

Is Fraud Happening in Your Company?

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Unfortunately, in this poor economy, fraud risk is increased due to personal, company, or other pressures. How do you know if fraud is happening in your company? What are the signs? What can you do to catch it? Or better yet, what can you do to prevent it?

There are typically three types of fraud. Financial statement fraud involves manipulation of the financial statement balances in order to achieve some desired result, for example, to be in compliance with a loan covenant. Corruption includes bribery, conflicts of interest, and kickbacks. Misappropriation of assets is basically stealing and is the most common type of fraud within a company. Misappropriation of assets obviously happens with cash, but can also include inventory, supplies, equipment, and information.

There are three conditions that are present when fraud occurs: opportunity, incentive, and rationalization. Here's an example:

Fred is in charge of payroll. Fred's supervisor reviews and approves the payroll report prepared by Fred before Fred submits it to the outside payroll processing company. But no one (other than Fred) looks at the final payroll report received back from the payroll processing company after payroll is submitted and direct deposited into employees' accounts. Fred uses this final payroll report in order to record the payroll journal entry into the accounting system. The company Fred works for has been suffering due to the economy. As a result, Fred and the other employees did not receive salary increases this year. Fred has racked up a lot of personal credit card debt in the last few years and is struggling financially because of this. His financial situation is causing a lot of arguments with his wife. Fred knows that all of his problems would be solved if he could pay down his debt. Fred decides that he will pay himself an extra \$500 in the next payroll to help with his situation at home. He plans to only do this one time, but ends up paying himself an extra amount in the next payroll too. He eventually does this every payroll because it really helps with his financial situation. Fred is basically a good person. He is able to sleep at night because he doesn't think of this technically as stealing. After all, he is only paying himself what he rightfully deserves with the raise he missed out on and because of all of the long hours he puts in. He is also able to "hide" it when he records the payroll journal entry by expensing the extra pay to various expense accounts other than wages.

So let's see how the three conditions are present in this example:

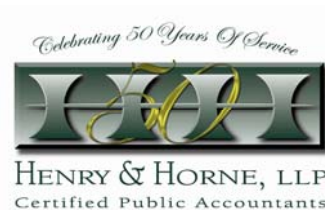
- (1) Opportunity: Fred is the only one involved in payroll and he is the only one to look at the final payroll report. Because of this, he knows his chances of getting caught are slim.
- (2) Incentive: Fred is feeling financial pressure and the effects on his marriage.
- (3) Rationalization: Fred feels that he deserved a raise, but didn't get one. He feels that he is only taking what is his.

Could this be a scenario in your company? Opportunity is the area that management or the owner of the company has control over. Designing appropriate internal controls and segregating duties can greatly reduce the opportunity for fraud. This can help prevent fraud from happening.

But what if fraud is *already* happening? What can you do detect it? You may already know what areas are potential fraud risk areas. Maybe it's within payroll, cash disbursements, cash receipts, credit card transactions, or inventory. If you have a feeling about a potentially risky area, you should examine that area to determine if there are effective internal controls in place. Approval and review processes are very important and should be performed by someone other than the person entering the information into the accounting system. For any areas that appear to be susceptible, you may want to select a sample of transactions and trace them to backup substantiation. For example, select a few final payroll reports (obtain them directly from the outside payroll processing company) and trace all paycheck amounts to employee personnel files to be sure they are being paid the wages that were approved.

Henry & Horne, LLP can perform a fraud review for your company where we discuss with you what procedures should be performed to specifically look for evidence of possible misappropriation of assets. We can also be engaged to perform a consultation on your internal controls, giving recommendations for improvements.

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