Heartland Confidential

Legal, Financial, Corporate Investigators   November 2008

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Now More Than Ever

Today's headlines are dominated by the $700 billion bailout/rescue plan, the impending recession, and major corporate frauds. In the midst of this crisis the Association of Certified Fraud Examiners released their 2008 Report to the Nation….and the news is not any better.

Participants in the association's survey estimated that U.S. organizations lose 7% of their annual revenues to fraud. Applied to the projected 2008 Gross Domestic Product, this 7% figure translates to approximately $994 billion in fraud losses.

The report's findings are staggering:

Occupational fraud schemes tend to be extremely costly. The median loss caused by the occupational frauds in this study was $175,000. More than one-quarter of the frauds involved losses of at least $1 million.

Occupational fraud schemes frequently continue for years before they are detected. The typical fraud in our study lasted two years from the time it began until the time it was caught by the victim organization. This report focuses on 11 distinct categories of occupational fraud.

The most common fraud schemes were corruption, which occurred in 27% of all cases, and fraudulent billing schemes, which occurred in 24%. Financial statement fraud was the most costly category with a median loss of $2 million among the 99 financial misstatements in this report. Despite increased focus on anti-fraud controls in the wake of Sarbanes-Oxley and mandated consideration of fraud in financial statement audits due to SAS 99, our data shows that occupational frauds are much more likely to be detected by a tip than by audits, controls or any other means.

Lack of adequate internal controls was most commonly cited as the factor that allowed fraud to occur. Thirty-five percent of respondents cited inadequate internal controls as a primary contributing factor in the frauds they investigated. Lack of management review and override of existing controls were each cited by 17% of respondents.

Seventy-eight percent of victim organizations modified their anti-fraud controls after discovering that they had been defrauded. The most common change was to conduct management review of internal controls, which occurred in 56% of cases. Implementation of surprise audits was the next most common response, followed by fraud training for managers and employees.

Occupational frauds were most often committed by the accounting department or upper management. Twenty-nine percent of frauds in this report were committed by persons in the accounting department, while 18% were committed by executives or upper management. Frauds committed by executives were particularly costly, resulting in a median loss of $853,000.

Occupational fraudsters are generally first-time offenders. Only 7% of fraud perpetrators in this study had prior convictions and only 12% had been previously terminated by an employer for fraud-related conduct. These results are consistent with our 2004 and 2006 reports.

Fraud perpetrators often display behavioral traits that serve as indicators of possible illegal behavior.

The most commonly cited behavioral red flags were perpetrators living beyond their apparent means (39% of cases) or experiencing financial difficulties at the time of the frauds (34%). In financial statement fraud cases, which tend to be the most costly, excessive organizational pressure to perform was a particularly strong warning sign.

So what do you do?

The number one deterrent to fraud and occupational abuse is instilling the perception that perpetrators will be caught. A solid fraud prevention program should include:

- enhanced due diligence on new executive hires
- surprise audits and observation
- rapid and responsive investigation when fraud is suspected

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Source: Association of Certified Fraud Examiners, Report to the Nation, Oct 2008