

FRAUD!!!

No, not in my company! ...*would you bet your company's life on it?*

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Over the last five years you've probably read, heard or actually experienced fraud in an organization - maybe even more than once.

Fraud is committed by the most seemingly respectable people and is a cancer that can infect any business with deadly results. From the spectacular Enron disaster to the clerk at the local store skimming cash receipts, fraud is either an actual reality or a potential reality in any business...including yours.

The Fraud Triangle

Prior to returning to public accounting last year, I spent 15 years in industry, serving as CFO or Controller with both large and small privately-owned organizations. During that time I uncovered a \$2 million embezzlement of cash by the general partner and a \$100,000 theft of rebate checks by an employee. I also investigated a number of other frauds in a variety of areas such as fraudulent billings, bogus vendors, asset theft, counterfeit checks, ghost employees and bogus expense reports. In all cases, the following key elements (known as the Fraud Triangle) were always present:

Motivation, Rationalization And Opportunity

As an owner or manager of a business it's highly unlikely you have any significant control over another person's motivation or rationalization process. Here are some examples why.

MOTIVATION – What motivates an employee today will not always be the same thing that motivates them tomorrow, next week, next month or next year.

Example: An employee who's been with the company for years, thought of as honest and loyal, could perhaps someday be motivated by personal financial challenges such as divorce, family health issues, excessive debt, college finances, supporting elderly parents, legal bills, addictions, etc.

RATIONALIZATION (also known as moral breakdown or justification) – when opportunity meets motivation, then rationalization is probably just a short step away.

Example: An employee that thinks: "I'll just borrow the money and put it back before anyone notices it's gone. The company makes plenty of money and they will never miss it. I work hard and deserve a raise. I hate this company/manager/owner.... I'll show them!"

OPPORTUNITY – So now you're probably thinking...ok, so what do I do about managing the opportunity element of the fraud triangle?

The short answer is to have an effective system of internal control. Internal control is an integrated web of policies, procedures, attitudes and actions that work together to achieve a desired result. Although no system of internal control is invincible because of factors like collusion or management override, an effective system of internal control still provides the best defense against fraud vulnerabilities in your organization.

Another way to reduce the opportunity threat is with fraud awareness. The owner/manager should always pay special note to circumstances or factors that could negatively impact current and future behaviors and events (e.g. employees obviously living beyond their means, business partners with new unexplained bursts of income, a customer or vendor in a serious cash flow situation, increased sales but less profit and cash distributions, internal cash flow issues, lack of timely and accurate financial information)

Remember that it's not always your employees who might be tempted to commit fraud. Your vendors, customers and others you have business dealings with can be influenced by some or all of the elements of the fraud triangle in their world.

Management's Responsibility

Since the Enron scandal, auditors, regulators and financial statement users have placed a renewed emphasis on evaluating a company's system of internal controls and producing reliable financial reports. Business owners are being called upon to understand and explain their company's internal controls and, in some cases, to attest to its reliability.

Auditors may make observations and suggestions about internal control as part of performing their financial statement audit. Business owners may see the annual audit as a deterrent, a means to help control the risk of loss due to fraud, but the independent auditor is not part of their client's internal control. The financial statement audit does not find or correct errors in the information used every day to manage the organization or to detect fraud.

The business owner, board of directors (if one exists) and the company's management team shares the ultimate responsibility for establishing and maintaining the organization's internal control system. Only management has the ability and the authority to analyze the various elements of internal control, make decisions, supervise and otherwise ensure that the system functions effectively.

Establishing An Effective Control Environment

Management must establish a proper tone, *from the top*, that consistently reinforces the company's commitment to complete, transparent and accurate financial reporting. This control environment is the foundation of the organization's internal control. Without a solid foundation, all other control components are quickly rendered ineffective.

The Business Cycles Within Organizations

Every organization has three or more critical business cycles in which money changes hands (in whatever form of value it takes). Typical business cycles are as follows:

- Revenue Cycle - Sales/accounts receivable/cash receipts
- Purchasing Cycle - Purchases/accounts payable/cash disbursements
- Payroll Cycle – Hire to pay
- Inventory Cycle – Purchase to shipping
- Capital Expenditure Cycle – Investments in capital assets

Every business cycle requires segregation of duties between those that initiate, approve, record and report the transactions. Controls must be in place to prevent and/or detect errors or other irregularities in the transaction process.

Internal Control Isn't Just For The Accounting Department

Internal controls span many aspects of an entity's operations and involve many individuals outside the accounting department, for example:

- The entity's hiring, training and promotion policies are an important element of the control environment, helping to ensure that qualified personnel perform key procedures.

- Operations personnel may observe non-financial inaccuracies in the information they use to run the business. The reporting of these inaccuracies is critical if management is to effectively monitor the performance of internal controls.
- Sales personnel may negotiate special terms with certain customers, and these terms must be communicated to others within the organization so that the sale can be authorized and properly accounted for.

- Are the transactions that have been captured valid and properly authorized?
- Have all valid transactions been captured?
- Have all transactions been recorded at their proper amounts?
- Have all transactions been captured in the proper accounting period?
- Have individual transactions been properly summarized?
- Have all summarized transactions been posted correctly to the accounting records?
- Have the transactions been classified properly for accounting purposes? (That is, if an expense is a marketing expense, are there controls in place to make sure it has been classified as a marketing expense?)

Internal Control Action Steps

Any organization that seeks to produce reliable financial reports, maximize profits and minimize risk from either errors or fraud requires a reliable system of controls. The following are internal control action steps:

First, identify your organization's major transaction cycles and then ask "what can go wrong"?

Good internal control begins with management's assessment of the risk facing the entity. With regard to preparing reliable financial reporting, management should have a working knowledge of risks in the capture, processing and reporting of all financial information.

Implement controls to manage risk

Control activities are designed to address the specific risks that management has identified. For example, if the business owner is concerned about fraudulent cash disbursements, then control procedures should be designed and implemented to specifically address this risk.

Monitor internal control performance

Management should supervise the performance of the control activities it puts in place and take both timely and appropriate corrective action if control weaknesses are identified.

Communicate information

Information must be effectively shared throughout the organization. Policies, procedures, feedback and a clear understanding of each person's responsibilities must be clearly communicated.

Seven Questions Management Should Ask About Internal Controls

Here are seven risk questions management should ask about each class of transaction that is significant to the company's operations (e.g. sales, payroll, cash receipts, cash disbursements, etc.):

Summary

What Can You Do To Improve Your Organization's Internal Control?

In order to establish and maintain internal control, management should actively be involved in matters such as

- Identifying and assessing risks by preparing reliable financial information (see seven questions above).
- Determining how best to mitigate or control these risks, based on the magnitude and likelihood of the threat.
- Monitoring others in the performance of their control functions.
- Setting an appropriate tone for employees to follow by displaying a serious attitude and actions toward financial reporting and internal control matters.
- Exercising proper oversight of the financial reporting process.

Remember that internal control is not one size fits all. Your organization's internal controls should be designed to fit the particular circumstances of your organization, including its people, its information system and its organizational structure.



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If you have any questions, need additional information or require assistance in establishing and documenting your system of internal control, please do not hesitate to contact him via email at JMurray@GPPcpa.com or directly at 214-635-2519.



About Jerry Murray, CPA **Senior Audit Manager**

Managing the Assurance Team, Jerry Murray is capable of dealing with various aspects of the auditing processes. His 25 years of experience in both public accounting and industry have placed him in Audit Manager and Audit Partner positions throughout his career. He has served in roles ranging from Controller to Chief Financial Officer and companies ranging in size from \$12-\$500 million in annual revenue. Mr. Murray has extensive experience in start-up, high growth and turn-around situations, which require rapid upgrades and changes in processes and personnel. He has personally been involved in more than 20 business acquisition or divestiture transactions, including due diligence, negotiations and integration of the acquisition.



About Goldin Peiser & Peiser, LLP

Located in Dallas, Texas, Goldin Peiser & Peiser, LLP not only provides the traditional public accounting services, but our team of experienced professionals assist privately held clients in the middle market with business consulting, mergers/acquisitions, cost segregation, research and development credits and business valuation services, to name a few. Your business can benefit from the specialized knowledge that our accountants, auditors and consultants provide.



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