Fraud Threatening Mid-Sized Businesses

Conni Ochs
RSM McGladrey

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A recent study by the Association of Certified Fraud Examiners (ACFE) underscores what many business owners know all too well: job-related fraud imposes enormous costs on employers. Small to mid-sized businesses— those with fewer than 100 employees—suffer a dramatically disproportionate number of fraud-related losses, the study says.

Why mid-sized businesses?
Occupational fraud causes a median loss per incident of $159,000—but for small to mid-sized businesses, the median loss is $190,000, according to the ACFE. The most common occupational frauds in these organizations involve employees writing fraudulent company checks, skimming revenue and processing bogus invoices.

Many small to mid-sized businesses suffer high fraud losses because they fail to proactively detect wrongdoing. Less than 10 percent of those studied have anonymous fraud-reporting systems, the ACFE says. And less than 20 percent have internal audit departments, conduct surprise audits or provide fraud-detection training for their employees. Not surprisingly, then, small to midsized businesses more often uncover fraud accidentally than by any other means, according to the study.

Several other factors contribute to the disproportionate rate of fraud among small to mid-sized businesses, says Andi McNeal, an editor on the ACFE research team.

“First, the familiarity and level of trust between employees in (small to mid-sized) organizations frequently results in fewer questions from other employees and managers,” McNeal says. “In an atmosphere where employees and management know each other well, they tend to be less alert to the possibility of fraud.”

Further, McNeal says, many small to mid-sized business owners hold the attitude that “it can’t happen to me”— that fraud is a problem only big companies face. This attitude, combined with a lack of awareness and education, often leads to a decreased emphasis on preventing fraud in an organization.

Those factors may not directly cause a greater rate of fraud in small to mid-sized companies, but they certainly make such organizations more susceptible to being defrauded and allow greater opportunity for potential wrongdoers, McNeal says. In addition, she says, the inherent lack of segregation of duties in some businesses means an individual may have the ability to perpetrate and conceal a fraudulent act more easily than in a larger organization that divides responsibilities and provides greater oversight.

Who’s committing fraud?
The size of losses from fraud closely corresponds to the position of the perpetrator. According to the ACFE study, business owners and executives who committed fraud caused a median loss of $1 million. That is nearly five times the median loss

managers caused and almost 13 times as large as the median loss employees generated.

The majority of occupational fraud incidents in the study involved either the accounting department or upper management. Employees in the accounting department committed more than 30 percent of the frauds, and upper managers or executive-level employees committed slightly more than 20 percent.

High-level executives who commit fraud are not immune from detection and punishment. High-profile corporate scandals in publicly held companies, such as those involving Arthur Andersen and Enron, have emboldened federal, state and local prosecutors and given law-enforcement officials more far-reaching powers. Since the adoption of the Sarbanes-Oxley Act of 2002 (SOX), the U.S. Department of Justice Corporate Fraud Task Force has secured more than 1,000 convictions or guilty pleas, including cases against more than 200 corporate chief executives, presidents and chief financial officers.

And judges aren’t going easy on corporate crooks. Witness the lengthy sentences handed down in some highly-publicized cases: Adelphia Communications Corp. founder John Rigas was sentenced to 15 years in prison; Tyco’s chairman and CEO Dennis Kozlowski, 25 years; and WorldCom Inc., CEO Bernard Ebbers, 25 years.

Tips for stopping fraud

Detecting occupational fraud can be very difficult, even though fraud incidents often occur over many months. In the ACFE study, fraud incidents lasted a median of 18 months from inception to detection. How can a small to mid-sized business uncover fraud?

Confidential hotlines and other reporting mechanisms are the most effective fraud-detection tools. Tips are more likely to uncover fraud than other means, such as audits or internal controls. The importance of tips is especially evident in cases involving losses of $1 million or more. Tips exposed 44 percent of the million-dollar frauds in the ACFE study. That’s more than twice the rate of detection by internal audits and three times the rate of detection by external audits.

Certain anti-fraud procedures can measurably affect an organization’s bottom line. In the ACFE study, organizations with anonymous fraud hotlines suffered a median loss per fraud incident of $100,000, while organizations without hotlines lost a median of $200,000. Similar reductions in fraud losses occurred in organizations that had internal audit departments, regularly performed surprise audits and conducted anti-fraud training for employees.

A different study, conducted by research firm Lord & Benoit LLC, surveyed the share-price performance of nearly 2,500 companies that follow the internal-controls rules contained in SOX. During the course of the two-year study, companies that employed the best fraud-control practices outperformed those with weak internal controls in terms of earnings. The process of evaluating internal controls promoted earnings growth when the companies acted.

Fraud likely worse than numbers show

“Fraud, by its nature, is hidden, so the true amount of fraud taking place in U.S. businesses at any one time cannot be calculated,” said John Warren, ACFE general counsel. Many fraud cases go unreported because the victim organizations do not recognize that they have been defrauded, do not report the crimes for fear of bad publicity or simply do not want to deal with the repercussions. ***IBI***

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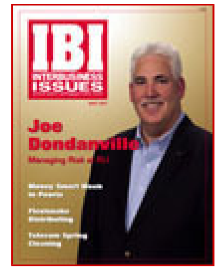

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