Training: a powerful way to prevent Fraud

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Preventing fraud is a big responsibility for all levels of financial management—manager, controller, and CFO. Since managers are responsible for preventing and detecting fraud, they must constantly ask themselves, "What more can we do?"

Most fraud is discovered through internal controls, auditors, and employees who notice suspicious activities. Therefore, you may want to consider training fiscal employees and managers to detect fraud.

Training offers several benefits. Well-trained employees can protect your company by identifying suspicious activity. Training provides an effective way to communicate management's commitment to ethical operations. If employees and external auditors see that management is serious about reducing fraud, training could help control audit fees by reducing the time the external auditor must spend on fraud assessment.

An important component of anti-fraud training is the case study. Surveys of corporate training directors indicate that case studies help users develop problem-solving skills, critical thinking, and judgment. They also emphasize intuitive thinking rather than rule-based thinking. Further, case analysis allows trainees to experience the challenge of putting meaningful clues together. This is particularly important because it's often hard to put clues together in a timely fashion—the average time to detect misappropriation of assets is two to three years.

Figure 1: Background

The foundation is a highly respected, well-known charity. Susan, the executive director, has improved its fiscal health and regional prominence over the past decade. As a result, the nonprofit organization is now in a position to be much more influential in helping the local community as well as citizens of the surrounding area.

Although it has grown steadily, the number of employees has not increased due to the uncertainty of the donor base and the level of available contributions. The assets of the organization are more than $30 million, and this year's annual operating budget is just over $15 million. The director of finance controls the budget closely to be certain the foundation doesn't exceed the expected level of yearly contributions.

The foundation doesn't have an internal audit staff. For more than a decade, the foundation engaged the CPA firm of West & West, but seven years ago the auditor-in-charge identified financial irregularities and recommended Susan's termination.

The Board of Directors accepted Susan's explanation that she was so eager to improve the nonprofit's financial position that some policies and procedures were overlooked. She agreed to repay the $30,000 in question. West & West resigned, and a new CPA firm was engaged. No further instances of inappropriate use of funds were noted.

The case study we present here is based on the content and guidance contained in Statement on Auditing Standards (SAS) No. 82, "Consideration of Fraud in a Financial Statement Audit." It has three learning objectives:

1. Help employees identify risk factors and explain how these clues might help identify wrongdoing,
2. Help employees identify features of schemes that make them difficult to detect, and
3. Help employees identify characteristics of perpetrators that make misappropriation difficult to detect.

The case introduces employees to several clues usually associated with fraud, including four control risk factors contained in SAS No. 82:

- Lack of management oversight,
- Lack of timely and appropriate documentation for transactions,
- Lack of appropriate segregation of duties or independent checks of performance, and
- Discrepancies in accounting records, such as when payments are made but inventory purchases can't be identified.

THE CLUES

As a first step in the training, have the instructor give each employee a copy of the information included in Figures 1-4.

Figure 2: The Foundation's Organizational Chart

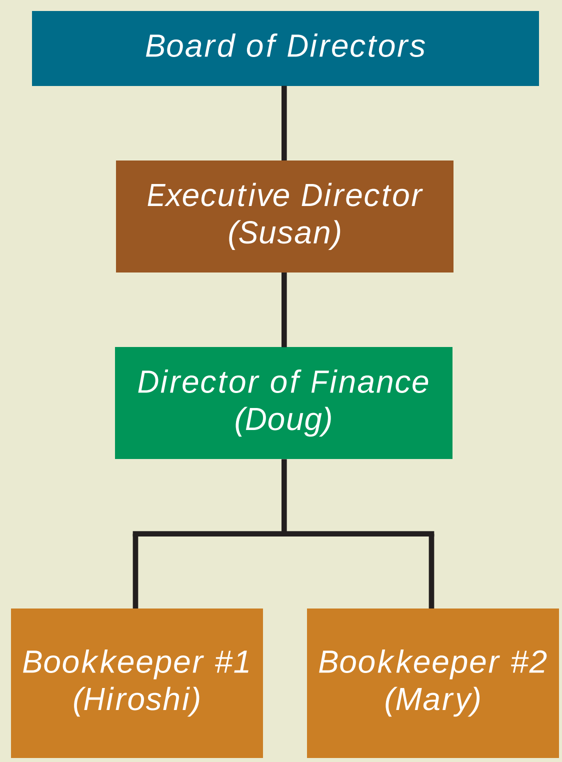

Figure 3: The Employees

1. Executive Director. Susan has worked for the nonprofit for about 12 years and is involved with a variety of well-respected service organizations. During her tenure, the foundation's stature has improved dramatically. Susan recruited several prominent citizens who significantly increased the foundation's resources.

2. Director of Finance. Doug joined the foundation a little more than seven years ago. He has a degree in accounting and more than 20 years' experience with similar organizations across the country. He has a loud, assertive personality and is physically imposing at 6'10".

3. Bookkeeper #1. Hiroshi has a degree in accounting from an Asian university and about 10 years' experience in his home country. When he moved to the United States two years ago, the foundation hired him to be responsible for accounts payable.

4. Bookkeeper #2. Mary, who earned her associate degree in accounting at a community college, has worked for the foundation for almost nine years. She is responsible for payroll, travel reimbursement, and corporate credit cards.

Figure 4: The Scenario

◆ Over the past six months, Hiroshi noticed a number of invoices for computers and furniture. He felt uncomfortable asking the executive director or director of finance about the purchases, so he decided to look around. He noticed a few new pieces of furniture in Susan's office.

◆ Each Tuesday evening the foundation runs checks for invoices due that week. Wednesday mornings, Hiroshi verifies the amount of each check with the register and confirms that all supporting documents are attached. After reviewing the register and documentation, he mails the checks. But this week, Hiroshi is concerned about one of the checks. It is for travel reimbursement to the executive director, but no supporting documentation is attached. Hiroshi speaks with Mary, reminding her that she still has not given him documentation for several such reimbursement requests in the past.

◆ Hiroshi checks with their supervisor, Doug, the director of finance. Doug tells him Susan is vacationing in Europe for a couple of weeks. He says he'll check with her as soon as she returns. While Hiroshi and Doug are talking, a contractor comes to Doug's office with a construction invoice. Doug hands the invoice to Hiroshi and tells him to process it, using the account code for the foundation's new building.

After the employees finish reading the materials, ask them to write out short answers to the following questions. Then initiate discussion.

Discussion Questions

1. Do you think Mary is a competent employee?

2. Is Mary pushing off some of her work on Hiroshi?

3. Do you think Hiroshi is a competent employee?

4. Do you think Doug is a competent employee?

5. Do you think an employee theft of assets may be occurring?

6. If you think theft may be occurring, who is the most likely suspect? Why?

Most likely, some employees will speculate about a possible theft, and they are eager to know if their suspicions are correct. But the first four questions are actually distractions so that the intent of the case isn't too transparent. Disclosing the answers is usually most effective if saved until the end of the discussion.

ADDING IT UP

Once the trainees have shared their responses, the instructor may introduce the specific risk factors in the scenario. First, ask the participants if Hiroshi was able to find all of the furniture and computers that were invoiced for payment. (This corresponds with the risk factor related to discrepancies in the accounting records.) Since he was only able to identify some furniture and none of the computers, this suggests a possible concern with inventory levels.

Another risk factor is missing documentation. The trainer might ask if anyone thinks this should be a matter of concern. Apparently, the executive director is requesting numerous reimbursements, but she doesn't give the accounting clerks the appropriate doc-

umentation to substantiate the payments. Missing documentation may suggest control problems, but it could also be an important clue to employee theft.

The next question is whether Doug handled the contractor's invoice appropriately. Doug simply handed it to Hiroshi and told him which account to use for payment. Although we would like more information, it appears that Doug is being far too casual about this vendor payment. Hiroshi should try to validate the vendor, the work that was done, and the materials that were used so he can be satisfied that the work actually related to the construction of the foundation's new building. The new building should have a list of approved vendors who may legitimately claim reimbursement.

Many training aids assume the perpetrator is at a lower level of the organization than the person who detects the fraud. In such cases, the person in charge may decide the level of punishment and the degree to which the incident should be disclosed. The interesting twist in this case is that the perpetrators are supervisors, and the individuals who detect the wrongdoing are subordinates. Thus, the personal concerns (loss of job) and the ethical dilemma (supervisor wrongdoing) combine to present a more complicated situation.

This case is based on two actual instances of misappropriation of assets by two persons in authority at the same charity. In the first case, the executive director misappropriated $30,000. The foundation's CPA firm resigned because the Board wouldn't fire Susan, who remained in charge for more than a decade.

After about seven years, she started misusing assets again. She charged personal expenses on the corporate credit card and wasn't required to produce receipts. These expenses included expensive foreign travel and resort vacations for Susan and her husband, personal computers, home furnishings, the cost of entertaining, and gifts for family. The total exceeded $250,000.

The second fraud was perpetrated by Doug, the director of finance. Doug hired a contractor to remodel his home at the same time the foundation was building a new office building. When Doug received the invoices for the work on his house, he directed the bookkeeper to code the work as part of the foundation's project and to process the invoices for payment. The fraud totaled over $100,000.

NEW CASES

If an anti-fraud trainer wants more case studies, they are easy to develop. The trainer can search newspapers, magazines, and business journals for recent incidents. Next, he/she should identify risk factors from SAS No. 82 that were present. The trainer can use those factors to determine whether the employees recognize them in a different context.

But what can an organization do when a subordinate knows—or suspects—fraud is taking place? Or maybe the employee knows accounting policies and procedures have been circumvented but doesn't challenge the supervisor.

First, consider installing an employee hotline so lower-level employees can report such instances anonymously. Second, management at all levels must be committed to ethical standards and a code of conduct that is well-known throughout the organization.

Also, consider the benefit of ongoing fraud training. Making sure employees can identify risk factors on a regular basis helps them become more sensitive to clues of "misappropriation in action." The more employees you have who can identify risks, the more power you have to detect—and deter—fraudulent activity. ■

A presentation-ready version of these case materials is available from the first author.

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