

## The Basics of Fraud Risk Management

Among your many duties as a CPA in business and industry is the day-to-day detection of and protection against fraud in your organization. With the U.S. economy in the midst of a significant crisis, it may be difficult to focus on fraud prevention; however, it is exactly those moments of distraction that allow for an open door to fraud activity.

### Introduction

Fraud can happen anywhere. While major fraud situations are typically what garner media attention, huge sums are lost by all types of businesses as a result of the high number of smaller frauds that are committed. The *2008 Report to the Nation on Occupational Fraud & Abuse* published by the Association of Certified Fraud Examiners (ACFE) estimates that U.S. organizations lose an estimated seven percent of their revenues to fraud. According to the ACFE report, small businesses—classified as those with less than 100 employees—suffer fraud more frequently than large organizations and are hit by higher average losses. When small companies incur large fraud losses, they are less likely to be able to absorb the damage than a larger company, and may even go out of business as a result. The risks of fraud may only be increasing with growing globalization, more competitive markets, rapid developments in technology and periods of economic difficulty.

Despite the serious risk that fraud presents to business, many organizations still do not have formal systems and procedures in place to prevent, detect and respond to fraud.

While no system is completely foolproof, there are steps which can be taken to deter fraud and make it much less attractive to commit.

### What Is Fraud?

The ACFE identifies three main categories of fraud that affect organizations. The first of these is asset misappropriations, which involves the theft or misuse of an organization's assets. Examples include theft of inventory or cash, false invoicing, accounts receivable fraud and payroll fraud. The second category of fraud is fraudulent statements, which are the most costly with a median loss of \$2 million among the 99 financial misstatements included in the 2008 ACFE study. The final of the three fraud categories, and the most common, is corruption, occurring in 27 percent of all fraud cases. Corruption includes activities such as the use of bribes or acceptance of 'kickbacks,' improper use of confidential information, conflicts of interest and collusive tendering.

### Combating Fraud

A sound, ethical business culture and an effective system of internal control are essential elements of an anti-fraud strategy. An effective anti-fraud strategy has four main components: prevention, detection, deterrence and response.

### Prevention and Detection

Fraud prevention and fraud detection both play a role in combating fraud and it is unlikely that either can fully succeed without

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the other. Therefore, it is important that organizations consider both fraud prevention and fraud detection in designing an effective strategy to manage the risk of fraud.

Prevention starts with effective internal controls which can reduce exposure to financial risks, protect businesses by preventing fraud and help create systems for detecting fraud. However, a sound system of internal control cannot provide complete protection against all fraudulent behavior, highlighting the importance of other fraud prevention and fraud detection measures. Prevention also includes adopting methods that decrease motive, restrict opportunity and limit the ability for potential perpetrators to rationalize their actions. In the case of deliberate acts of fraud, the aim of preventative controls is to reduce opportunity and remove temptation from potential offenders. Policies, procedures, training and fraud awareness also help prevent fraud from occurring.

It is worth bearing in mind that fraud prevention techniques, while worth investing in, cannot provide 100 percent protection. It is difficult, if not impossible, to remove all opportunities for perpetrating fraud. Organizations should ensure that systems are in place that will highlight occurrences of fraud in a timely manner. This is achieved through a fraud detection strategy.

A fraud detection strategy should involve different types of procedures, including analytical, to highlight anomalies, and the introduction of reporting mechanisms that provide for communication of suspected fraudulent acts. Key elements of a comprehensive fraud detection system include:

- Exception reporting
- Data mining
- Trend analysis
- Ongoing risk assessment

## Deterrence and Response

Within an organization, fraud deterrence goes hand-in-hand with two important issues: awareness surrounding ethics and the organization's response to the discovery of fraud. When organizations stress the importance of ethical behavior and sharing responsibility for upholding an ethical culture, it can have a profound effect on deterring fraudulent acts. Some methods that organizations can employ include:

- Codes of ethics
- Training on ethical standards
- Hotlines for reporting unethical behavior

It is also important for organizations to employ a consistent and comprehensive response to suspected and detected incidents of fraud. This sends a message that fraud is taken seriously and that action will be taken against perpetrators. Each case that is detected and investigated creates a deterrent and acts as a form of fraud prevention. Some effective response methods include:

- Conducting thorough investigations
- Disciplining the individuals responsible through internal, civil or criminal action
- Preserving evidence for prosecution
- Taking statements from witnesses and suspects
- Reviewing existing systems to investigate system flaws and implementing changes
- Creating and distributing an annual fraud report

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