

**FRAUD IN SMALL BUSINESSES –
There’s A Little Bit Of Fraud In Everybody
(and a lot in some)**

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Fraud In Small Businesses

**Fraud from Several Perspectives – CPAs,
Management and Governance**

Whether providing audit, review, compilation, tax or other services, CPAs are expected by clients and users of the financial statements to find fraud whenever it exists. Learning how to recognize the fraud risks that exist in your clients, how to increase the likelihood of detecting fraud, and how to communicate the potential for fraud to your clients is critical to effectively serve your clients, and to minimizing the damage to your practice when you don’t detect the fraud

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Fraud In Small Businesses

Topics to be Covered

- Professional Standards Regarding Fraud
- Financial Statement Fraud and the CPA
- Occupational Fraud Data
- Communicating with Clients

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PROFESSIONAL STANDARDS FOR AUDITORS

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Way back when

"The usual financial examination is not specifically designed and cannot be relied upon to disclose fraud. This is not its purpose. However, in making his (*sic*) examination and in giving his opinion on the fairness of the financial statements, the auditor is aware of the possibility that fraud (including defalcations and other similar irregularities) may exist, and that in some instances it may be of such significance as to affect the fair presentation of financial position or the results of operations. ...

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PROFESSIONAL STANDARDS FOR AUDITORS

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Way back when

Accordingly, the auditor is responsible for failure to detect fraud of such significance through negligence in the performance of, or failure to comply with, generally accepted auditing standards ...” (*Audit Objectives and Procedures*, Arthur Andersen & Co., 1961; Based on SAP 30; AU 200, issued 1960)

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PROFESSIONAL STANDARDS FOR AUDITORS

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- Statement on Auditing Standards number 1, issued in 1972, was superseded by SAS 16, issued in 1977
 - Both referred to “irregularity” rather than “fraud”
 - Standard was based on “Plan to Search” for material errors and irregularities
- Expectation Gap Standards Issued in 1988 – SAS 53
 - Still used “irregularity”
 - Standard was based on “Design to Detect” material errors and irregularities

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PROFESSIONAL STANDARDS FOR AUDITORS

- 1997 – SAS 82

“The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.”
(Statements on Auditing Standards No. 82; AU 110)

- Specifically requires the auditor to “inquire of management (a) to obtain management’s understanding regarding the risk of fraud in the entity and (b) to determine whether they have knowledge of fraud that has been perpetrated on or within the entity.”

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PROFESSIONAL STANDARDS FOR AUDITORS

- 1997 – SAS 82

... Some examples of matters that might be discussed ... are (a) whether there are particular subsidiary locations, business segments, types of transactions, account balances, or financial statement categories where fraud risk factors exist or may be more likely to exist and (b) how management may be addressing such risks.”

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PROFESSIONAL STANDARDS FOR AUDITORS

- 2002 – SAS 99 issued in May 2002
 - Basic responsibility unchanged (see above)
 - Includes requirement to expand inquiry to include management and other personnel, and the audit (or similar) committee
- 2007 – Risk assessment standards issued in 2006
 - Requires auditors to assess the risk of material misstatement and design audit procedures to detect misstatements, whether caused by error or fraud
 - Requires auditors to obtain a better understanding of internal controls over financial reporting, and to ask “what can go wrong questions

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PROFESSIONAL STANDARDS FOR AUDITORS

- 2007 – Risk assessment standards issued in 2006
 - SAS 114 requires communication of fraud –
 - “Whenever the auditor has determined that there is *evidence that fraud may exist*, that matter should be brought to the attention of an appropriate level of management”
- And, the public expectation:

“If it’s there, the auditors should find it.” (Apocryphal Jury Foreman; circa 1929)
- And, the client’s expectation:

“I want to know if anybody is stealing from me”

Everybody’s client; recently)

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PROFESSIONAL STANDARDS FOR AUDITORS

- Fraud Risk Management for Auditors
 - Increase professional skepticism
 - Communicate client responsibilities as stated in engagement letter
 - Accounting matters, especially estimates
 - Fraud matters, both financial statement and theft
 - Communicate client fraud risk areas to all levels
 - Avoid “engagement creep” (performing work not in an engagement letter)

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CPA/CFO REQUIREMENTS

- Criminal law
 - “You have the right to ...”
 - Sarbanes-Oxley legislation made lying to auditors a criminal offense
- Tax law
 - Filing a false tax return
- Civil law
 - Bankers, vendors, stockholders, employees
- Securities law
 - Not just for public companies

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CPA/CFO REQUIREMENTS

- State Boards of Accountancy
 - “Practice of public accounting ... mean(s) ... performing for a client ... services involving the use of accounting or auditing skills, ... while holding oneself out in such manner as to state or imply that one is a licensee.” (Georgia State Board of Accountancy, *Rules and Regulations*)
 - Client – the person or entity which retains a practitioner ... for the performance of professional services.
 - Professional services – any services performed ... by a licensee for a client in the course of the practice of public accountancy.

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CPA/CFO REQUIREMENTS

- State Boards of Accountancy
 - Code of professional conduct for most states provides that “A licensee shall not in the performance of professional services knowingly misrepresent facts, nor subordinate his (*sic*) judgment to others.” Further, “A licensee shall not commit any act that reflects adversely on his fitness to engage in the practice of public accounting.”

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CPA/CFO REQUIREMENTS

- AICPA Standards for Members not in Public Practice
 - “A member shall not commit an act discreditable to the profession.”
 - And later, a discreditable act is defined as “Makes, or permits or directs another to make, materially false and misleading entries in the financial statements or records of an entity ... Fails to correct ... false and misleading entries when the member has the authority to (do so) ... Signs, or permits or directs another to sign, a document containing materially false and misleading information.”

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CPA/CFO REQUIREMENTS

- CFO Fraud Protection would include –
 - Educate employees to the Organization's compliance policies
 - Be on constant lookout for fraudulent behavior
 - Take precautions if involved in criminal or civil investigation
 - Develop and use an Organizational Ethics Policy
- For larger organizations, facilitate a Fraud Hotline
- Consider use of Benford's law software

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FINANCIAL STATEMENT FRAUD

Fraud Triangle

Pressure

Opportunity Rationalization

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FINANCIAL STATEMENT FRAUD

- "There's a little bit of fraud in all of us" (Chris Rouse Audit Principle, and SAS 99, Healthy Skepticism)
- SAS 99 "Risk Factors" is resource for CPAs, CFOs and Governance
 - Incentives/Pressures include –
 - Third party pressures
 - Competitive pressures
 - Management/governance/owners personal financial situation threatened by the entity's performance

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FINANCIAL STATEMENT FRAUD

- SAS 99 “Risk Factors” is resource for CPAs, CFOs and Governance (con’t)
 - Opportunities include –
 - Related party transactions
 - Significant estimates in the financial statements
 - Highly complex transactions
 - Ineffective monitoring by governance
 - Complex or unclear organizational structure

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FINANCIAL STATEMENT FRAUD

- SAS 99 “Risk Factors” is resource for CPAs, CFOs and Governance (con’t)
 - Attitudes/rationalizations include –
 - Ineffective support, communication or enforcement of entity’s ethical values
 - Non-financial management excessive participation in accounting principles or estimates
 - Achievement of communicated corporate goals

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FINANCIAL STATEMENT FRAUD

- Attitudes/rationalizations include (con’t) –
 - Reduce income taxes
 - Usually owner inspired for personal benefit
 - Personal expenses run thru company
 - Reduce inventory
 - Reduce receivables
 - Increase payables

Lesson learned: CFO responsibility to detect and report

 - Suborning judgment
 - Failing to correct known false entries

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FINANCIAL STATEMENT FRAUD

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- Attitudes/rationalizations include (con't) -
 - Get (keep) the bank loan
 - Material to debt covenants
 - Manipulation of estimates
 - Case - Increased prices for inventory items
 - Case - Increased inventory quantity

Lesson learned: Unsupported adjustments

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FINANCIAL STATEMENT FRAUD

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- Attitudes/rationalizations include (con't) -
 - Satisfy the regulators
 - Nature of assets and liabilities
 - Case - Broker/dealer hiding pledge of assets for debt of related company
 - Case - Insurance company manipulation of security inventory
 - Case - Broker/dealer manipulation of security inventory

Lesson learned: Understand the business

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FINANCIAL STATEMENT FRAUD

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- Attitudes/rationalizations include (con't) -
 - Keep a job
 - Performance goals
 - Case - Divisional revenues
 - Case - Student aid
 - Case - not-for-profit contributions
 - Lesson learned: Unsupported adjustments
 - Making revenue and earnings estimates
 - Case - Sales cutoff
 - Case - Consolidation journal entries

Lesson learned: Overriding authorization pro

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FINANCIAL STATEMENT FRAUD

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- Attitudes/rationalizations include (con't) -
 - Keep the stock price up; the Current Topic
 - Hiding contingencies
 - Case - Yesterday's headline
 - Transparency
 - Hiding risk and uncertainty
 - Case -
 - Case - Estimates of ticket revenue

Lesson learned: Healthy skepticism

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FINANCIAL STATEMENT FRAUD

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- Attitudes/rationalizations include (con't) -
 - Not following GAAP
 - Lesson learned: Understand the transaction
 - Lesson learned: Acts discreditable

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MISAPPROPRIATION OF ASSETS

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- SAS 99 "Risk Factors" is resource for CFOs, Management and Governance
 - Incentives/Pressures include -
 - Personal financial obligations
 - Adverse relationships with entity
 - Opportunities include -
 - Cash transactions
 - Inadequate controls over assets
 - Attitudes/rationalizations include -
 - Dissatisfied with entity or personal treatment

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MISAPPROPRIATION OF ASSETS

- **The old fashioned way, stealing it**
 - **Coin, currency and checks**
 - Lesson learned: **Develop expectations**
 - **Cash in banks**
 - Lesson learned: **Circumvented controls**
 - **Inventory**
 - Lesson learned: **Analytical review**

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MISAPPROPRIATION OF ASSETS

- **The new way, not earning it**
 - **Kickbacks**
 - Case – **Inventory purchase kickbacks**
 - Lesson learned: **Analytical review**
 - **Retirement accounts**
 - Case – **Unauthorized withdrawals**
 - Lesson learned: **Circumvented controls**
 - **Bonus arrangements**
 - Case – **False sales reports**
 - Lesson learned: **Count the beans**

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OCCUPATIONAL FRAUD AWARENESS

Occupational Fraud


- **It is not a question of, “Is it happening?” it is more a question of, “How much is it happening?” within your organization.**

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ACFE REPORT ON OCCUPATIONAL FRAUD



The information following is based on data compiled from 959 cases of occupational fraud that were investigated between January 2006 and February 2008. All information was provided by the Certified Fraud Examiners (CFEs) who investigated those cases.

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OCCUPATIONAL FRAUD AWARENESS

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About the ACFE

- The ACFE is the world's premier provider of anti-fraud training and education.
- Together with nearly 50,000 members in more than 125 countries, the ACFE is reducing business fraud worldwide and providing the training and resources to fight fraud more effectively.

20 YEARS ACFE Association of Certified Fraud Examiners

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OCCUPATIONAL FRAUD AWARENESS

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"Occupational Fraud" is defined as:

- The personal use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets.



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OCCUPATIONAL FRAUD AWARENESS

Executive Summary

- This study is based on data compiled from 959 cases of occupational fraud that were investigated between January 2006 and February 2008. All information was provided by the Certified Fraud Examiners (CFEs) who investigated those cases
- Participants in this survey estimated that U.S. organizations lose 7% of their annual revenues to fraud. Applied to the projected 2008 United States Gross Domestic Product, this 7% figure translates to approximately \$994 billion in fraud losses

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OCCUPATIONAL FRAUD AWARENESS

Executive Summary

- 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

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OCCUPATIONAL FRAUD AWARENESS

Executive Summary

- Small businesses are especially vulnerable to occupational fraud. The median loss suffered by organizations with fewer than 100 employees was \$200,000. This was higher than the median loss in any other category, including the largest organizations. Small businesses also suffered the largest losses in our 2006 study. Check tampering and fraudulent billing were the most common small business fraud schemes

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OCCUPATIONAL FRAUD AWARENESS

Executive Summary

- 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

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OCCUPATIONAL FRAUD AWARENESS

Measuring the Cost of Occupational Fraud

- Fraud, by its very nature, does not lend itself to being scientifically observed or measured in an accurate manner. One of the primary characteristics of fraud is that it is clandestine, or hidden; almost all fraud involves the attempted concealment of the crime.



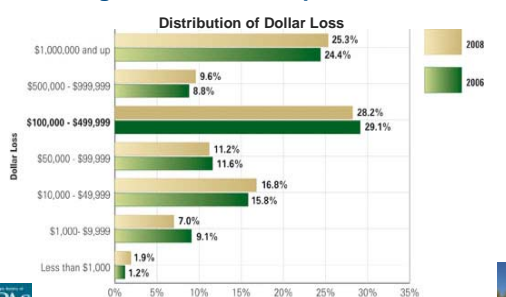
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Measuring the Cost of Occupational Fraud

Distribution of Dollar Loss



Dollar Loss	2006 (%)	2008 (%)
\$1,000,000 and up	24.4%	25.3%
\$500,000 - \$999,999	8.8%	9.6%
\$100,000 - \$499,999	29.1%	28.2%
\$50,000 - \$99,999	11.6%	11.2%
\$10,000 - \$49,999	15.8%	16.8%
\$1,000 - \$9,999	9.1%	7.0%
Less than \$1,000	1.2%	1.9%


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OCCUPATIONAL FRAUD AWARENESS

How Occupational Fraud is Committed

- Based on previous ACFE research on and observations of the methods used to commit occupational fraud, we have broken down the schemes reported to us into three primary categories:
 - Asset misappropriation
 - Corruption
 - Financial statement fraud



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OCCUPATIONAL FRAUD AWARENESS

How Occupational Fraud is Committed

- Asset misappropriation schemes are frauds in which the perpetrator steals or misuses an organization's resources.
- Common examples of asset misappropriation include:
 - False invoicing
 - Payroll fraud
 - Skimming



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OCCUPATIONAL FRAUD AWARENESS

How Occupational Fraud is Committed

- In the context of occupational fraud, corruption refers to schemes in which fraudsters use their influence in business transactions in a way that violates their duty to their employers in order to obtain a benefit for themselves or someone else.
- For example, employees might receive or offer bribes, extort funds from third parties, or engage in conflicts of interest.



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