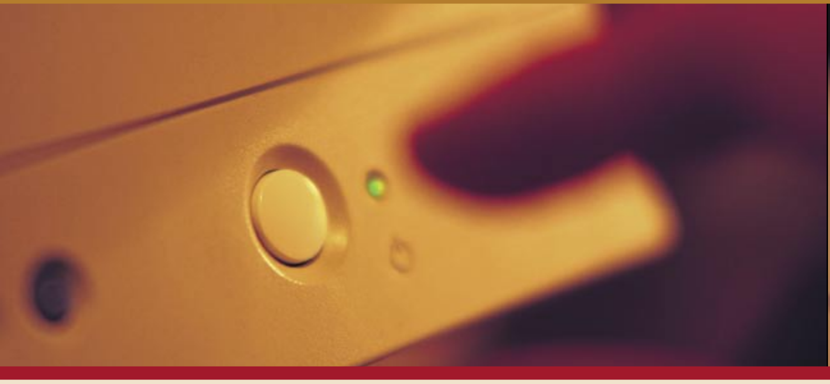

Fraud Prevention

Trust, but Verify

by Brett Pyrtle

Despite waking to a beautiful June morning in 1997, John Benedict's mood was partly cloudy. As CEO of Bentec Engineering, a 28-employee firm that provided instrumentation and control systems for municipal and industrial clients, he had for several months grown increasingly concerned with the discovery that his chief financial officer had been forging his signature on company accounts.

If that violation of trust was disturbing, the phone call he received from his business bank that Monday was devastating. The bank told him it was seizing Bentec's corporate checking account, which contained $74,000, because an investigation revealed over 100 checks had been fraudulently cashed—all without Benedict's knowledge, but with his forged signature.

But forged checks were just part of the problem. As the investigation unfolded, Benedict learned that his financial officer had failed to make 401(k) deposits, had overstated a financial statement by $600,000 and, perhaps worst of all, had not made required deposits for federal, state and FICA employee tax withholdings in nearly two years. The missing amount came to almost $400,000.

For Benedict, an engineer who built a successful business on innovation and marketplace focus, that phone call signaled not only the end of a dream, but the end of his financial security. As sole owner of his company, the IRS held him—not the CFO who committed the acts of fraud—responsible for repaying back taxes and making good on 401(k) deposits.

Today, at age 67, Benedict has had seven years to reflect on how fraud ruined his business. From that distance, he says the worst part may have been how he was blindsided by

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the scope of his problem.

"I had always thought that if I ran into financial difficulty, I would know in advance and just cut back, sell off the assets, or close things down," he says. "But as it turned out, I didn't have that luxury. I never saw it coming."

Headline news, continued abuse

Even a casual observer of business news recognizes that such fraud scams are, sadly, all too frequent. The reason is simple: white-collar crime is a relatively low-risk, high reward enterprise.

"Even if you knew you'd be caught stealing $100 million, you can hide much of it away offshore, confess to your crime in exchange for leniency, and serve your time in a Club Fed prison," says Robert Jensen, a noted scholar on corporate fraud and professor of business administration at Trinity University in San Antonio, Texas.

While the financial scandals that brought down large companies such as Enron and Worldcom have raised public awareness about the damaging effects of fraud, the headlines do not illustrate a long-standing truth: Fraud is far more common—and more devastating—in small- to medium-size businesses.

In its most recent *Report to the Nation*, published in 2002, the Association of Certified Fraud Examiners (ACFE) noted that nearly 40 percent of all fraud cases occur in organizations with less than 100 employees. The median loss to those small companies, at $127,500, far exceeds the average $53,000 loss for firms with 1,000 to 10,000 workers, or the average $97,000 loss for firms employing over 10,000 people. Fully 85 percent of all fraudulent activity involved the theft or misuse of company assets, most notably cash, rather than outright corruption or falsification of financial statements.

"In smaller businesses, those numbers can be killers," says Jim Blanco, a former U.S. Treasury and California Justice Department forensic investigator and author of *Business Fraud: Know It and Prevent It*. "Look at bookkeeping scams. The same person who pays the bills in a company should not be the one logging the revenue. Should things like that happen? No. Do they happen? Yes."

Craig Arends, principal in charge of LarsonAllen's corporate governance services, agreed that such "segregation of duties" is a vital first step to curbing the potential for fraud.

"A recurring issue for small- to medium-size companies is cost control," Arends says. "If a business can't afford to hire three more people to do this, good cross-training can help flush out potential problems. For example, if someone is doing payroll, but they know someone else in the office is trained to handle it, that serves as a deterrent because the chances of getting caught are higher."

Tools to improve fraud prevention

Virtually every fraud expert agrees on one point: There is no absolute preventive tool. However, those same experts are quick to add that most small- to medium-size businesses could be far more diligent—and more public—about improving their defenses.

"You're never going to have an ironclad curtain against fraud, but you can define your risk tolerance around internal controls," says Arends. "If you design a strong control system, set up some random testing procedures, and then talk about all of that with your employees, you're probably preventing fraud without knowing it."

However, the basic elements of internal control, such as regular audits or effective records management, are often overlooked by small business owners. While such items do add cost, the results can be well worth the investment.

For example, a report by the American Institute of Certified Public Accountants (AICPA) showed that companies conducting regular internal or external audits had losses averaging 35 percent less than firms with no audit function at all. Meanwhile, a good records management system can be one of the single most effective deterrents to identity theft, which opens the door not only to a variety of fraudulent activities, but to significant public relations issues.

"One company here in California just threw out boxes of old financial records. When they wouldn't fit in the dumpster, they just stacked the boxes next to it," says Blanco. "A citizen came by, saw all those records with Social Security numbers and the like sitting in the open, and reported it to the media. Now, just because someone wasn't thinking, that company has got a big confidence problem."

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Source: American Institute of Certified Public Accountants (AICPA)

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Another often-overlooked control step is conducting detailed background checks as part of the hiring process. A 2003 study conducted by the Society for Human Resource Management (SHRM) reported that at least 75 percent of all companies do basic reference checks. But the gap between large corporations and smaller firms widens considerably when the investigations extend to an applicant's work history, criminal background, and education. In fact, while 77 percent of all companies with 500 or more workers do verify educational credentials of prospective hires, only 47 percent of firms with less than 100 workers take that step.

Background checks serve as more than an additional control point. The process also makes a statement that the organization values honest, above-board behavior.

"Much of fraud prevention starts with good hiring practices, particularly with people in high-risk areas such as finance and accounting," says Blanco, who has investigated over 5,000 fraud cases during a 20-year career. "If you bring quality people on board, then you've already stacked the deck in your favor."

Ethics: The missing dimension?

In the post-Enron era, government regulators and the accounting profession moved quickly to reassure a nervous American public by constructing new safety nets.

The Sarbanes-Oxley Act of 2002, for example, created a five-member Public Company Accounting Oversight Board (PCAOB), which has the authority to set and enforce auditing, attestation, quality control and ethics standards for public companies. It is also empowered to inspect the auditing operations of public accounting firms that review public companies, as well as impose disciplinary and remedial sanctions for violations of the board's rules, securities laws and professional auditing standards. Meanwhile, the AICPA, representing over 350,000 CPA's nationwide, introduced SAS (Statement on Auditing Standards) 99, *Consideration of Fraud in a Financial Statement Audit*, which broadened the reporting and assessment tools for auditors to evaluate potential deception in financial reports.

While the control improvements were welcome news in the fight against fraud, many experts believe problems will continue without stronger ethical leadership.

"All of these recent scandals called attention to the fact that many top corporate executives were seeking to loot their companies while paying little heed to the stewardship responsibilities of their offices," says Jensen of Trinity University. "The important thing about that is the tone that it sets at the top of the company, and what we're finding is that a lot of top managers are out of tune."

Chuck Ladd is a CPA and Certified Fraud Examiner based in Hudson, Wis. In recent years, he says he has encountered a greater acceptance of unethical behaviors. While issues around motivation and opportunity—two sides of what he describes as the "fraud triangle"—have changed very little in his 30-year career, there has been a large spike in peoples' ability to rationalize fraudulent behavior.

"Frankly, I'm concerned that so many people are able to do this and justify it in their own minds," says Ladd, noting that an ethics component is a required part of the accounting courses he teaches part-time at the University of St. Thomas in Minnesota. "That's why I think accounting is the perfect place to discuss ethics, because the accountant is the scorekeeper."

For Benedict, the former owner of Bentec Engineering, Ladd's call for ethical behavior is too little, too late. Benedict's former scorekeeper, the chief financial officer, received a minimal sentence for his acts and has no financial liability for repaying back taxes or promised 401(k) deposits. Those responsibilities fell to Benedict, who will spend at least the next three years turning over his personal income to the Internal Revenue Service.

His best advice to other business owners? Trust, but verify.

"The perception in the small business world is that things like this aren't a concern, because you've got other day-to-day things to focus on," he says. "And when it comes to the books, you just trust your financial people. You wouldn't hire them if you didn't trust them. But for me, trusting them was a mistake."

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