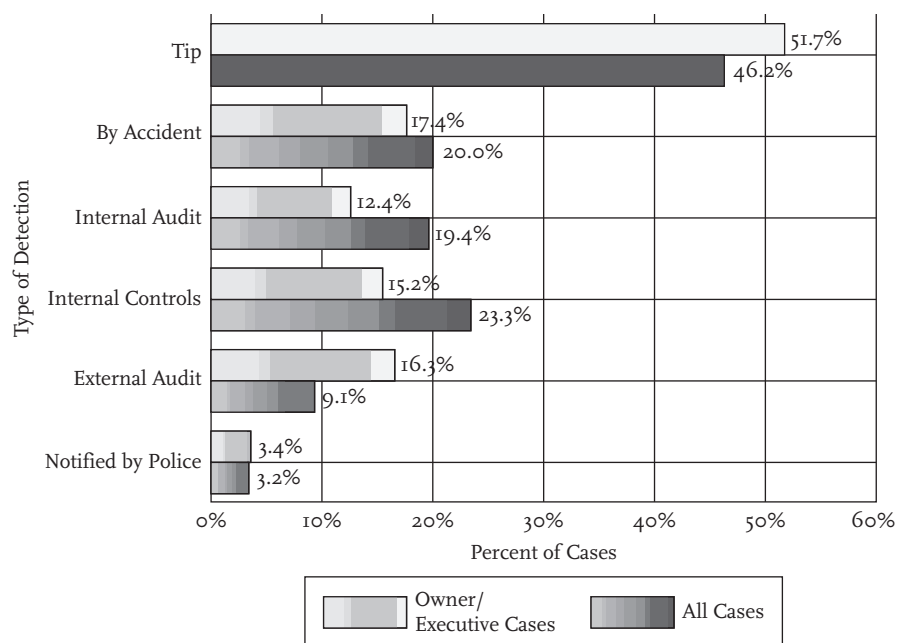
Exhibit 1.3   Initial Detection of Frauds by Owners/Executives

The sum of percentages exceeds 100 percent because in some cases respondents identified more than one detection method.

Source: ACFE *2008 Report to the Nation on Occupational Fraud and Abuse.*

Remember

Employees play a crucial role in detecting incidents of misconduct. Experience shows that under the right circumstances, employees will report fraud before it gets out of hand. Equally important in reducing fraud risk are properly executed internal fraud audits and anti-fraud processes and procedures—all aimed at detecting fraud before it does significant financial or reputational damage.

► Tone at the Top

You may have heard the term *tone at the top* in discussions about fraud or ethics. What does it mean, and why should you be concerned about it?

Tone at the top is best described as leading by good example. When top management of any organization lives by the standards of integrity and ethics that are set out in its Code of Conduct and, ideally an accompanying Anti-Fraud Policy, employees throughout the organization get the message that activities such as harassing co-workers, discriminating against minorities, engaging in conflicts of interest, and all types of fraud are strictly forbidden.

Another commonly used term for this is "Zero Tolerance" toward fraud. As long as management demonstrates its commitment to zero tolerance—without exception—there is a very good chance that employees throughout the ranks will conduct themselves in a similar way.

By contrast, consider the situation where the top bosses *say* they believe in ethics, but routinely award lucrative contracts to businesses in which they have a conflicting financial interest or falsify financial documents to persuade bankers to lend the organization money or accept kickbacks from vendors who are not well-equipped to deliver the goods or services needed by the organization.

Put another way, a company with good tone at the top is one whose top executive team and board of directors walk the talk with regard to integrity, honesty, and commitment to zero tolerance of unethical or criminal conduct. In this type of company, the doors of the management team are always open to employees at all levels to report or ask questions about fraud and ethical issues. In these companies, management's commitment to employees is openly demonstrated by taking modest bonuses and rewarding excellence and creative thinking throughout the employee population. Management's insistence on unconditional adherence to high standards of ethical conduct is exemplified by swift and decisive investigative and disciplinary action whenever instances of fraud do become known.

By contrast, Enron was an extreme example of an organization with negative tone at the top. There, executives set the example of abject disregard for responsible corporate leadership, greed, contempt for ethics, and habitual violation of major regulatory and legal standards. Unfortunately, similar behavior is still hitting the headlines almost every day.

Remember

Management and the board must walk the talk regarding the organization's values and integrity. *Lip service is deadly.*

► Review Points

- **History of fraud.** Fraud has been around from the beginning of time. But the world has gotten better at catching the bad guys over the centuries. Nonetheless, the problem persists, making it necessary for you to inform yourself about the current forms of fraud and how to prevent them.

- **Definitions of fraud.** There are several, but some are more accurate than others.

- **Statistical picture of fraud.** The numbers do not lie: Fraud is a *huge* worldwide problem—for all organizations.

- **Myths about fraud.** It is easy to become complacent about fraud, but this can be very costly.

- **Main types of fraud.** There are more ways than anyone could imagine by which fraudsters ply their trade.

- **How fraud is detected.** The main way is by tips from employees and outsiders. But internal auditors and financial managers can enhance their ability to detect fraud.

► **Chapter Quiz**

True or False:

1. The average percentage of annual revenue lost to fraud for organizations is 7 percent.

   ❏ True   ❏ False

2. The most common method by which fraud is detected is tips.

   ❏ True   ❏ False

3. Financial managers in most organizations are well trained in fraud.

   ❏ True   ❏ False

Circle the correct answer to the following questions:

4. The average amount of money lost to fraudulent financial reporting fraud is

   a. $100,000

   b. $1 million

   c. $ 2 million

   d. $ 5 million

5. The new U.S. law enacted to prevent financial statement fraud is the

   a. Securities Act of 1933

   b. COSO Act of 1985

   c. Sarbanes Oxley Act of 2002

   d. Securities and Exchange Commission Act

6. Cooking the books is a form of

   a. Stealing

   b. Deception

   c. Concealment

   d. Misleading

7. Circle the choice below that is *not* one of the myths about fraud:

   a. Ethics and Compliance training has us covered.

   b. Our finance staff are qualified to protect the organization against fraud.

   c. Fraud is an unavoidable cost of doing business.

   d. Fraud is a problem for law enforcement.

Fill in the blank:

8. *Leading by example* is a term similar in meaning to _____.

9. The main objective of this workbook is to help you learn how to prevent, detect, and _____ fraud.

10. The place for spelling out the organization's concept of leading by example for employees to see is in its _____.

For the answers, please turn to Appendix A.