How to Avoid or Minimize Fraud Exposures

By Ron Klein

Fraud cuts a wide swath across businesses and other organizations. The typical organization loses 5% of revenue each year to fraud, according estimates from the most recent *Report to the Nations*, a survey produced by the Association of Certified Fraud Examiners (ACFE 2014). When applied to the 2013 estimated gross world product, this revenue loss translates to a global figure of nearly $3.7 trillion.

Fraud losses impact a variety of CPA engagements. Audits of financial statements are especially prone to fraud claims, but surprising numbers of other engagements are affected as well, such as tax engagements, compilations, reviews, and bookkeeping/accounting services (see *Exhibit 1*). Exacerbating these problems are the high expectations clients and the public have for CPAs, to the point where CPAs are expected to: 1) always detect fraud; and 2) advise and warn clients about their exposure to fraud.

Meeting the Public's Expectations

The expectation to always detect fraud can be extremely difficult for CPAs to meet, but the expectation to advise and warn is much less difficult. CPAs can better manage fraud risks by communicating and working with clients on fraud prevention. Many businesses underestimate the consequences of fraud and the amount of damage it can cause to both owners and employees. Robust warning letters and advisories to clients about the risks of fraud—and how to guard against it—are therefore of great benefit when heeded.

Exercising skepticism enhances the CPA's ability to advise and warn—and not only the "professional skepticism" required of auditors, but also a healthy realization that there is no absolute assurance that a fraud has not been completely concealed. If two or more employees have conspired to conceal fraud, detecting it can be extremely difficult, whether the engagement is an audit, a bank reconciliation, or a tax return preparation.

The expectation that CPAs will detect fraud in non-attestation engagements is a result of jurors caring about CPAs "getting it right." Juror expectations of CPAs are generally higher than professional standards, which tend to be regarded as minimum requirements. Although a CPA is required to verify relatively little information when performing non-attestation services, if something looks irregular, one should investigate, document, and communicate it.

Providing good client service includes helping clients become more aware of their financial weak spots and vulnerabilities. When internal controls are inadequate (e.g., no segregation of duties, late bank reconciliations), or there are financial "loose ends" such as careless bookkeeping, clients should be informed in writing of the problems and how to address them.

If a CPA's warnings to clients are not documented, and fraud is later alleged, a legal defense of the CPA against the claim becomes problematic. Juries (and the public from which they are drawn) expect CPAs to document advice and warnings about important issues such as fraud. CPAs should also offer to help clients address their exposures and problems, and the offer should be documented as well.

The following example contains the basic elements of a general internal control warning letter:

Dear <Client Representative>:

How are you managing your business finances? Many business owners are discovering that their assets are not as well protected as they thought. This is especially true in small business environments where a single employee manages all the finances. Often there are no checks and balances to verify that transactions are accurate.

When proper and consistent procedures are not in place, employees can learn to manipulate the accounting system to their benefit. Whether they take money from the company or their mistakes are undiscovered, the end result can greatly impact your company's management discussions, financial reports, and tax filings.

Unfortunately, once your financial records have been altered, discovering problems is extremely difficult. Most standard accounting practices are not designed to uncover internal problems such as embezzlement.

Therefore, the best way to safeguard your company's assets is to recognize and improve weaknesses in your internal procedures. The following business practices can help you minimize potential internal control problems:

■ ***Assign related duties to different people.*** Certain accounting functions are designed to cross-reference each other for accuracy; for example, writing/signing checks, ordering/paying/receiving materials, handling cash/recording cash. These procedures can reveal inconsistencies in your records in a timely manner.

■ ***Reconcile and scrutinize your bank statements every month.*** A bank statement can tell you a lot about your business if you review the information in a timely manner. Examine checks and endorsements, track transactions between accounts, compare payroll checks with employee records, and ask questions.

■ ***Always ask for proof before you sign a check or authorize a transaction.*** When you insist on reviewing original documentation, your employees become more accurate and communicate their needs more clearly. You should also verify the names of your vendors and your employees occasionally. And remember to cancel supporting materials after signing a check.

■ ***Lock and protect your valuables.*** Keep blank checks and signature stamps secured, and deposit cash and checks daily. It's also important to secure fidelity bonds and insurance for all accounting and key personnel.

■ ***Know your employees and examine behavior changes.*** Always verify employee references before hiring. Also consider the need for conducting other background checks as appropriate, including, but not limited to, the need for credit information, motor vehicle report, and criminal searches. Many white-collar crimes go unreported and continue to be repeated. Watch for trouble signs: possible substance abuse, change in lifestyle, living beyond means, possessiveness of work.

Small businesses and organizations suffer disproportionately large losses due to occupational fraud, partly because they have fewer antifraud controls in place.

These internal controls can help you reveal many discrepancies as well as recognize the excellent efforts of your staff. Our firm can help you develop and implement any of these important internal controls. Please call me if you have any questions. I will be happy to assist you any way I can.

Sincerely,

<CPA>

Claims Experience

Camico's 28 years of experience in CPA liability claims has shed light on other aspects of fraud as well. For example, the longer a CPA has provided services to a client, the greater the CPA's risk exposure. That exposure is also greater when the breadth of services provided is more expansive. At some point, the CPA is viewed as a trusted financial advisor with fiduciary responsibilities to safeguard the client's financial resources. The CPA might not be expected to detect fraud in the initial years of the relationship, but in later years juries often expect a CPA to have warned a client about conditions prone to fraud.

Fraud tends to flourish undetected in good times. When the economy is doing well, and businesses are flush with money, people are less likely to notice funds missing. When the economy takes a downturn, capital starts to become more precious, and people look more closely at accounts. Missing funds are more often detected. The longer frauds last, the more financial damage they cause—all the more reason to help clients reduce their exposures sooner.

Small Business Fraud

Small businesses and organizations suffer disproportionately large losses due to occupational fraud, partly because they have fewer antifraud controls in place. The most common incidents of occupational fraud are asset misappropriations, which account for about 85% of all cases and cause a median loss of $130,000, according to the ACFE 2014 *Report to the Nations* survey.

Losses can run much higher, however, such as the embezzlement of some $53 million from the city of Dixon, Ill., from 1990 to 2012 (see "How a $53 Million Fraud Went Undetected for 22 Years: Learning from Past Mistakes," by David R. Hancox, *The CPA Journal*, May 2014). Although the Dixon case involved a small town of 16,000 residents instead of a small business, the loss was caused by a common business scenario: One person had unquestioned authority over the organization's finances. Inadequate internal controls call upon the owner or management to fill the gaps in controls and to verify the legitimacy and accuracy of transactions. The CPA is also expected to warn owners and management about the gaps and how to eliminate or reduce them.

Red Flags

Fraudsters are also known to exhibit certain behavioral traits that can be warning signs. Some of the common red flags for employees include the following:

- Living beyond their means, or having a substantial change in lifestyle
- Becoming extremely possessive of their work records, or reluctant to share tasks
- Becoming apprehensive about vacations and time off, or always being the first in the office and the last out
- Showing signs of substance abuse
- Holding grudges against employers—whether justified or not (which can make occupational fraud more likely).

Employers should consider purchasing fidelity bonds designed to respond to dishonest acts committed by an employee.

Loss Prevention

A tip hotline or complaint-reporting mechanism enables employees, vendors, customers, and outside sources to report suspected fraud anonymously and without fear of reprisal. This is one of the most effective fraud detection techniques and is the most common fraud detection method, according to the ACFE. In the last six ACFE surveys, the most common initial detection method of occupation fraud was the tip, with more than 40% of all cases detected by this method—more than twice the rate of any other detection method in the last three surveys.

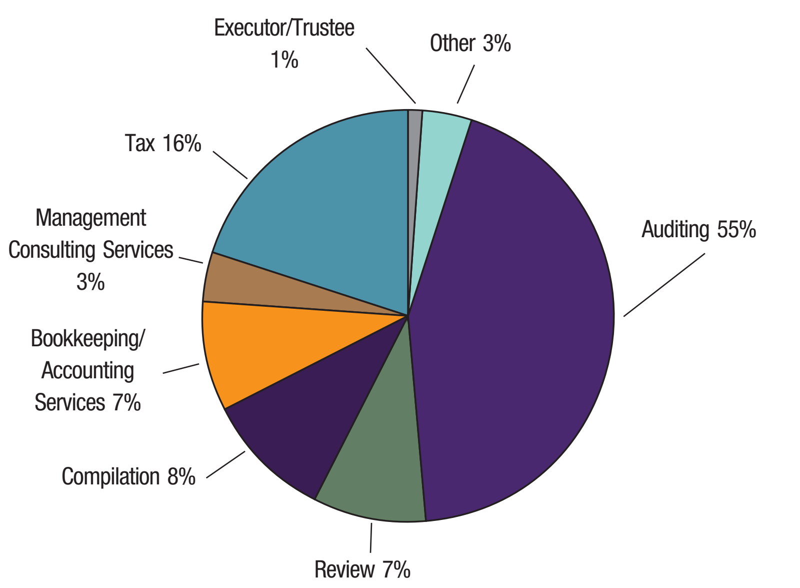
Employees accounted for nearly half of all tips that led to the discovery of fraud. Organizations with hotlines experienced frauds that were 41% less costly and detected frauds 50% more quickly than organizations without hotlines (ACFE 2014).

Implemented anti-fraud controls generally result in reduced losses, partly because the frauds are caught early in the process. The following are other time-proven fraud prevention and detection measures that businesses can implement:

- All engagements require an understanding between the CPA firm and the client, and the best way to document the understanding is with an engagement letter signed by the client. Clearly spell out the nature of the work that will be performed. Describe the limitations of the work and what is expected from the client. CPAs should clarify that fraud detection and prevention are management's responsibilities, that the client understands the assumption of risk in any investment, and that CPAs are not responsible for the outcome of investments.
- Offer a two-tiered approach to bank reconciliation services. This approach helps communicate that standard bank reconciliation services are not designed nor intended to deter or discover fraud. Offering basic (as well as more thorough) bank reconciliation services and having the client choose which service is performed further reduce a CPA's risk exposure. The client can't later successfully allege that they would have opted for the more expensive procedures that might have identified the fraud.
- Insist that employees take a vacation for at least one week every year, and use that time to have the books reviewed for discrepancies.
- Obtain background, credit, and reference checks before accepting significant engagements, paying close attention to client integrity and competency, or lack thereof.

When a business does not provide needed information you need, a CPA should carefully consider the problem. Is the problem sloppy record keeping, or are the actions deliberate? If it appears deliberate, caution is required, especially if one is urged to proceed with work without sufficient documentation. Behavior such as this is a red flag, and repeated delays could be the result of unethical or illegal activity.

EXHIBIT 1
Fraud Claims by Engagement, Three-Year Average (2012–2014)



An Informed Relationship

Effective communication, advice, and warnings are key factors in any CPA-client relationship. By working to stay informed and in control, and by providing good client service, a CPA is helping to safeguard the client's business and is better managing the engagement risk exposures. ❑

Ron Klein, JD, CFE, *is vice president and risk management counsel with Camico where he managed the claims department for 20 years. He is coauthor of the* CPA's Guide to Effective Engagement Letters.