Steps to help prevent and mitigate occupational fraud

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Occupational fraud is a pervasive and costly problem for businesses. In its 2014 Report to the Nations, the Association of Certified Fraud Examiners (ACFE) noted that a typical company loses about 5 percent of annual revenue to fraudulent acts, which take an average of 18 months to detect. While the median loss in the global ACFE study was $145,000, 22 percent of fraud cases caused at least $1 million in economic damage. Even worse, ACFE reported that only 14 percent of organizations victimized by fraud had fully recovered their losses.

Where is organizational fraud most likely to be found? In its latest study, the ACFE discovered that banking/financial services, government, public administration and manufacturing sectors had the greatest number of reported cases. When identifying fraudsters by job category, the report showed that 77 percent worked in one of seven business units: accounting, operations, sales, executive management, customer service, purchasing and finance. While senior leaders accounted for the lowest reported fraud activity (19 percent), those acts resulted in the highest median losses ($500,000). Similarly, fraud schemes that involved four or more employees also had median losses exceeding $500,000, well above the $80,000 median loss caused by a solitary fraudster. As these figures bear out, fraudulent activity involving more than one individual (collusion) tends to be larger in size, and these situations can also be more difficult to detect.
Since the *Report to the Nations* study began in 1996, the ACFE has consistently identified the majority of fraud cases as asset misappropriation, corruption or financial statement schemes. For the 2014 cycle, asset misappropriation and corruption were by far the most reported cases, with median losses of $130,000 and $200,000, respectively. Just 9 percent of all reported events involved financial statement fraud, but those cases produced median losses of $1 million.

Many leaders of small to midsized firms are busy tending to daily operational activities, which means the issue of fraud assessment, prevention or detection is generally not top of mind. But the ACFE data shows it can be an expensive mistake to overlook potential financial misconduct by employees or other stakeholders. With that in mind, here are four quick steps executives can take in an effort to reduce and mitigate occupational fraud in their organizations.

**Review and strengthen internal controls.** According to the ACFE’s most recent report, nearly one-third of all companies where fraud was discovered had little or no internal controls in place. This issue was magnified in small organizations (fewer than 100 employees), where a lack of controls was cited as the primary fraud vulnerability in 41 percent of reported cases. Additionally, the ACFE noted that 20 percent of reported frauds may well have been prevented by stronger management oversight of accounts, processes or transactions.

In its 2014 report, the ACFE said businesses using proactive data monitoring and analysis had median fraud losses of $73,000 — nearly 60 percent below the $181,000 median loss for firms without this reporting tool. In addition, companies with strong management review protocols reduced median losses by nearly 52 percent. At the same time, companies using these internal controls were able to detect fraudulent activity about twice as fast as firms lacking such controls.

In short, executives and business owners should be, at a minimum, aware of the risk of fraud to their organizations and take at least some actions to address the issue. Implementing and strengthening internal fraud risk controls is an important first step in addressing the issue.

**Encourage use of tip and fraud hotlines.** The presence of employee support programs, which included fraud tip reporting tools such as reporting hotlines, helped companies hold median fraud losses to $90,000. That’s substantially better than the $200,000 median loss the ACFE reported for firms that had no such programs in place. In the 2014 *Report to the Nations*, the ACFE found that employees supplied 49 percent of all fraud tips, with others coming from customers, vendors or anonymous sources. Those collective tips produced the first detection of fraud activity in 42 percent of all cases. Meanwhile, the availability of fraud hotlines for both employees and external stakeholders was shown to cut median losses by over 40 percent ($168,000 to $100,000), while also reducing the median duration of fraud activity from 24 to 12 months.

**Leverage low–cost anti-fraud efforts.** Clearly, smaller organizations suffer disproportionately large losses from occupational fraud. According to the ACFE’s most recent data, the median fraud loss for companies with 100 or fewer employees is $154,000. By contrast, the median loss for companies with 100 to 999 workers was $128,000, and businesses with 1,000 to 9,999 employees had a median loss of $100,000. The biggest reason for the disparity: midsized and large firms are more likely to have anti-fraud controls in place and typically have greater financial and human resources with which to monitor and prevent fraudulent activity.

Still, there are low– or no–cost steps smaller businesses can take to reduce their risk. For example, companies with a written and posted code of conduct (versus those with no such control) cut median fraud losses by 50 percent in reported incidents, while also reducing the duration of frauds from 24 to 18 months. Meanwhile, fraud training programs for executives and managers are a low–cost investment that the ACFE data indicated can reduce fraud losses by up to 40 percent. Fraud training for non-management workers also proved to be effective, cutting median fraud losses by 39 percent in reported cases.

**Articulate clear, consistent “tone at the top.”** All other steps previously mentioned will likely be less effective and provide less value if senior leaders do not set clear ethical boundaries and demonstrate consequences for behavior outside of those areas. This big picture of what is — and is not — acceptable in corporate culture typically resides in a code of conduct, though it may also be part of the organization’s stated mission, vision and values. As mentioned above, this tone at the top can be strengthened through fraud training for executives, managers and all employees.

While a strong leadership tone is crucial, that tone needs to be followed by actions that dovetail with the message. Organizations should also implement policies that minimize fraud opportunities. This may include mandating that staff take a defined period of time off each year (often one or two weeks taken in a block of time) so that another worker handles those specific duties while they are on vacation. This control step makes it harder for an employee to operate a fraud that depends on single party activity. Mandatory job rotations can also serve the same purpose as vacation time.

To learn more about tools to help your business reduce its potential exposure to fraudulent activity, contact RSM’s Forensic Accounting and Fraud Investigations team.