COVER & ROSSITER
Certified Public Accountants & Advisors
Advancing Tradition

To Catch a Thief

By Pete Kennedy, CPA

GetInvolved Nonprofit Guide Article published in the July, 2010 News Journal

The Association of Certified Fraud Examiners recently released its "2010 Report to the Nations on Occupational Fraud and Abuse" (full report is located at www.acfe.com/rttn). The report categorizes 1,843 fraud reports investigated by Association members by type of fraud scheme, dollar amount of loss, how the fraud was detected, position of the thief, duration of the fraud, etc. The 84-page report is a statistical study with no real-life examples – not a great beach read. It does manage to confirm some pre-conceived notions about the nature of fraud itself, but also gives some surprising insight to fraud detection and prevention.

By a wide margin, the single most common means by which the fraudsters were caught was … inside tips (a/k/a "whistleblowers") at 40.2%. As a general category, internal controls were higher (43.7%), but the report segregates internal controls into Management Review (15.4%), Internal Audit (13.9%), Account Reconciliation (6.1%), Document Examination (5.2%), Surveillance/Monitoring (2.6%) and IT Controls (0.5%).

So where is the external audit in the detection process? Of the cases in the study, 76.1% had external audits performed. But those audits resulted in detection of the fraud only 4.6% of the time. As a point of reference "By Accident" was noted as the detection method in 8.3% of the cases. Clearly the external audit cannot be relied upon as the only means of detecting fraud should any be occurring. While the audit likely provides a measure of deterrence, the far more important function (in my opinion) is to identify internal control deficiencies and advise on ways to implement effective controls – something your auditor should be doing on a routine basis. Organizations which did not have external audits suffered a median loss of $200,000 vs. $150,000 for those which did have the audits done – the average duration also dropped from 24 months to 15. This appears to suggest that, while the external audit often does not directly catch the fraud, controls are generally stronger at those organizations as a result of the audit process.

It bears repeating that external audits are NOT a component of your internal controls; rather they should be viewed as a check on them. This study reinforces the fact that external audits alone (without adequate internal controls and oversight) cannot be relied upon to detect fraud.

So where can controls be established or strengthened at an organization to (cheaply) provide additional deterrence and detection against fraud?

As is often the case, some of the most effective controls can also be the simplest. Where a "Fraud Hotline" existed in an organization, 47% of the frauds were brought to light via tips vs. 34% at organizations without one. This suggests that 13% of frauds at organizations without a hotline either go unreported entirely or are caught through another means – but with a longer duration and greater expense. The median loss at organizations with a fraud hotline was $100,000 vs. $245,000 for those without one.

Another interesting area that the report discusses is the action taken after the fraud was discovered. – 61.3% responded that they had increased the segregation of duties, while 50.6% replied that they had implemented or modified the scope of management review responsibilities. The logical conclusion from this is that the organizations feel that, had the enhanced controls existed in the first place, the fraud would have been prevented or nipped in the bud. [By the way, if you are interested in seeing what can (and did) happen at an organization without ANY internal controls or oversight, Google "Father Kevin Gray" – yikes!]

Internal control modifications are often not as difficult or costly to implement as you might imagine. It can simply mean swapping responsibilities from one person to another, giving a board member an added monthly responsibility, having the bank statement sent to another individual's address for review. The guiding principle with controls and segregation of duties should be to have more than one individual involved with each transaction.

Unfortunately, there is a percentage of the population that is wired a bit differently – they will steal if given the opportunity. While "living beyond their means" is a common hind-sight observation noted in the report, such things can be explained away (wealthy parents, legal settlement, wise investing, etc.) and there is a natural inclination to avoid prying. For all intents and purposes, fraudsters are indistinguishable from the rest of us and hide within our midst. Effective internal controls and oversight will limit the opportunity for fraud. Clear fraud reporting mechanisms will limit the duration where a fraud is occurring.

For advice about on establishing an effective system of internal controls, or any other aspect of nonprofit management, please contact Pete Kennedy or any other member of our Nonprofit Practice team at Cover & Rossiter at (302) 656-6632.

Cover & Rossiter, P.A. (www.CoverRossiter.com) is one of the most respected and experienced CPA firms serving the accounting, tax and audit needs of the nonprofit community in Delaware.