GREAT AMERICAN & LOWERS RISK GROUP | ISSUE #41 | APRIL 2018

FIDELITY/ CRIME OBSERVER

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OCCUPATIONAL FRAUD:

A Hidden Killer of Organizational Performance

Occupational fraud is a largely hidden threat to the bottom line of almost every organization in our economy worldwide. Also known as employee theft or embezzlement, occupational fraud describes a range of willful employee misconduct through which businesses lose money.

No industry is exempt, with a collective global cost estimated at more than $3.7 TRILLION ANNUALLY.

In the end, occupational fraud is a crime that violates the basic trust an employer or organization puts in a person. In many cases, especially those involving financial statement fraud, the perpetrator is often a person with considerable authority and/or is a highly trusted leader within the company, or a close friend or family member. No department or position is exempt, a top-to-bottom zero tolerance policy, a code of conduct, and other controls are critical for every organization. Later in this guide we offer information about perpetrator profiles and red flag behaviors.

Downloand Full Guide Here: http://www.lowersriskgroup.com/lp/occupational-fraud-whitepaper

ABOUT US

Lowers Risk Group
provides comprehensive enterprise risk management solutions to organizations operating in high-risk, highly-regulated environments and organizations that value risk mitigation.

Great American Insurance Group
understands the importance of choosing a financially strong company. We are an organization built for the long term and are committed to giving you that strength. For nearly 150 years, Americans have trusted us to protect them. Our innovative insurance solutions and specialization serves niche marketplaces that we know well. This expertise gives us a successful foundation that spans generations.

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THEY DO THINGS DIFFERENTLY OVER THERE

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Well run U.S. based companies have more than adequate checks and balances in place. For starters, publicly traded companies have to comply with Sarbanes-Oxley requirements. While these companies may have acceptable controls in their domestic operations, the same may not be true for their foreign locations. You hear managers rationalize that the company is not centralized, that overseas operations are run independently and may do things differently. The problem they face is that ***inconsistent controls will leave the company vulnerable to major losses.***

Such is the case of a retailer with franchisees that operates stores in Asia. In order to maintain the appearance of their U.S. stores, the company subsidizes renovations of furniture, fixtures and fittings. One employee in China was responsible for the program. He was tasked with oversight of tens of millions of dollars of renovations.

The renovations were supposed to be completed by pre-approved vendors. The employee obtained bids from these vendors, approved the bids, verified the work was completed and approved the invoices for payment.

At first, the employee followed procedures to the letter. In time however, he saw an opportunity to syphon funds from the program. He approved two new vendors in the system. He then cut deals with the new vendors to steal in three ways.

One was to inflate the invoices for work to be done. After the invoices were approved by the employee, the vendors shared the inflated amount with the employee.

Second, the employee issued duplicate payments for the same work. Part of the payment was kicked back to the employee.

Last, the employee approved invoices for work that was not done. He did so with the intent of splitting the payments with the vendor.

Life was good for the employee who enjoyed weekend gambling trips to Macau where he was known as a high roller.

His world came crashing down after three years when an anonymous tipster brought the scheme to the attention of the company. The employee was arrested and spent five years in prison.

THE COMPANY LOST $4.5M AS A RESULT OF THE SCHEME.

This type of loss would not have happened to the domestic company. They had vendor controls in place. Vendors were subjected to screenings and background checks before given approval. The Asian operation did not do this. No due diligence was completed on the new vendors the employee approved. Domestically, there was a separation of duties regarding construction projects. No one person could obtain bids and then approve them, much less verify the work and approve payment. Not so in Asia. The domestic operation was subject to yearly audits by outside auditors. Asia expected a visit from internal auditors every five years. This gave the dishonest employees time not only to steal, but to figure out a way to cover it up.

The employee in this case saw an opportunity to steal and took full advantage it. This company accepted that they do things differently over there.

THE QUESTION IS...
WHY IS THAT ACCEPTABLE?

OCCUPATIONAL FRAUD:

A HIDDEN KILLER of Organizational Performance

PREVENTION

When it comes to limiting the losses associated with occupational fraud, prevention is critical. Fraud prevention measures range from anti-fraud training, reporting programs (whistleblower programs), and hiring policies to "setting the tone from the top," performing risk audits and assessments, and putting in place strong antifraud controls are essential in being proactive about risks.

As author and leadership expert Robert Stevenson pointed out in his keynote address at a recent ERM Conference, "If you don't like paying attention to risk, you will hate paying attention to extinction." He emphasized the need to approach risk management beyond just reducing the chance of losses, but rather to ensure the survival of an organization. He emphasized, "Future success is not inevitable because of past triumphs." In other words, waiting until something 'bad' happens is waiting too long.

Further proactive preventions include:

- Fostering a Culture of Awareness
- Requiring Compliance
- Expecting Detection of Incidents
- Zero Tolerance
- Clear Consequences & Disciplinary Action
- Appropriate Oversight
- Regular Periodic Analytical Reviews
- Employee Job or Duty Rotations
- Internal Audits – both routine and surprise.

DETECTION

Detecting fraud can come from a variety of sources, including an internal audit, an internal or external whistleblower, surveillance, or even by accident. The means of detection also correlates closely with the likely loss and resulting recovery. Frauds detected by internal controls or internal audits generally result in far smaller losses than frauds detected by external or reactive measures such as a whistleblower tip. However, the most common source is usually a whistleblower tip from a fellow employee.

To be effective, all compliance programs must have some systems in place for reporting fraud. The most effective ones include an anonymous hotline or web-based portal for reporting a suspected fraud. While anonymous tips via reporting system or hotline are not necessarily the most effective for prevention, they end up helping the most often of all systems.

Since most tips come from within, it makes sense to set up an anonymous reporting system that allow employees to do so effectively and without fear of repercussion. These outlets are one of the best guards against fraud. Empowering all levels of staff to be protecting the company can build morale and deepen employee commitment to the company's healthy bottom line.

Internal controls, or a direct reporting system, are also highly effective.

- REPORT TO A DIRECT SUPERVISOR: 20.6%
- REPORT TO COMPANY EXECS: 18%

External controls in the form of regular audits and complementary internal/external controls designed to work in collaboration are the other most effective detection systems.

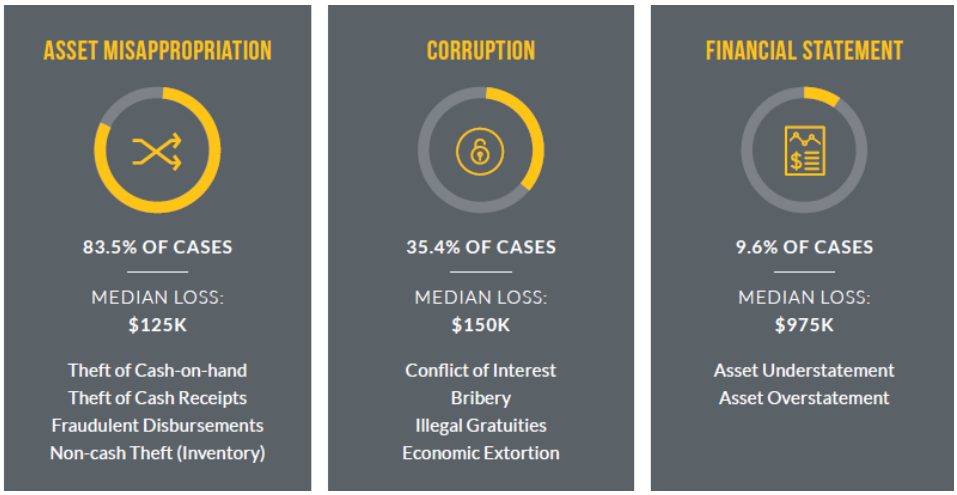
A final factor in detection is direct discovery - whether active or passive. Active discovery, meaning putting methods in place with an expectation of detection, results in lower median loss and durations than detection through passive discovery, which is more happening upon an incident. Active discovery methods include surveillance, monitoring and account reconciliation. Examples of passive discovery methods are police findings or discovery by accident.

RESPONSE / RECOVERY

If and when an incident is suspected, a timely, efficient and appropriate investigation is critical. Acting fast and being proactive can not only mitigate the risk but in some cases can even recover losses. Especially if an internal control is the method for detection (whistleblower or direct report), fast action will reinforce the risk management system and further the protective quality of the entire program. Conversely, a slow response or ignoring a suspected threat will deteriorate any anti-fraud program and can send a message that the organization is complacent, potentially even encouraging others to pursue misconduct.

Sadly, more than 40% of victim organizations don't report misconduct for fear of damage to an otherwise respectable reputation. Not reporting, however, can be translated into condoning. As much as it pays to pay attention, it also pays to report.

81% of the time legal action proceeds, the judgement is awarded to the victim organization. In less than 10% of cases is a victim organization fined.



CONCLUSION

Occupational Fraud: A Hidden Killer of Organizational Performance

Whatever the methods employed, fraud prevention systems are critical to protecting your business. When a program is designed and managed well, internal and external teams can continuously flourish and collectively produce a healthy culture and bottom line. Left hidden or ignored, occupational fraud can quietly drain the profits as well as the resilience of the organization.

TAKE ACTION TODAY.

Proper planning can help your business avoid becoming a statistic in the next study. If you need help designing an effective fraud prevention program that doesn't let "red flags" go unnoticed, we can help. Request a consultation with a Lowers Risk Group consultant, and download the full Occupational Fraud Guide today.

http://www.lowersriskgroup.com/lp/occupational-fraud-whitepaper

WHY FRAUDSTERS DO WHAT THEY DO

Most managers and owners eventually discover a case of fraud and abuse in their organization. The fraudster is often a trusted, long-time employee or manager who had or created access to some of the organization's assets, and helped him or herself to it.

WHY DOES THIS HAPPEN?

The answer is not simply greed, but most, maybe even all, people want things and want more things. There are studies that show an amazingly high proportion of employees or managers have taken small things from their organization. However, there is a line between this petty theft and intentional fraud that a few people cross over.

THE FRAUD TRIANGLE: A MODEL FOR UNDERSTANDING FRAUD

The fraud triangle, created by criminologist Donald Cressey, lays out the three factors that make up a true case of fraud. Like all crime, fraud requires both motive (called "pressure" in most discussions of the fraud triangle) and opportunity. Cressey named two of the legs of his triangle after these, but added a third element—rationalization—that is needed to account for the fact that occupational frauds can go on for a very long time before being discovered. The rationalization allows the fraudster to dull the pain of remorse and carry on as if nothing were wrong.

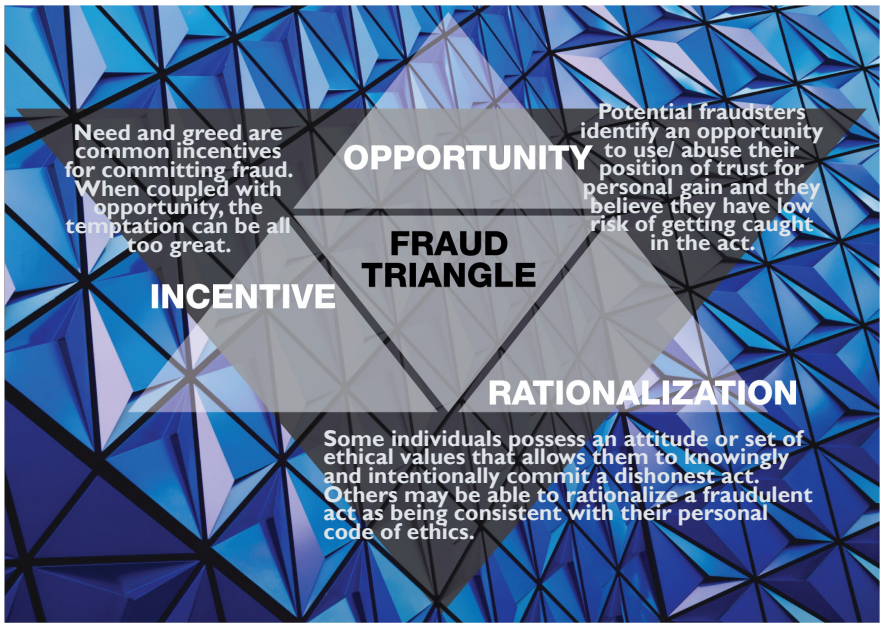
It's difficult to explain the incidence of fraud by opportunity. Of course, the crime cannot occur without opportunity, but the same circumstances are available to other people in the organization who do not yield to the temptation. Even the fraudster may be exposed to the opportunity for many years before stepping across the line.

The key to the fraud is pressure. There are as many sources of pressure as there are fraudsters, but the most typical one is financial. Fraudsters may suddenly need money they cannot get quickly enough by saving, perhaps for a debt or loss, or to compensate for a bad investment. Of course, greed plays a role when a desirable lifestyle cannot be supported by income. Some fraudsters may simply feel entitled by a real or perceived slight, by being passed over for a promotion, or other personal affront.

If the pressure is the motivation, then rationalization allows the fraudster to continue to live as a thief. The purpose of rationalization is to justify bad behavior, so it will frame the behavior as a righteous act. For instance, the fraud may be seen as a response of a mistreated small person against a cold, uncaring corporation. Whatever the specifics, think of the fraudster as believing that their gains are just deserts.

Most financial and organizational controls like segregation of duties are aimed at known opportunities. These are generally well known, documented, and taught. However, occupational fraud is almost always done by an insider who knows the controls very well. So, the motivational component is key, and neither internal controls nor external audits are designed to assess motivation.

HOW WELL DO YOU KNOW YOUR EMPLOYEES?



KEY FACTOR:

What is important to note is that of the three factors of the Fraud Triangle, reducing or eliminating the opportunity for a person to commit fraud is generally the most effective way to reduce fraud risk. Proactively setting and utilizing controls has proven to make THE difference to protect company performance above all else.