

## BUSINESS FRAUD: IT CAN HAPPEN TO YOUR COMPANY, TOO

No matter what your industry, the size of your company, or how well you “know” your colleagues or employees, the potential for fraud is real and ever-present. That potential becomes even greater during difficult economic periods. According to a 2009 survey conducted by Kroll, Inc.<sup>1</sup>, 30 percent of survey respondents said that the global financial crisis has increased the levels of fraud at their organizations, while 85 percent said that their company has suffered at least one fraud in the last three years. Lower profits heighten the risk of fraud. One in six companies responding said that they saw greater vulnerability to fraud from the reduction in internal controls, while one in seven said that increased fraud was the result of salary freezes.

Fraud drains American companies of an average seven percent of their revenues annually, according to a 2008 survey conducted by the Association of Certified Fraud Examiners (ACFE), a major trade group representing fraud investigators and forensic accountants; others put that estimate closer to five percent annually. Either way, the annual cost of business fraud to the American economy ranges between \$700 billion and \$1 trillion, based on the approximately \$14 trillion value of the U.S. Gross Domestic Product in 2009. The losses to the bottom line are equally damaging.

While business-related fraud is widespread and many executives recognize this reality, they often act as if “it can’t happen to us.” They typically trust their own employees as being honest and ethical individuals, and may furthermore believe that their organization is already well-protected



against the potentials risks of fraud. As a result, such executives may not be as pro-active against these risks as is warranted, and they may fail to properly assess their risks and vulnerabilities to fraudulent activity.

The truth is that American businesses are at significant risk of falling victim to the relatively few dishonest managers and employees, and that a large number of companies do not have effective systems in place to prevent the occurrence of fraud.

### The Fraud Triangle: Explaining the Occurrence of Fraud

The Fraud Triangle, developed decades ago by criminologist Dr. Donald Cressey, explains that fraud typically occurs when three factors are simultaneously present: pressure or incentive to commit a fraud; opportunity; and rationalization.

- The incentive to commit a fraud can be triggered by a variety of factors,

including an individual’s real or perceived need for additional cash (e.g., to repay debts, living beyond their means, to pay for medical emergencies, etc.); the belief that additional income will reduce personal stress; or to raise their reputation or status within their social setting. A weak economy provides a further compelling reason to commit fraud. For example, since raises or bonuses may be reduced or eliminated during such a period, or job mobility will be more limited, the individual may look to illegitimate means to raise his or her income.

- Opportunity occurs when there is an opening or gap in the company’s current financial or operating system that can be exploited (for example, gaps in internal controls).
- Rationalization enables an individual to feel justified in committing the fraud, e.g., “everyone is doing it,” “the company owes me,” or “the lawyers said it was okay.”

## The Need for Effective Internal Controls

Quite often, the opportunity to commit fraud arises because there is too much trust placed in certain managers and employees, without any effective system of checks and balances or internal controls to prevent them from manipulating the financial accounts, misappropriating the company's assets, or participating in corruption or bribery.

When an individual has sole responsibility or sole access to financial information, bank accounts, information about receivables, and other critical company data, this should be a signal to senior management, CFOs, controllers, and the audit committee that internal financial controls need to be tightened.

Indeed, the most important factors that enable fraud schemes to succeed are: (1) lack of internal controls; (2) lack of management review and oversight; and (3) the ability of certain individuals to override existing controls, according to the 2008 ACFE survey. Other significant factors include lack of the following: competent oversight; independent checks and audits; clear lines of authority; employee fraud education; a fraud reporting mechanism.

## What to Do If You Suspect Fraud

When fraud is suspected in an organization, most business owners are unsure what to do first. Of course, general or outside counsel should immediately be contacted. Simultaneously, contact the company's internal auditors to discuss the implementation of additional controls and changes to existing processes to prevent any suspected fraud from continuing or reoccurring. While it's important not to accuse anyone at this time, procedural changes can help. For instance, if asset misappropriation is suspected, add another approver to the sign-off process for

expenses. Companies should note that any interim actions do not replace the need for strong internal controls.

In addition, the Company should consider engaging the services of an independent forensic accountant, who will investigate the suspected fraud and provide answers to such questions as:

- How did the fraud occur?
- Who perpetrated it?
- Was it a sole individual or was there collusion among employees or third parties?
- What was the dollar impact of the fraud?
- Is the fraud still occurring?
- Is this fraud/theft occurring in other areas of the company?

The independent forensic accountant will issue a formal report on the findings.

If the independent forensic accountant concludes that fraud has occurred, the resulting report on findings can be used in a number of ways. In cases of sizeable frauds, the report is often used as a basis to pursue legal action. Other times, the reports are given to the State Attorney General. In lower-profile situations, or in situations in which the company does not wish to raise awareness of the perpetuated fraud, the report may be used as a basis for employee termination.

About 90 percent of corporate fraud involves asset misappropriation, such as billing schemes, check tampering, check reimbursements, payroll schemes, and cash register disbursements, according to the ACFE survey. Also included in this category are non-cash misappropriations, which involve the theft or misuse of physical assets, such as inventory or equipment, or the misappropriation of proprietary information.

For the purposes of developing effective internal controls, the focus is on deterring financial misstatements—which includes frauds in such areas as revenue recognition, expense capitalization, misstatement of inventories, overstatement of receivables, and manipulation of intercompany transactions.

It is impossible to overstate the need for every company to develop a fraud risk program that encompasses fraud risk assessment, disclosure of conflicts, violation-reporting procedures and whistleblower protection, among other components. At J.H. Cohn, through our Corporate Governance Services Group, we remain committed to assisting our clients in developing such a comprehensive risk management function. Protecting your company from financially damaging fraudulent activities is essential to the long-term success of your business.

In addition, should you suspect the occurrence of fraud or other irregularities, J.H. Cohn's Business Investigation Services Group has the expertise and resources to help you investigate the facts related to the suspected fraud and/or violations of company policies. ■

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For more information on J.H. Cohn's Business Investigation Services, [click here.](#)

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