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TACTICS FOR PREVENTING AND DETECTING FRAUD

There is a growing focus by companies and accounting professionals on the prevention and detection of fraud?. What exactly is fraud? A basic definition is "*a deliberate act made to secure unfair or unlawful gain*". This article focuses primarily on fraud perpetrated through the misstatement of financial statements, more so than the misappropriation of property or money.

The 2005 PriceWaterhouseCoopers *Global Economic Crime Survey* stated that 45% of companies who responded to the survey experienced fraud in the last two years. On average, these companies had experienced eight serious incidents resulting in damage to one or more of the following: reputation, employee morale or business relations. The average financial impact was $1.7 million for each incident. A disturbing fact to come out of the survey was that over 30% of fraud incidents were discovered by accident. This makes *chance* the most common source of fraud detection.

Given the significant impact that fraud can have on a company, or even an entire industry, it is not surprising that increased attention is being given to the topic. Detecting and preventing fraud is taking on a much more significant role in the accounting industry. There has been a shift in the general public's perception of the purpose of a financial statement audit and the responsibility of the auditor. It is not uncommon for people to believe that a primary function of an audit is to detect fraud. An unqualified opinion is sometimes interpreted as an indication that there was no fraud. Companies and the auditing industry are responding to this perception and taking action to meet the expectation.

Although auditors are increasingly expected to assure the company and the public that no fraud was committed, the company is still primarily responsible for detecting and preventing fraud. For fraud to occur, three conditions must be present:

- The opportunity for deception must be present (e.g. in effective controls, the ability of management to override controls).
- There must be incentive or pressure to commit the fraud (e.g. unrealistic performance goals, lucrative financial incentives).
- The perpetrator must have the attitude to commit the fraud or be able to rationalize the act.

The company has responsibility for the first condition, can have strong influence over the second condition and has some ability to control the third condition through hiring and performance review practices.

The responsibility for fraud detection and prevention must be shared by all levels of the organization, working closely with outside experts, including the external auditors. Appropriate anti-fraud tactics differ depending on the roles and responsibilities of the organization and function employing them. The following is a summary of anti-fraud tactics generally recommended for each of the functions with significant anti-fraud responsibilities:

Board of Directors/Audit Committee

The best anti-fraud tactic a company can have at its disposal is a culture of honesty and integrity. If the company is comprised of ethical individuals, it greatly reduces the chance of fraud. Building such a culture starts at the top with the board of directors and the audit committee. They need to create and communicate a clear message that fraud will not be tolerated anywhere in the company.

TACTICS FOR PREVENTING AND DETECTING FRAUD

The board should also identify who will lead the risk management efforts and set the expectations for risk management performance. The level of risk a company is willing to accept must be articulated. This will provide the risk manager and operating management with an understanding of circumstances which require involvement of the board of directors.

Company Management

Management is responsible for day-to-day anti-fraud efforts. A company is less likely to experience fraud if it is efficiently run and its resources properly controlled and applied.

Using a strategic plan to set expectations and address business risks allows for solid budgeting and forecasting. Variance analysis is then more meaningful and can assist in identifying irregularities in the financial statements.

Creating metrics to measure key activities and keeping accurate operating statistics can identify areas of exposure. These metrics aid interpretation of operational results, increasing the likelihood that unusual activity will be identified and tracked to the source. Metrics also provide a means of feedback and communication between the operations and the finance departments. Managers must understand their responsibility for fraud detection and deterrence. This understanding will guide them in building effective controls and processes in their areas of responsibility. A well run company limits the opportunity for fraud. When fraud is discovered, consistency and visibility in the response to it is crucial. The perpetrators need to bear the consequences of their actions and these consequences need to be visible to the organization. Also, any discovered conflicts of interest need to be addressed and resolved openly. This builds credibility and integrity within the company's workforce and provides examples of desired conduct.

Internal Audit

The internal auditor's focus is more on controls and processes than on day-to-day activity. Internal auditors help ensure that the company's controls and guidelines are enforced and that the company's processes produce financial statements of the highest integrity. Internal Auditors also identify risks and opportunity for fraud in the organization on an ongoing basis.

Anti-Fraud Specialists

Many companies are now engaging anti-fraud specialists in addition to, or as part of, their external audit efforts. These specialists specifically look for fraud and for opportunities for fraud to be committed. They interview employees in a wide variety of positions and have open discussions with the audit committee about all concerns regarding the risk or actual occurrence of fraud anywhere in the company.

External Auditors

The primary objectives of the external auditors are to determine whether the company produces accurate and complete financial statements and maintains an effective system of internal controls. Their role has become more challenging as they must now customize the audit to address the risk of fraud in response to the changed fraud detection expectations.

External auditors need to review all key control functions and the volume and type of transactions to effectively assess the risk of fraud. Auditing software is frequently used for the analysis of large volumes of transactions to reveal discrepancies and process problems. Special attention is given to higher risk transactions such as post-closing entries, non-standard entries, entries with no back-up, and entries requiring the use of estimates. Fraudulent financial misstatements are often the result of recording these types of transactions.

Tactics employed by auditors also include varying the timing, nature and scope of the audit to avoid being predictable as well as to target areas of high risk. Varying audit activities can be useful in revealing activities that company personnel are actively working to conceal.

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In summary, building a culture of good communications and integrity and maintaining strong internal controls are the best tactics for preventing fraud. Anti-fraud tactics need to be placed at all levels of an organization. Since fraud can happen at many levels and is customized to the organization, its prevention and detection needs to be just as customized and pervasive.

Sources

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Back to Newsletter

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