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Fraud in 2010

Its Prevalence, Cost, Detection, and Prevention

On June 2, 2010 the Association of Certified Fraud Examiners ("ACFE") issued its *2010 Report to the Nations on Occupational Fraud and Abuse*. (Click HERE to see the report.) This is the fifth such report by the ACFE since 2002 and the first time they have collected data outside the U.S. to provide a truly global study. Geographical location notwithstanding, most frauds have very similar characteristics.

This article summarizes the key findings of the ACFE study as well as other fraud data and, perhaps more importantly, suggests appropriate control measures that should be taken by all organizations to reduce the risk of fraud.

The ACFE report classifies fraud into three main categories:

- **Corruption** – such as kickbacks and bid rigging;
- **Asset Misappropriation** – such as skimming, falsifying expense reports, and payroll schemes; and
- **Financial Statement Fraud** – such as improper revenue recognition or concealment of liabilities.

On May 20, 2010 the Committee of Sponsoring Organizations of the Treadway Commission (COSO), a private-sector organization dedicated to providing guidance to executive management, issued its study entitled, *Fraudulent Financial Reporting: 1998-2007, An Analysis of U.S. Public Companies*. (Click HERE to see the report.) This data provides further insight into the third category of fraud – financial statement fraud – by analyzing 347 alleged fraudulent financial reporting cases investigated by the SEC.

For the most part, the findings of both reports are consistent and provide fraud examiners with helpful insights regarding new and ongoing issues that should be addressed in order to minimize opportunities for fraud.

ACFE 2010 Fraud Data (U.S. Only)

	Frequency % of Cases*	Median Loss	% of Total Reported Dollar Losses
Corruption	21%	$175,000	11%
Asset Misappropriation	90%	$100,000	21%
Financial Statement Fraud	4%	$1,730,000	68%

**Certain cases may involve more than one fraud category*

High Cost of Fraud

The ACFE estimates that worldwide, the typical organization loses 5% of its annual revenue to fraud. When applied to the 2009 Gross World Product it amounts to more than $2.9 trillion lost due to fraud. Worldwide, while asset misappropriation was involved in 86% of all frauds, fraudulent financial reporting resulted in the greatest median loss of $4.1 million vs. $135,000 for asset misappropriation. The median dollar loss within each of the three fraud categories was higher globally than in the U.S.

Although the results of the ACFE study might lead one to believe that asset misappropriation in the U.S. is not a costly problem, my own experience over the last several years has been that these types of frauds result in an average loss of close to $1 million.

Frauds committed by owners and executives last twice as long as those committed by employees (24 months vs. 13 months) and are therefore significantly more costly. It stands to reason that when an organization places a high level of trust in an individual, he or she is also given access to significant assets and thus

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can exploit the organization to a greater extent. These individuals are also in a better position to be able to override internal controls. As a result, it is extremely important to perform periodic tests of existing internal controls in order to determine their effectiveness.

However, testing internal controls is simply not enough. Organizations evolve over time. They may have a greater number of transactions, employees, customers and vendors, as well as significant changes in the technology they utilize. In addition, employees become complacent; positions that once provided a specific internal control function may have been eliminated and people may just look for shortcuts. These factors cause internal controls to erode over time. This is why it is so important for organizations to periodically take a critical look at their internal controls to determine whether they are not only effective but also adequate for their current business environment.

How are Most Frauds Detected?

One might expect most frauds to be detected through external financial statement audits, but it is important to remember that audits are not designed to detect fraud and did so in less than 5% of the cases examined by the ACFE. In fact, virtually all of the publicly-traded companies in the COSO study received an unqualified opinion from their external auditors.

The reality is that approximately 40% of all frauds are detected by tips from employees, vendors, customers, and others. Another 30% of all frauds are detected through management review and internal audit. Despite the number of frauds detected through tips, less than half of all companies in the study had an anonymous fraud reporting hotline. Even more disconcerting is that fact that only 8% of all victim organizations implemented a fraud hotline in response to a fraud.

In the majority of cases I have investigated, other employees were aware of their co-worker's misconduct yet did not feel they had someone to go to, particularly when the perpetrator was their superior. I have also seen many situations where co-workers should have known but did not have the training to help them recognize the warning signs.

Organizations in the ACFE study that had a fraud hotline suffered a median loss of $100,000 vs. $245,000 for those that did not have such a hotline. Organizations that provided fraud training suffered half the median loss as those that did not provide training. One explanation for these findings is that frauds are detected much sooner in organizations with a fraud hotline or that provide fraud training.

Can Fraud Be Prevented?

It is clear that although fraud is everywhere, there is much that can be done to reduce an organization's vulnerability to fraud. Management should implement a fraud hotline, provide fraud training to all employees, perform periodic surprise audits, and test the effectiveness of internal controls.

When deciding whether to invest the resources in a fraud deterrence program, one should consider the true cost of fraud. It is not only the amount that is stolen from the organization but also the costs involved in an investigation and the damage to the company's reputation. The COSO study reported that during the two days following a public company's announcement of an alleged fraud, their stock price declined more than 16% on average. Long-term consequences were often bankruptcy or delisting from a stock exchange. A high profile fraud can impair an organization's ability to raise capital or, in the case of a not-for profit organization, to obtain contributions.

For more information on how we can assist you with a fraud deterrence program and employee training please contact Partner Anthony M. Bracco at (212) 697-6900, ABracco@hrrllp.com.

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