

MFA Perspective

The Four Pillars of Fraud Prevention
How Leaders Can Safeguard Their Organization



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THE FOUR PILLARS OF FRAUD PREVENTION: HOW LEADERS CAN SAFEGUARD THEIR ORGANIZATION

Fraud is a business epidemic that continues to thrive despite the focus on internal controls made popular by Sarbanes-Oxley. But company leaders who believe that only large public corporations suffer the setbacks caused by fraud are missing a reality that could cost them their business: small to mid-sized private companies are not only impacted, they are the leading victims.

Indeed, fraud is wreaking havoc on the private sector which currently accounts for approximately 40 percent of all fraud cases at a median loss of \$200,000. Even more startling is the size of these companies, as most carry fewer than 100 employees. Given that the average fraud has been occurring a full two years before detection, it can often deliver a crippling blow.

The risk of fraud is therefore substantial and the median loss amounts have been increasing steadily over the years. Company leaders must remain aware and alert to the dangers, especially in the current economic climate. Fraud is a direct result of overwhelming financial pressure placed on an individual, and those pressures are increasing as consumerism meets a historically difficult economic environment. The collapse of the financial sector, falling housing prices and the pressures of a consumption lifestyle will motivate the unlikeliest of individuals to commit acts of misappropriation.

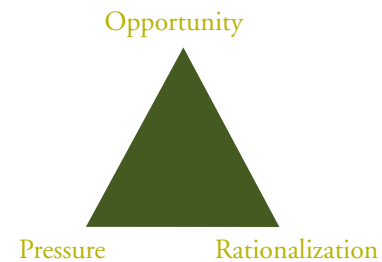
The first step to minimizing the risk of fraud is to acknowledge that even in a small company with a family atmosphere, blind trust is not an acceptable business practice. Executives often believe their companies to be immune from the risk because they know their staff and every inch of their operations. Most fraud, however, is committed by people who have a long history with an organization and are well trusted by its leaders.

Establishing a strong internal controls environment, instituting fraud prevention and detection measures, and

understanding that no organization is exempt from this risk will help to safeguard a company. There are four key considerations that management should undertake to effectively mitigate the risk.

1. Know the Fraudster

Those who commit fraud come from all levels of an organization, but they have a couple of things in common. They follow the pattern of the Fraud Triangle, which paints a simple picture of what leads individuals down this road: Pressure, Rationalization, and Opportunity.



Pressure arises from perceived urgent financial needs that outpace compensation. In extreme cases, this can be linked to kidnapping or extortion that places employees in an untenable situation. More frequently, the pressures of everyday life catch up to people and leave them with limited options to maintain or enhance their lifestyle. Mortgages, college tuition, illness in the family, etc. can result in debt accrual beyond expectations. Meanwhile, as professionals grow older their earning power plateaus and it becomes clear that significant jumps in legitimate compensation will not be the answer.

And although the practice is dishonest, every fraudster is capable of **rationalizing** their actions. They may believe they deserve higher compensation, or that the company is not treating them fairly. It may even be as simple as wanting to show that they can “beat the system” and come out on top.

Pressure and rationalization are personal issues to which companies are rarely attuned. It is only the third corner of the triangle – **opportunity** – that can be addressed by companies to help prevent fraud.

2. Know the Opportunity

Few organizations have truly air-tight internal controls, and fraudsters know that as well as the executives who run the company. From reimbursement procedures to data security, every enterprise has processes that can be exploited for financial gain.

As potential criminals can identify these opportunities, management must know where the risk lies and reduce it as much as possible. For example, a small company that allows one employee to take full ownership of a process is inviting risk: with no checkpoints from beginning to end, this gives an individual ample opportunity to betray the organization's trust. Duties should be segregated across different teams in order to close that window of opportunity.

3. Prevent

Armed with an understanding of what is at stake and where the organizational weaknesses are, management can take effective steps to prevent fraud. Practical deterrence works when it is founded upon the key principles of secure processes: instituting reasonable oversight, establishing checks and balances, segregating responsibilities, and eliminating management override.

There is a range of activities that serve as preventive measures. Shoring up internal controls is the widest reaching initiative, and fraud training, developing a code of conduct, and communicating a strong anti-fraud policy are also beneficial programs.

The process should extend to external relationships as well. Systems as simple as regularly scheduled account reviews should be in place with vendors and customers so that management can keep an eye on the books from all angles.

4. Detect

Prevention initiatives are only half the battle. Companies that are serious about safeguards should also implement detection tools that can help uncover a fraud in progress.

There are a number of effective detection measures, but none is as powerful and cost effective as a tip hotline. Tips are the leading cause of fraud detection by a wide margin, and they continue to be successful primarily because of their ease of use and human nature. Honest workers will often take action against dishonest activity if they have safe means to do so, and an anonymous hotline provides them with just that. With this simple tool in place, employees feel empowered and fraudsters may hesitate. Meanwhile, the organization spends a few dollars each month on a hotline that could save millions.

Fraud is also frequently detected by a strong internal controls environment and internal and external audits.

The Perfect Mix

To most effectively address fraud, a blend of detection and prevention measures should be ingrained in an organization's culture. Of course many companies are limited by resources, especially more vulnerable, small to mid-sized private companies. In such a case, the key to selecting the best course of action is to rationalize each control. Management should closely scrutinize initiatives and evaluate why the control is in place, what risk it mitigates, who performs it, and if there is a more efficient alternative.

Whichever implementation course is followed, the most important starting point in fraud prevention is realizing that the responsibility to mitigate risk rests squarely on management's shoulders. Applying principles of effective oversight can promote efficiency, create transparency and effectively minimize an organization's exposure to fraud.

FOR MORE INFORMATION, PLEASE CONTACT

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