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Developing the Fraud Resistant Company

By Rick Balog, CPA

It's good to think the best of your employees and customers, but the reality is that people are not always honest, and their dishonesty costs companies a great deal. A survey conducted in 2009 by The Association of Certified Fraud Examiners, showed that employees, customers, and suppliers steal more than 7% of the average U.S.-based company's revenues. That's a lot of money, and it hurts your bottom line.

Although no organization or consultant can create a fraud-proof company, it is possible to make fraud more difficult to occur within your business. With consistent business planning, effective forecasting, a culture and environment that significantly reduces the potential of devastating loss.

The Birth of a Fraud

Fraud is not a random act. It occurs when three elements, known as the "Fraud Triangle" come together for an employee or known person:

- **Incentive (Financial problems).** The typical fraud perpetrator usually has a financial problem and decides your money can solve it. They may need the money because of a gambling debt, a substance abuse problem, or out-of-control spending. In today's economy of "Hope and Change" this is all too common.
- **Rationalization.** The perpetrator feels they are not paid enough; they may dislike the company or you; feels their value to the organization is under appreciated; sees others performing similar fraudulent acts. What the rationalization comes down to is "getting even."
- **Opportunity.** Finally, people commit fraud because the opportunity exists. Poor internal controls, the ability to override existing controls, a poor or non-existing system of internal financial reporting, or ineffectual variance analysis all give a perpetrator opportunity to commit fraud.

When people commit fraud, they usually also go to great lengths to hide it. They may develop false invoices, doctor receipts for an expense report, or destroy files. The act of intentional concealment is what differentiates a fraud from a mistake.

Set the “Tone From The Top”

As the business owner, you are the one to set the tone of conduct for your company. A commitment to run an ethical company in which “doing right” permeates all facets of the business. The best “first step” toward minimizing the possibility of fraud within your organization is to be a good manager and set the right example with your words (messages) and behavior.

Put into place—and live by—good management practices that hold everyone accountable for their performance and behavior. Accountability in itself is a strong fraud deterrent. Send clear messages that honesty is expected and that fraud will not be tolerated.

Those management practices include:

- Hiring right (including doing reference and background checks on all new hires);
- Writing and maintaining current job descriptions;
- Orienting New and constantly Training all employees;
- Establishing and maintaining performance standards;
- Conducting periodic performance reviews;
- Maintaining open communications; and
- Developing and managing budgets combined with effective variance analysis.

In addition to putting into place these basic management practices, convene a fraud-prevention task force. Doing so puts action to your words. Include on this task force members of every area of your company and have as its primary objective to identify potential fraud risks and possible solutions.

Finally, develop—and communicate to employees, suppliers, and customers—your commitment to stop fraud, up to and including a commitment to prosecute. In your communication, outline acceptable practices and behaviors so that there is no room for misunderstanding.

Watch for the “Red Flags” of Fraud

Your internal financial reporting structure is your first line of defense in minimizing the opportunity for fraud in your company. Your accounting system shows the economic impact of management decisions and employee behavior.

Develop a realistic budget based on your operating plan and set accountabilities and controls. Watch for red flags by watching for variances, which could suggest fraudulent behavior.

Typical “Red Flags”

Fraud Committed By Employees Against The Company

- Significant observed changes from past behavior patterns
- High personal debts or financial losses
- Inadequate income for lifestyle
- Extensive stock market or other speculation behavior
- Excessive gambling
- Undue family, company, or community expectations
- Excessive use of alcohol or drugs
- Resentment of superiors and frustration with job
- Peer group pressures
- Undue desire for self-enrichment and personal gain
- Emotional trauma in home life or work life

Banks, Lenders and Investors may look for these Red Flags before investing:

Fraud Committed By Management On Behalf Of The Company

- Dependence on one or two products customers or transactions
- Severe obsolescence
- Extremely rapid expansion through new business or product lines
- Reduced ability to acquire credit or restrictive loan agreements
- Profit squeeze; costs and expenses rising higher and faster than sales and revenues
- Difficulty in collecting receivables
- Progressive deterioration in quality of earnings
- Significant tax adjustments
- Urgent need for favorable earnings to support high price of stock or to meet earnings forecast \

- Need to gloss over a temporarily bad situation in order to maintain management position and prestige
- Significant litigation, especially between stockholders and management
- Unmarketable collateral
- Significant reduction in sales backlogs (indicates future sales have declined)
- Possibility of license being revoked or imperiled, especially if it is necessary for the continuation of business
- Suspension or desisting from a stock exchange
- Pressure to merge
- Sizable inventory increase without comparable sales increases
- Consistently late reports
- Managers who regularly assume subordinates duties
- Noncompliance with corporate directives and procedures
- Managers dealing in matters outside their profit center's scope
- Payments to trade creditors supported by copies instead of originals
- Negative debit memos
- Commissions not in line with increased sales

Profile of a Typical Fraud Perpetrator

People who commit fraud come in both genders, in all races, and are of all ages. That said, some employees raise red flags about their possible propensity to defraud. You may be at risk if you have employees who:

- Been with the company for 5 - 7 years
- Rarely misses a day of work
- Remembers Birthdays and Anniversaries
- Between the ages of 28 - 45
- Very friendly

- Comes in early, leaves late
- Office is always in a state of mild chaos
- 51% are Male; 49% are Female

These people tend to portray the following behaviors:

- Tend to place extraordinary high personal value on material things;
- Tend to treat people as objects for exploitation;
- Are highly self-centered;
- Tend to be conspicuous consumers;
- Appear to be reckless or careless with facts and often enlarge on them;
- Spend most of their time scheming and designing shortcuts to get ahead of or beat the competition;
- May gamble or drink a great deal;
- Feel like they are above rules and regulations;
- Have few real friends within their own industry or company;
- Are hostile toward those who don't agree with them; and
- Are disliked by colleagues and competitors.

Implement Internal Controls

Internal controls are any actions taken by management that enhance the probability of achieving the objectives of a specific process. To use a boating metaphor, internal controls are the channel markers and depth soundings on the charts associated with your route (business plan). They also represent the weather forecast for your journey— how your company is going to conduct business.

Controls provide an environment to deter the commission of fraud. In addition, they assist the CEO and senior management in the detection and investigation of fraud. They give you and your forensic accountants the means to identify:

- How well employees are complying with established policies;
- Evidence of intentional circumvention of procedures;
- Where to look for evidence to find the perpetrators of a fraud;

- How fraud was committed.

Internal controls include procedures that:

- Restrict access to valuable and moveable assets;
- Provide accountability for deviations from established procedures;
- Require monthly analytical reviews and reconciliations of cash and other valuable and moveable asset accounts;
- Make sure deviations are reported in a timely manner to the appropriate level of management;
- Provide a structure so that material deviations can be easily identified; and
- Allow perpetrators to be identified promptly.

Keep in mind that controls alone cannot guarantee fraud prevention or detection. You must also conduct periodic audits that are reviewed by forensic accountants who have an understanding of your company's industry as well as the environmental, institutional, and individual factors that increase the risk of the commission of fraudulent acts.

Investigate and prosecute

If your internal controls and/or audits raise red flags, don't delay in conducting an internal investigation—or, if necessary, calling in professionals to help assess the situation. When you find the perpetrator, live up to your commitment: Prosecute.

This is where an experienced, seasoned Forensic Auditor is essential. Unlike normal financial audits, Forensic Audits must comply with elements of the Federal Rules of Evidence (FRE) such as "The Daubert Rule" and others for the District Attorney to consider prosecuting. Also, failure to perform the process correctly can adversely impact the business owner. The best rule to follow when considering prosecution is to call a qualified, experienced Forensic Accountant to work with your legal council. Together, they can ensure the evidence is properly gathered and no one's rights are violated.

Richard T. Balog, CPA\CFF, CIA, CGFM, DACFE, is the Managing Partner of the Certified Public Accounting Firm of Balog + Tamburri, CPA's. B+T has offices in both Jacksonville, FL and Atlanta, GA. One aspect of their services, Forensic Accounting, brings local businesses over 35 years of hands-on forensic accounting and auditing experience. Mr. Balog, the founder of the Firm, developed the concept of the Fraud Resistant Company®. B+T is dedicated to evaluating the entire internal control and complete security (physical and electronic) organizations and establish an "Early Warning System" as a line of defense against a second strike. In addition, they provide "Expert Witness" litigation support.

If you would like a “Red Flag” fraud review, or an analysis of the current system of fraud prevention controls email Mr. Richard T. Balog, CPA\CFF, CIA, CGFM, DACFE, or call at 904-945-1220, today for a free, no-obligation consultation. You can also contact Rick Balog at rick@flgacpa.com.