FRAUD DÉJÀ VU—FOOLED ALL OVER AGAIN?

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INTRODUCTION: FOOL ME ONCE?

Have you ever heard the old saying, "Fool me once, shame on you, fool me twice, shame on me?" The proverb is intended to help you to learn from your mistaken trust. However, fraud history seems to repeat itself. Some twenty years ago in 2011, Enron declared bankruptcy, and the consequent criminal convictions of its executives Ken Lay, Jeffrey Skilling, Andrew Fastow as well as the collapse of its auditor Arthur Anderson was followed by more crime in high places at Tesco, Olympus, Tyco, Theranos, Worldcom, Valeant.[i] These frauds were not the work of minimum wage clerks in the bookkeeping department but devious behavior on the executive floor. Do C-suite occupants share some genes that predispose them to commit fraud?

The Pandemic has upped the ante on borrower fraud perpetrated on lenders. What can bankers do to identify, monitor, and prevent possible fraud? The good news is that the ACFE has published a new 88-page study on fraud that offers some new insights on fraud and its prevention.[ii] Bankers lend funds to borrowers, and lenders need to be sure their borrowers have adequate fraud prevention practices in place. What factors raise fraud risk?

FRAUD FINDINGS: HIGH CRIMES IN HIGH PLACES?[iii]

The Report evaluated over 2,500 surveys from 125 countries adding up to $3.6 billion in losses; fraud losses are estimated to run about 5% of annual revenues. Its international scope suggests that the causes and consequences of fraud are universal; as anthropologist Margaret Mead observed, "Always remember you are absolutely unique, just like everyone else." Here is a brief summary of the report's findings on factors that contribute to higher fraud risk.

Position. The fraud perpetrator's level of authority within an organization tends to strongly correlate with the size of a fraud. The higher his position, the more likely the person is likely to commit fraud. Owners/executives accounted for only 20% of the frauds in our study, but the median loss in those cases (USD 600,000) far exceeded the losses caused by managers and staff-level employees. This is consistent with AFCE's past studies, all of which found that losses tend to rise with a fraudster's level of authority. Owners/executives are generally in a better position to override controls than their lower-level counterparts, and they often have greater access to an organization's assets. Both of these facts might help explain why losses attributable to this group tend to be so much larger.

Tenure. The longer a fraud perpetrator works for a company, the more damage that person's scheme is likely to cause. Those who had been with the victim organization for at least ten years stole a median USD 200,000, which was four times greater than the median loss caused by employees with less than one year.

Department. The frequency and median loss of fraud schemes based on the perpetrator's department also needs to be examined. For example, the executive/upper management team and the accounting department were both associated with high frequency and median loss, which indicates that fraud risks in these areas should be carefully addressed in any anti-fraud program.

Gender. More than 70% of the perpetrators in the study were males. Men also caused a significantly larger median loss (USD 150,000) than women (USD 85,000). This is consistent with ACFE's past studies, all of which have found a significant gender disparity in fraud loss and frequency. However, distribution of occupational fraudsters based on geographic region. In the United States and Canada, males accounted for only 59% of occupational fraud perpetrators, but in Southern Asia, the Middle East and North Africa, men committed more than 90% of the occupational frauds. The study's examination of gender distribution and median loss data based on the perpetrator's level of authority revealed that at all levels of authority (employee, manager, and owner/executive), males committed a much larger percentage of frauds than women did. Male owners/executives and managers also accounted for much larger losses than their female counterparts, especially at the owner/executive level, where the median loss caused by men (USD 795,000) was more than four times larger than the median loss caused by women (USD 172,000). At the employee level, however, losses caused by males and females were equal.

Age. The age distribution of fraud perpetrators was bell-shaped, with 53% of fraudsters between the ages of 31 and 45. Median losses, on the other hand, tended to rise along with the age of the perpetrator. Those in the 56 to 60 and 60+ age ranges together accounted for less than 10% of all cases, but they caused median losses of USD 400,000 and USD 575,000, respectively, which were by far the highest losses in any age range.

Education Level. We also found a correlation between the perpetrator's education level and median loss. Fraudsters with a high school degree or less caused a median loss of USD 80,000, while those with a postgraduate degree caused a median loss of USD 200,000. Generally, we would expect losses to correlate with education because those with higher levels of education tend to hold higher positions of authority and might also have greater technical capabilities for committing fraud.

Collusion. About 51% of frauds in our study were committed by two or more fraudsters working in collusion. Losses tended to increase with multiple perpetrators—particularly when three or more individuals conspired to commit fraud. One reason collusive frauds might be more costly is that multiple fraudsters working together might be better able to undermine the systems of separated duties and independent verification that are critical to many anti-fraud controls.

Criminal Background. ACFE's past studies have shown that most occupational fraudsters have no prior criminal history before they commit their crimes, and this latest study corroborates those findings. However, 41% of the occupational frauds in this study were never reported to law enforcement, which is also consistent with past research, so the true number of repeat offenders is probably higher than what can be determined through criminal records.

Employment History. Some 86% of fraudsters had never been punished or terminated for fraud-related conduct prior to the crimes reported in this study. So, this suggests that most occupational fraudsters are first-time offenders. Still, like the criminal conviction data, this data might understate the true number of repeat fraudsters. 5% of fraudsters received no internal punishment, 10% were permitted to resign, and 11% signed private settlement agreements with the victim organizations. Therefore, a significant number of occupational fraudsters will have no record of employment-related discipline even after having been caught by their employers.

Non-fraud Related Misconduct. In order to determine if there is a correlation between fraud and other forms of workplace violations, survey respondents were asked whether the fraudster had been engaged in non-fraud-related misconduct prior to or during the time of the frauds. In fact, 45% of occupational fraudsters had engaged in some type of non-fraud-related misconduct; the most common was bullying or intimidation (20% of cases), followed by excessive absenteeism (13%) and excessive tardiness (12%).

Human Resources-Related Red Flags. In some circumstances, negative events surrounding a person's conditions of employment, e.g., poor performance evaluations, loss of pay or benefits, fear of job loss, etc., can cause financial stress or resentment toward the employer, which might play a role in the decision to commit fraud. Around 42% of fraudsters had experienced some form of HR-related red flags prior to or during the time of their frauds, and the most common of these were negative performance evaluations (13% of cases) and fear of job loss (12%).

The typical occupational fraud scheme lasts 14 months before it is detected; during this time, the perpetrator will often display certain behavioral traits that tend to be associated with fraudulent conduct. shows the relative frequency of 17 identified common behavioral red flags:

1-living beyond means	46%
2-financial difficulties	26
3-unusually close relationship with vendor/customer	19
4-no behavioral red flags	15
5-control issues, unwillingness to share duties	15
6-"wheeler-dealer" attitude	13
7-divorce/family problems	12
8-addiction problems	9
9-complaints about inadequate pay	8
10-refusal to take vacations	7
11-excessive pressure from within organization	7
12-past employment-related problems	6
13-social isolation	6
14-complaints about lack of authority	5
15-past legal problems	5
16-excessive family/peer pressure for success	4
17-instability in life circumstances	4
18-other	4

Significantly, all of these red flags had been identified by someone in the respective victim organizations before the frauds were detected. At least one behavioral red flag was present in 85% of the cases in our study, and multiple red flags were present in 49% of cases. The seven most common red flags were:

1-living beyond means

2- financial difficulties

3-unusually close association with a vendor or customer

4-excessive control issues or unwillingness to share duties

5-unusual irritability, suspiciousness, or defensiveness

6-general “wheeler-dealer” attitude involving shrewd or unscrupulous behavior

7-recent divorce or family problems

At least one of these seven red flags had been identified before the perpetrator was caught in 76% of all cases. At the very least, managers should be aware of the longer red flag list and especially these specific seven red flags.

Starve a Fraud, Feed a Code of Conduct?

It is in the lender’s interest to ensure that a borrower has a fraud prevention program in place. Here are 7 key components from the Association of Certified Fraud Examiners (ACFE) that a lender might suggest to clients:[iv]

1. **Start at the top**. The board of directors and executive management must set the tone.

2. **Educate the staff**. Employees must be trained to understand which types of behavior or acts constitute fraud, how costly it is to the firm, and how to report suspicious activity.

3. **Change the culture**. First- and second-generation companies may find it easier to make their cultures more fraud-intolerant than more established firms because employees in younger companies usually have more of a personal stake.

4. **Conduct surprise audits**. The ACFE reports that companies that conduct surprise audits tend to have lower fraud losses and usually detect fraud more quickly. Fraudsters commit fraud if they think they will not get caught.

5. **Check employee backgrounds**. Human resources should confirm all work history and education claimed in an applicant’s résumé and contact references. The ACFE recommends that new and current employees’ compliance with company ethics and antifraud programs be incorporated into performance reviews.

6. **Prepare a data-breach response plan**. Information loss and data breaches are now the most common form of fraud, so it is critical to implement a response plan for these events. In preparation, get answers to the following questions: Who will regularly review information policies and procedures, and who will monitor and test the physical security of the information assets? Government regulations have raised the penalties for firms that fail to protect their data.

7. **Make sure the board of directors focuses on fraud**. Corporate boards are held accountable for risk management and fraud. The board should be monitoring the firm's fraud prevention controls, demanding explanations for fraud incidents, and requiring fixes for fraud losses.

SUMMARY AND CLOSING: VERIFY BEFORE YOU TRUST?

The ACFE continues its efforts to guard against fraud and mitigate fraud risk. There is plenty of anecdotal evidence that the pandemic recession and turbulent economy have stressed both organizations and individuals. As Abe Lincoln noted, "Nearly all men can stand adversity, but if you want to test a man's character, give him power," and ACFE's *Global Study* notes that fraud risk rises with the perpetrator's position in the organization.

A banker doesn't need to be an internal auditor or a certified fraud examiner to conduct a basic fraud risk review of a potential or existing borrower. A lender should be aware of the basic elements of fraud risk—position, tenure, department, gender, age, education level, collusion, etc. By the way, the chief financial officer tends to be male, highly educated, hold a powerful position, be between the ages of 31 and 45, and manage potentially collusive accounting and financial employees—something to think about. As he points out to you his Ferrari in the parking lot and how much fun it is to drive from his penthouse condo to the office every day, you wonder if he really is the right guy to be handling the company's finances.

So, why not ask him about the organization's fraud prevention program? If he says he doesn't need one, slide this article across the desk and suggest management take a look at the 7-point fraud prevention program. Remember the fraudster's favorite quote from Groucho Marx: "The secret of life is honesty and fair dealing. If you fake that, you've got it made." On the other hand, according to Mark Twain, "If you tell the truth, you don't have to remember anything." But be careful, people sometimes mistake a short memory for a clear conscience. Verify before you trust.

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[i] Allen Lee, "20 Huge Companies That Have Been Accused of Massive Fraud," www.moneyinc.com, https://moneyinc.com/huge-companies-accused-of-massive-fraud/ (11/08/2021)

[ii] Report to the Nations: 2020 Global Study on Occupational Fraud and Abuse, https://acfepublic.s3-us-west-2.amazonaws.com/2020-Report-to-the-Nations.pdf Copyright 2020 by the Association of Certified Fraud Examiners, Inc. Association of Certified Fraud Examiners, Global Headquarters, 716 West Ave | Austin, TX 78701-2727 | USA, Phone: (800) 245-3321 / +1 (512) 478-9000. The 2020 Report to the Nations—the ACFE's 11th study on the costs and effects of occupational fraud—represents the latest in a series of reports dating back to the first edition published in 1996. Founded in 1988 by Dr. Joseph T. Wells, CFE, CPA, the Association of Certified Fraud Examiners (ACFE) is the world's largest anti-fraud organization and premier provider of anti-fraud training and education. Together with more than 85,000 members, the ACFE aims to reduce business fraud worldwide and provide the training and resources needed to fight fraud more effectively. The ACFE provides educational tools and practical solutions for anti-fraud professionals through events, education, publications, networking, and educational tools for colleges and universities.

[iii] Ibid.

[iv] [iv] Dev Strischek, "Character and Fraud: Protection and Prevention," *RMA Journal,* November 2011, pp. 32-35.