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Balog + Tamburri LLC.
CPAs, Consultants & Advisors

CREATING THE FRAUD RESISTANT COMPANY

Balog + Tamburri, CPA's Fraud Prevention Program

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Winston Churchill once said; "Civilizations that forget their past are doomed to repeat it." A recently completed national study revealed that employees, customers and suppliers, **steal over 7%** of the average U.S.-Based company's revenues over the 12 months ending December 31, 2008. The same study showed that during the massive frauds on the late 1990's and early 2000's, external CPA firms were complicit or knew about 50% of the biggest frauds—and did nothing! In these economic times, is it more critical than ever for senior corporate officers to embrace the concept of the "Fraud Resistant Company®."

While no organization or consultant can create a "Fraud-Proof" a company, the steps in this article will show you haw to make the commission of a crime more difficult, and how to establish an "Early Warning System of Red Flags" for early detection. While you cannot prevent a creative embezzler from stealing form you once, you can keep it from happening twice! Remember, in the world of Forensic Accounting, we believe that "Pigs get fat, Hogs get slaughtered!"

By a combination of basic, consistent business planning, effective forecasting, a structured system of operational procedures, and diligent analysis of results, it is relatively easy to create a corporate culture and environment that significantly reduces the potential of a devastating loss. The objective is to make your accounting and operational systems a crook's "Worst Nightmare!"

WHO SHOULD BE INVOLVED

The Fraud Resistance Team is comprised of a true cross-functional group. Typically, you need financial professionals, internal auditors, operational process owners, business management professionals, project managers, marketing, and anyone tasked with the effective and efficient evaluation of potential investments, acquisitions, outsourcing agreements, or long-term contracts with unknown entities. This team should be "Championed" by a member of Executive Management that has the ability to commit resources,intellectual, human and economic, to this strategic initiative.

A Cross-functional Matrix may look like the following Table:

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Audit Professionals	Financial Professionals	Technical Professionals	Operational Professionals	Strategic Management
P Staff	P Staff	P I / T	P Supervisors	P Managers
P Seniors	P Controllers	P Purchasing Mgrs	P Team Leaders	P Directors
P Managers	P Directors	P Proj. Managers	P Managers	P Vice Presidents
P Directors	P VP's & CFO's	P ISO & Quality	P Plant Managers	P CEO's

Yes, it is everyone. We are not talking about a covert "Spy" network to "Catch the Bad Guy." We are talking about cohesive, structured environment that begins with the proper tone from the top, and permeates every thread of the fabric of the organization. This commitment creates an ethical corporate culture which engulfs all aspect of the company's activities.

STEP ONE: ESTABLISHING THE FRAUD RESISTANT COMPANY7

There must be a "Tone from the Top" to begin to develop a Fraud Awareness and Fraud Prevention program. The CEO must ensure that management develops a basic structure of the organization that clearly defines and effectively communicates to line management and operational personnel the organization's direction and intended destination. There must be a clear route, consisting of set Policies and operational procedures to ensure that operational personnel know both the "What" and "Why" of the activities they perform. And the accounting and operational records must clearly and consistently document the economic impact of decisions and actions. Management can play a key role in the prevention and detection of fraud through:

- The development and implementation of a financial fraud awareness program which focuses on the existence of potential risks and the need for a corporate-wide fraud prevention strategy
- A review of the organization's commitment to prosecution as it pertains to the perpetrators of fraud. This commitment must be coupled with a focus developed to the identification of any material operational irregularities and financial reporting deficiencies and prosecuting the individuals involved
- The development of the necessary policy and guidelines, including an appropriate risk assessment model, for audit and other purposes

The first step in setting the "Tone from the Top" is the development of the strategic, tactical, and operational business plans that provide the key components of the "Fraud Resistant" organization. By allowing a free-form environment, you actually ENCOURAGE fraud.

The structure and make-up of the business plans is not of significant importance. What is important is that the structure ***mandates*** specific behaviors ***requires*** ethical conduct and ***evaluates*** results. Employees, clients and suppliers must understand what constitutes acceptable practices and behaviors.

The rigorous use of budgets, forecasts, and performance standards establish a "Baseline" of what the results should be, assuming everyone does what they proposed to do, or were expected to do. Budgets let employees know that the senior management will hold them accountable for results that differ from projected. This, in itself, is a strong fraud deterrent. Without this baseline, the company is much akin to a rudderless ship at sea, subservient to the currents, wind and tides. Chart you course before you set sail.

Some of the "Red Flags" of frauds perpetrated by members of management:

Top Management Defrauders

- Tend to have highly material personal values.
- Success to them means financial success, not professional recognition.
- Tend to treat people as objects, not individuals and often as objects for exploitation.
- Are highly self-centered
- Are often eccentric in the way they display their wealth or spend their money.
- They tend to be conspicuous consumers and often boast of the things they have acquired, the friends they have in high office, and all the fine places they have visited.
- Speak about their cunning achievements and winnings more than their losses.
- Appear to be reckless or careless with facts and often enlarge on them.
- Appear to be hard working, almost compulsive, spending most of their time scheming and designing short cuts to get ahead or beat the competition.
- May gamble or drink a great deal.
- Buy expensive gifts for their families usually to compensate for spending so little time with them.
- Are hostile to people who oppose their views.
- They feel exempt from accountability and controls because of their station or position.
- Create a greet deal of turnover among their subordinates and often set off one subordinate against the other.
- Play favorites among subordinates, but the relationship can cool very quickly because a subordinate often falls from grace after one mistake, even an insignificant one.
- Manage by crisis more often than by objectives.
- Tend to drift with the times and have no long-range plans, tend to override internal controls with impunity and argue forcefully for less formality in controls.
- Demand absolute loyalty from subordinates, but they themselves are loyal only to their own self-interests.
- Have few real friends within their own industry or company.
- Their competitors and colleagues often dislike them.

Understanding the Elements of Fraud

Frauds don't just happen. They are the result of three specific elements that must come together for the perpetrator to commit the fraudulent act. First, the person committing the fraud typically has a financial problem that they want your money to solve. They may need the money due to a gambling debt, substance abuse issue, or just may feel pressured to meet what they see as unattainable performance goals.

Secondly, they rationalize the behavior. They may feel that they you don't pay them enough, so they "self-compensate," they may dislike the employer or feel that their value to the organization is under appreciated, or they see others performing similar acts and believe that your company "owes them." Regardless of the perceived justification, they see their actions as "getting even."

Finally, they commit the fraud because the opportunity exists because of poor internal controls, the ability to override existing controls, a poor or non-existing system of internal financial reporting, or because of ineffectual variance analysis.

In addition to the aforementioned three elements, they also go to great lengths to hide the fraud. They may develop false invoices, doctor receipts for an expense report, or destroy files. This act of intentional concealment is what differentiates a fraud from a mistake.

STEP TWO: MAXIMIZE THE BENEFIT OF INTERNAL FINANCIAL REPORTING

The internal financial reporting structure of the organization is the "First Line of Defense" in creating the Fraud Resistant Company®. The company's accounting system shows the economic impact of management decisions and employee behavior. Simple disciplines, such as variance analysis, (measuring actual performance against the business plan) can raise the "Red Flags" that a fraudulent activity may have occurred. Some of these "Red Flags" of poor budgets and internal financial reporting include:

STEP THREE: DESIGN AND IMPLEMENT EFFECTIVE INTERNAL CONTROLS

To begin, Balog+Tamburri CPAs defines internal controls as any action taken by management that enhances the probability of achieving the objectives of a specific process The key to remember as we set sail on our business journey, internal controls represent the channel markers and depth soundings on the charts associated with our route. They also represent the weather forecast for our journey. In business terms, they represent how our company is going to conduct business.

How Internal Controls and Deter, Detect, and Aid in the Investigation of Fraud

The effectiveness of controls to deter, and detect fraud are highly dependent upon the existence of a tone from senior management based upon high ethical standards. This ethics-based tone flows from four interrelated components:

- The attitudes and behavior of the board of directors and executive management set the tone of the organization and signal to all parties the way that business affairs will be conducted
- A business plan, formulated by the board of directors and executive management, that clearly states the goals and objectives of the organization, identifies and ranks the business exposures expected to be encountered, and specifies the structure of business fundamentals required to address the identified business exposures
- A clearly defined structure of business fundamentals that establishes the elements and linkages needed to inform individuals about how to perform their work, including:

- Policy statements
- Operating procedures
- Performance standards
- Budgets
- Performance monitoring systems

Internal controls, both processing and environmental, provide a key tool to the CEO. Through the documentation and evaluation of controls, the CEO and the company's forensic accountants can identify:

- Management's commitment to attain and maintain a effectively controlled environment
- The level of compliance with established policies
- The level of compliance with established procedures
- Evidence of intentional circumvention of established procedures
- Where to look for evidence to identify the perpetrators of the fraud
- How the fraud was committed

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.

Controls and the Deterrence of Fraud

Through the establishment of a well-documented set of internal controls, CEOs and management effectively deters the commission of fraud, providing that management ensure total compliance with such controls.

Effective controls deter fraud by:

- Restricting access to valuable and moveable
- Providing specific accountability for deviations from established procedures
- Requiring monthly analytical reviews and reconciliations of cash and other valuable and moveable asset accounts
- Ensuring that deviations are reported timely to the appropriate level of management
- Providing a structure wherein regulatory agencies and audit committees can identify material deviations
- People know that the perpetrators will be identified promptly

Management's dedication to ensure total compliance with established controls aid in the detection of fraud. When compliance is mandatory and monitored, routine reports and reconciliations identify the existence of minor deviations from typical procedures.

Controls and the Detection of Fraud

Effective controls aid in the detection of fraud by:

- Providing an effective trail of documentation that details how the controls were circumvented and the fraud perpetrated
- Providing a structure for CEOs to determine the monetary amount of cash and other assets deviated by the perpetrators

- Highlighting any unexplained differences resulting from timely account reconciliations and analytical review procedures
- Assigning specific accountability for the safeguarding of valuable and moveable assets

However, controls alone cannot ensure the detection of fraud. Meaningful audit evidence from these procedures depends on the seasoned judgment of experienced CEOs and their forensic accountants who have a total understanding of the company's industry as well as the environmental, institutional, and individual factors that increase the risk of the commission of fraudulent acts.

Controls and the Investigation of Fraud

Controls provide the basis on which a CEO can build the basis of their fraud investigations. It through the control structure the CEO and senior management identifies the intended results of the operation. They then compare the planned results to the actual results to identify the potential existence of fraudulent activities.

Controls provide the structure for the gathering of evidence to calculate the losses resulting from fraudulent activities. In addition, controls provide the information essential to assist in the identification of the perpetrators of the fraud.