

Fraud Happens

How to minimize the cost

BY KEN SMITH

FRAUD IS one of the most costly events that can occur in any organization. A quick scan of the news reveals that any organization can fall victim – from large corporations, such as WorldCom and Enron, to government agencies and non-profits. And the cost is not only financial – there also are significant emotional and cultural impacts on employees, customers and resource providers.

While it may seem that fraud is on the rise, history is filled with episodes of deceit and loss perpetrated by the ingenuous and greedy. Thus, it might be surprising that the academic study of fraud by accountants has a relatively short history. Joseph Wells founded the Association of Certified Fraud in 1988 – the year I graduated from college.

I was never exposed to fraud in college, nor did I receive any formal training on how to deal with it. Similarly, most business and accounting professionals also have limited training; Willamette University first offered a course in its MBA program in 2003.

When I was trained in the mid-1980s, prevailing wisdom among accountants was that internal controls would prevent most cases of fraud from occurring. The most powerful of these controls was the “segregation of duties.” Additionally, the public generally has trusted auditors to uncover any fraud. Both of these controls are misguided. This article describes some of the leading misconceptions about fraud in the workplace and offers additional resources for managers wanting to learn more.

Misconception #1: Controls prevent fraud. The main idea of segregation of duties is that you separate certain tasks – such as the *custody* of an asset such as cash – from the *record-keeping* or counting of that asset. Without separation, an employee (or volunteer) easily can steal the asset and neglect to record it as incoming (for a receipt) or outgoing (for an expense). The *authority* to complete a transaction also should be separated among multiple individuals. The bottom line: Do not

have one person in charge of all cash and accounting duties, which is often the case in small businesses and non-profits.

Misconception #2: Auditors uncover fraud. The evidence is overwhelming that one of the least effective methods for uncovering actual frauds is the external auditor. An internal auditor is only slightly less effective. Most frauds are uncovered by fellow employees, followed by tips from customers or hotlines. If you want to uncover fraud quicker, provide a safe communication method for employees, customers and other stakeholders.

Role of Trust

The mental model used by fraud examiners is the Fraud Triangle. A fraudster needs three variables: opportunity, rationalization and perceived pressure. Controls reduce opportunity – but they are not very effective for the other two variables. Hiring quality employees and retaining them with open, honest communication mitigates the likelihood that fraud can be rationalized. Pressure to perform is difficult to balance – some pressure is useful while too much is harmful. Talented managers have to use their professional judgment to know the right amount of pressure to keep employees performing honestly and effectively.

Trust certainly has a place in every organization and in our society. The key is to not have misplaced trust. Consider the example of putting warm cookies in front of a 3-year-old, asking him or her not to eat them and then leaving the room. This is obviously misplaced trust. However, managers need to think carefully about what kind of pressures exist for their employees – and adjust accordingly.

Prescription: Prevent, detect, and then publicly punish. Combating fraud is achieved through a 3-step plan: prevent what you can, detect as quickly as you can, and publicly punish those who are caught. A great example of the latter is how the University of Texas handled the firing of their Director of Financial Aid. The University issued a 33-page report



detailing Lawrence W. Burt’s inappropriate dealings, naming him, and his actions, specifically.

Final Thought

Fraud is only one of the myriad things that can keep a manager awake at night. The good news is that most frauds are pretty explainable and preventable. Managers should establish a clear tone at the top, recruit and retain good employees and foster open and honest communication lines. This helps prevent most cases of fraud, detect activities promptly of the few that occur and publicly resolve those few in a way that reduces the likelihood of future incidents.

Resources

A growing set of resources for professionals is accumulating at organizations such as the Association of Certified Fraud Examiners (www.ACFE.com) and the American Institute of Certified Public Accountants (www.antifraud.aicpa.org).

The new thinking is that “Tone at the Top” is the single most important internal control. This is not to say that a full range of internal controls are unimportant, but it seems virtually impossible to have control without proper tone at the top. A good 20-minute overview video is free online at <http://www.acfe.com/video/VideoBox.asp?Video=tone-at-the-top> ■■

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