

MANAGING THE RISK OF FRAUD

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SAFEGUARDING CORPORATE ASSETS

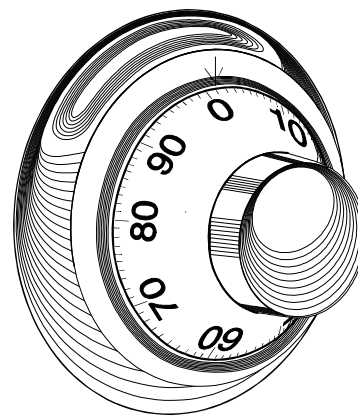
DIFFICULT ECONOMIC TIMES REQUIRE THAT YOU REVIEW INTERNAL OPERATING AND ACCOUNTING CONTROLS

The level of economic turmoil and uncertainty produces a variety of new problems for management and auditors alike. As the number of business failures and personal bankruptcies rise so does the incidence of unemployment and the increased need for funds by more and more people in order to afford basic necessities. This need has surfaced as a greater incidence of employee fraud.

More and more our clients are turning to us for assurance with regard to preventing against employee fraud.

We would like to explore some of the factors surrounding white collar employee fraud and possibly create a greater awareness among our readers in order that they may properly safeguard their corporate assets.

Typically, employee white collar fraud is driven by a desperate need for funds in excess of those being earned by the employee and usually not the result of larceny in the employee. However, in some cases, the ease of obtaining these funds as well as the lack of detection by management or the company's auditors of the irregularities which have occurred, induce ongoing "loans" which have, in some cases, an intention of repayment prior to detection.



The ability for a defalcation to occur within a company can be greatly reduced if proper *division of duties* exists among personnel and if certain *basic internal controls* are in place with *adequate management supervision* and approvals.

The examination of a company's financial affairs is performed by auditors with a presumption that no fraud exists. The audit is designed to reduce the likelihood that a material misstatement is not uncovered. But, the audit is not designed to detect fraud. However, should any irregularities be discovered during the normal course of an audit, these are immediately brought to the attention of management for further investigation.

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Furthermore, any weaknesses which are found within the system of internal control are usually reported to management verbally or in some cases, in writing in a document commonly referred to as a “management letter” or “report on internal accounting controls”.

The Canadian Institute of Chartered Accountants revised the standard auditors report to incorporate a clarification of management’s responsibility and role with regard to internal controls within an organization.

It is important to note that although the wording of the auditor’s report has been modified, the responsibility for the financial statements as well as the primary responsibility for the establishment, monitoring and enforcement of internal accounting and operating controls within an organization always has been that of management. The detection of employee fraud has not been an easy task nor will it be in the future. In particular, where any form of employee collusion exists, it increases the complexity of the theft and consequently makes detection more difficult.

The extent that a routine annual audit can be relied upon to detect irregularities is somewhat limited since an audit is not designed for that purpose. An audit determines, verifies and then relies on the existence and adequacy of internal operating and accounting controls as well as the adherence to these systems during the performance of the normal daily routines. If top management are prepared to

circumvent the procedures established in the system, then employees will certainly follow.

The audit is structured on the basis that if the system of internal accounting and operating controls is well designed, in place and being followed, then the system’s output (i.e. financial records) should be proper. Auditors therefore perform a review and analysis of the controls in place and test check a sample of the transactions which are indicative of the company’s activities, to ensure that the system is in fact being followed. In those instances where weaknesses are detected within the design of the system or should a sample indicate that planned controls are not being adhered to, the auditor is in the position to bring this to management’s attention.

However, it is not possible from both a time and cost constraint, to review every transaction and every aspect of every system within an organization to provide for complete and total assurance to management that every asset is secure. In specific situations, as a result of suspicions originating from within the company or emanating from an audit, more extensive investigations into various areas have been performed. In these circumstances, special audit procedures exist wherein the premise that no fraud has occurred, is not the basis of the audit.

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These extensive audits would identify a specific area within an organization and perform a much more rigorous verification, in some cases 100%, of transactions for a specified period.

Should management of a company suspect that there are areas within their organization which warrant a more careful scrutiny, this matter should be discussed with the auditors at any time during the year, not only when the year-end is being performed, in order to adequately design and execute a special purpose audit.

Management should presume that its employees are functioning honestly, efficiently and within the expected guidelines for the performance of their duties. However, management also have the responsibility to be cognisant of factors which could indicate employee fraud and be aware of the methods available to explore this suspicion further.

We all practice preventive medicine for our health and preventive maintenance for our machinery and equipment. So too should we follow a plan of preventive controls for the operating and accounting system within our organizations.

BASIC MANAGEMENT CONTROLS

Generally, many internal control procedures which have very significant effects with regard to the prevention of employee fraud are circumvented by management, criticized as being time consuming or considered frivolous. However, experience has shown that this attitude by management could prove very costly. Some examples of these types of controls would include:

Receipt and review of company bank statements with all relevant documentation pertaining thereto by management prior to release to the accounting personnel for reconciliation.

Careful division of duties among all personnel in any area involving the handling of cash.

Insistence that all personnel take appropriate annual vacations and have their responsibilities performed by other personnel during their absence.

Monthly review of aged accounts receivable listings as well as subsidiary accounts receivable records with reconciliation to the general ledger control account and review of the monthly trial balance.

Insistence on timely bookkeeping and monthly interim financial reporting.

Proper controls and division of duties with regard to inventories, shipping area, receiving area and interplant transfers.

Perpetual inventory system, verified independently during the course of the year and monitored for accuracy by means of periodic physical counts.

Management review and approval in writing of weekly payroll listings.

Two signatures for all corporate cheques with careful examination of supporting documentation when cheques are presented for payment.

The above is a not to be considered an all inclusive listing of the controls to prevent against fraud. However, these are an indication of the types of controls which are too often found to be missing and leave the company susceptible to fraud or other irregularities.

FRAUD FACTS:

- ❖ Bank losses in the U.S measure \$80 million from robberies and \$2.1 billion from employee criminal activity.
- ❖ Fraud of one type or another occurs in almost every business today, costing American businesses approximately 6% of revenues or \$600 billion annually, according to the Association of Certified Fraud Examiners.
- ❖ Over 80% of occupational frauds involve asset misappropriations. Cash is the targeted asset 90% of the time.
- ❖ Corruption schemes account for 13% of all occupational frauds and they cause over \$500,000 in losses, on average.
- ❖ Fraudulent statements are the most costly form of occupational fraud with median losses of \$4.25 million per scheme.
- ❖ The most common method for detecting occupational fraud is by a tip from an employee, customer, vendor or anonymous source. The second most common method is by accident.
- ❖ Small businesses are the most vulnerable to occupational fraud and abuse. The average scheme in a small business causes \$127,500 in losses. The average scheme in the largest companies costs \$97,000.
- ❖ There is no significant difference between the profile of the white collar criminal and the general population - anyone within the company can be an embezzeler.
- ❖ There is more than a 50% chance of a sizeable dishonesty occurring in any firm and a 75% chance of harmful malpractice sufficient to impair the profit structure.
- ❖ 23% of all workers in the U.S. use dangerous drugs on the job.

**IF YOU ARE NOT FINDING FRAUD IN YOUR COMPANY,
IT MAY BE BECAUSE YOU ARE NOT LOOKING FOR IT !**

MANAGING THE RISK OF FRAUD has been prepared for the general information of our clients, staff and other interested parties. The enclosed comments are of a general nature and are not intended to cover all aspects of the subject matter. Prior to implementing any planning based upon information in this publication, the specific facts pertaining to any particular situation should be carefully considered. We will be pleased to assist in this regard and to provide further details pertaining to the matters discussed herein.

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