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***THE MATH OF FRAUD PREVENTION***

**PRESENTATION TO COMPANIES/CO-OPERATIVES  
ON A FRAUD PREVENTION STRATEGY**

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## INTRODUCTION

Fraud is by far the most serious economic crime in the world. It is the biggest illegal money-spinner, ahead of drug running. Almost every large business has suffered from fraud and the latest survey by the *Association of Certified Fraud Examiners* (ACFE) shows that an estimated average of 7% of company turnover is lost to fraud every year. Small and medium businesses are often destroyed by frauds perpetrated against them. The bad news is that not only is the cases of fraud at the workplace accelerating, the amounts involved are also increasing. Yet, law enforcement is unable to cope with the enormous number of frauds perpetrated against businesses and the public sector. Businesses will have to deal with this risk themselves.

## THE ATTITUDE

A fundamental building block of a company's vulnerability to fraud is that executives very often refuse to accept that fraud will happen in their organisation. Fraud, or the incidence of it, has long been considered a taboo subject within corporate circles. No one seriously wanted to talk about it, let alone admit that it could potentially happen within the company.

### *We have no fraud*

No company is completely immune to fraud, even if it's the smallest infraction, such as the clichéd theft of company-owned pencils. More realistically, if a company is so well run that the 7% estimate of revenue lost to fraud is vastly overstated, it is unlikely that such a company would be losing nothing to fraud. Even more compelling is the result of a survey by *The Economist*, which found that as many as 85% of companies were already victims of fraud and this does not include companies where fraud occurred but was not detected. So, by implication, management of any company must assume that some fraud exists or will occur and they would be well advised to be alert to the risk.

### *Our people don't commit fraud*

Sadly, they do. Research by *Ernst & Young* indicates that insiders commit 85% of frauds. The reality is that every company has some employees who are either fundamentally dishonest and who without doubt will at some point commit fraud or some employees who, while essentially honest, will succumb to the temptation to commit fraud if the opportunity presents itself. The statistics for workplace fraud of the ACFE therefore confirms that it's the older dogs that learn the new tricks:

- 88% are first time offenders;
- 46% were employed for more than 6 years;
- 49% were over 40 years of age;
- 50% has a bachelors or post graduate degree;
- 34% were managers.

### ***Implementing an effective anti-fraud program is too costly***

In the latest report of the ACFE (2008) they concluded:

- Occupational fraud schemes frequently continue for years before they are detected. The typical fraud in this study lasted two years from the time it began until the time it was exposed.
- The implementation of anti-fraud controls appears to have a measurable impact on a company's exposure to fraud. Fraud cases where businesses conducted surprise audits suffered a median loss of \$70,000, while those that didn't had a median loss of \$207,000.
- Lack of adequate internal controls was most cited by 35% of the respondents as the factor that allowed fraud to occur.

### **WHY IS IT IMPORTANT?**

Do the math. Based on the 7% norm, a company with an annual turnover of R50 million is probably losing R3,75 million a year because of fraud. On the other hand, there is the possibility that a fraud prevention program can limit this loss by more than half after it has paid for its own cost.

Say that such a program cost, for the sake of the argument, R500 000 to implement while the loss to fraud decreases by 50%, the anti-fraud program saved the company R1,875 million immediately. The net saving amounts to R1,375 million after deduction of the R500 000 cost of the program. This is a return of 275% on the initial cost, not to mention the opportunity cost in the form of lost customers, higher insurance cost and a lower share price the negative publicity of an exposed fraud incident will cause.

Apart from making economic sense, having the right strategy to identify, stamp out and prevent fraud is not just good practice anymore, it is essential. According to the International Auditing Standard 240 and the Companies Act, those charged with governance of the entity has a duty in terms of legislation and regulation to stamp out fraud. The principles of good corporate governance as dictated by the King II report also necessitate fraud prevention.

The establishment of a Fraud Prevention Plan also acts as a deterring factor to would be perpetrators and enhances the external perception of stakeholders that the entity is taking positive action. Essentially, every company should answer the following questions to its own satisfaction:

- Are we maintaining an anti-fraud environment?
- Do we understand and manage our risks?
- Are we proactive in defending our assets?
- Can we react swiftly when fraud is uncovered?

Implementing measures to address these questions not only helps companies protect themselves and their employees against fraudulent acts but also potentially saves revenue, enhances market value, averts civil lawsuits and maintains a positive company image.

## WHO IS RESPONSIBLE?

Don't be mistaken in assuming that it is the external auditor's responsibility to address fraud in your company because it isn't. International Auditing Standard 240 clearly states that the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and with management. It further states that management, along with the oversight of those charged with governance, should place a strong emphasis on fraud prevention and fraud deterrence with the possibility of detection and punishment. Adding to this, Section 424 of the Companies Act states that if any business of a company was or is being carried out recklessly or for any fraudulent purpose, any person who was knowingly a party to the carrying on of the company shall be personally responsible, without any limitation of liability, for all the debts or other liabilities of the company.

Directors should therefore not lose sight of the fact that they remain ultimately responsible, both jointly as a board and individually, for the well being of the company. Furthermore, by virtue of the neglect of his fiduciary duty to the company, the company's stakeholders may hold a director personally liable if losses occur.

## THE WAY FORWARD

Only through diligent and continuous effort can a company protect itself against significant acts of fraud. We have identified ten key principles for proactively establishing a control environment to effectively manage a company's fraud risk:

1. The success of fraud prevention requires an acceptance and **commitment** by all role players. Strong support and direction from the executive team is thus essential to create the corporate governance and management oversight the stakeholders expect from the company.
2. The board of directors and the executive management must be **made aware** and coached to understand where, by whom and why fraud is committed at the workplace in order to create a culture of honesty and high ethics.
3. As part of a company's governance structure, a fraud risk management program should be in place, including a **written policy** to convey the expectations of the board of directors and senior management regarding managing fraud risk.
4. Fraud **risk exposure** should be assessed periodically by the company to identify potential schemes and events that the company needs to mitigate.

5. The staff should be educated in **honest and ethical behaviour** to ensure that the entire organisation is aware of their responsibility to prevent and detect fraud within the framework of a written code of conduct.
6. **Prevention** techniques to avoid potential key fraud risk events should be established, where feasible, to mitigate possible impacts on the company.
7. **Detection** techniques should be established to uncover fraud events when preventive measures fail or unmitigated risks are realised.
8. A **reporting process** of which the confidentiality is guaranteed should be in place to solicit input of employees on potential or possible fraud.
9. A coordinated approach to investigation and **corrective action** should be used to help ensure that occurrences of fraud are addressed appropriately and timely.
10. Let employees, shareholders, suppliers, contractors and customers know, by both statement and deed, that **fraud will not be tolerated**.

Fraud is perpetrated where motive and opportunity are present. In addition, when the employee is able to rationalise his behaviour as something other than a crime, a fertile breeding ground for fraud is created. As no prevention strategy is ever foolproof, an effective investigation capability is of utmost importance because it reduces the potential for loss, increases the prospect of recovery and acts as a deterrent.

## **WHY FORENSIC ACCOUNTANTS?**

An effective internal audit team can be extremely helpful in performing aspects of the oversight function. Their knowledge about the entity may enable them to identify indicators that suggest fraud has been committed. Internal auditors also have the opportunity to evaluate fraud risks and controls and to recommend action to mitigate risks and improve controls. This risk assessment is to serve as the basis from which audit plans are devised and against which internal controls are tested.

Independent auditors focus on errors, omissions, exaggerated assertions and misstatements of fact. According to the North Carolina Wesleyan College, a regular auditor detect fraud only 10% of the time, and then it will probably be by accident, most likely because of the random sampling nature of what a regular auditor looks at. However, independent auditors can assist management and the board of directors (or audit committee) by providing an assessment of the entity's process for identifying, assessing, and responding to the risks of fraud.

Forensic accountants on the other hand provide extensive knowledge and experience about fraud that may not be available within a company. The forensic accountant does not replace the internal and independent auditor but assist the audit committee and board of directors with aspects of the oversight process either directly or as part of a team of internal or independent auditors. They are complimentary to the existing

functions and are distinctively positioned to explore the design of corporate governance systems, the role of the financial reporting system in corporate governance, the effect of the governance board on employee and managerial behaviour, and the efficacy of the internal control system. By helping companies prevent and detect fraud, the forensic accountant's role is a key component in the corporate governance system.

**Do the math.**

**Can your company afford to be without a fraud prevention strategy?**