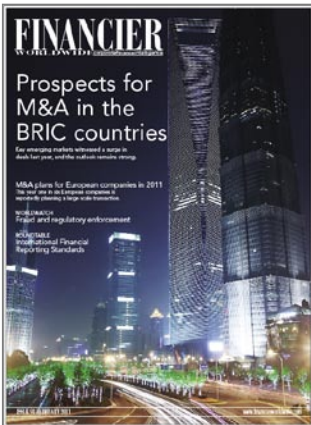


WORLDWATCH

FRAUD AND THE REGULATORY ENVIRONMENT



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FRAUD AND REGULATORY ENFORCEMENT

UNITED STATES

Fraud and the regulatory environment

BY JERRY OLDHAM

The Association of Certified Fraud Examiners' (ACFE's) 2010 Report to the Nations is based upon data compiled from a study of 1843 cases of occupational fraud that occurred in 106 nations between January 2008 and December 2009. The resource is worth referencing herein for its thorough presentation, statistics and findings. Any discussion of the current topic of fraud should be framed by the scope of the issue and its impact on the world economy, which this resource document provides. Following are some of the key statistics taken from the report.

The impact of occupational fraud

According to the report, the typical organisation loses 5 percent of its annual revenue to fraud. Applied to the 2009 Gross World Product, this statistic translates to a potential global fraud loss of more than \$2.9 trillion. The median loss caused by occupational fraud is \$160,000; however, nearly one-quarter of all frauds involve losses of at least \$1m. Small organisations are disproportionately victimised by occupational fraud. These organisations are typically lacking in anti-fraud controls compared to their larger counterparts.

Fraud detection

Frauds last a median of 18 months before being detected. Occupational frauds are much more likely to be detected by a tip than any other means. This finding is consistent since 2002 when the ACFE began tracking data on fraud detection methods. Anti-fraud controls

appear to help reduce the cost and duration of occupational fraud schemes.

Perpetrators of fraud

High level perpetrators cause the greatest damage to their organisations. Frauds committed by owners/executives were more than three times as costly as frauds committed by managers, and more than nine times as costly as employee frauds. Executive level frauds also take much longer to detect. More than 80 percent of the frauds are committed by individuals in one of six departments: accounting, operations, sales, executive/upper management, customer service or purchasing. More than 85 percent of fraudsters have never been previously charged or convicted for a fraud-related offence. This finding is consistent with ACFE prior studies. Fraud perpetrators often display signs that they are engaging in illicit activity. The most common behavioural red flags displayed by the perpetrators are living beyond their means (43 percent of cases) and experiencing financial difficulties (36 percent of cases).

Additional facts and findings

Occupational fraud is a global problem. Fraud reporting mechanisms are a critical component of an effective prevention and detection system. Organisations should implement hotlines to receive tips from both internal and external sources. Organisations tend to over-rely on audits. Although clearly important, they should not be relied upon exclusively to detect fraud. Employee education is the foundation of preventing and detecting fraud. Surprise audits are an effective, yet under-utilised, tool in the fight against fraud. Asset misappropriation schemes are the most common form of fraud by a wide margin, representing 90 percent of cases. Financial statement fraud schemes represented only 5 percent of the schemes, but caused a median loss of more than \$4m – by far the most costly category. The industries most commonly victimised are banking/financial services, manufacturing and government/public administration sectors. Given the high costs of occupational fraud, effective fraud prevention measures are critical.

The above statistics and findings, some surprising and some not, certainly frame the fraud issue. But as a provider of debt or equity capital to businesses, how do these findings affect

the daily work of lenders, private equity firms, mezzanine finance firms and intermediaries? The findings that may either reinforce our certain predispositions or surprise us should also assist in framing the importance of performing extensive due diligence before the making of a significant loan or investment.

The statistics and findings that most impact a lender's/investor's perspective about detecting fraud include the following. Frauds by owners/executives are three times more costly than those perpetrated by managers and nearly nine times as costly as those committed by employees. Asset misappropriation schemes are the most common form of fraud by a wide margin of 90 percent. Financial statement fraud schemes represent only 5 percent of all schemes, but an average median loss of more than \$4m. Fraud is a global problem. More than 85 percent of the fraudsters have never previously been accused or convicted of committing a fraud, and, once discovered and proven, they are first time offenders. Small organisations are disproportionately victimised by fraud. More frauds are detected by tips than any other method. The typical organisation loses 5 percent of its revenue annually to fraud. Fraud perpetrators often display signs that they are engaging in illicit activities in the form of lifestyle or financial distress. Surprise audits are an effective, yet under-utilised, tool in the fight against fraud. The industries most commonly victimised by fraud are banking/financial services, manufacturing and government/public information sectors.

So, banks and financial service businesses are among the most common fraud victims. And detecting the fraud is most difficult, as evidenced by the fact that most frauds are detected by tips, in spite of all the other formatted and routinely practiced anti-fraud detection methods. For lenders and investors this is very disconcerting, considering the fact that their independent due diligence is essentially a 'snap shot' of several fraud investigations techniques.

The best take away from performing this independent due diligence is that prospective lenders and investors can be, and usually truly are, an independently interested third party and, therefore, not tied to a prospect's internal fraud prevention protocol. Although certainly interested in making a specific business loan or

Frauds last a median of 18 months before being detected.

investment, and maybe somewhat predisposed based upon extensive preliminary interviews and research, lenders and investors can afford to be completely independent in their research, due diligence and investigations prior to making a final commitment to loan or invest. With proper notice, consent and releases and authorisations by the subject companies, owners and managers, banking, accounting and other privacy regulations will not get in the way of proper and prudent due diligence. While not a surprise to the prospective borrower or seller, an audit or field exam by a reputable account-

ing firm or an independent asset investigation and appraisal may be a surprise to the specific perpetrator of a fraud in motion. Also, and in fact, regarding the performance of background investigations on key members of the ownership or management team, there are now US banking regulations that require a Know Your Customer (KYC) policy and a certain level of background investigation. A few short years ago there were no insurance requirements or federal statutes that required a state or national bank or federally chartered savings and loan institution to check a list for terrorists, narcot-

ics traffickers or those engaged in the proliferation of weapons of mass destruction. The FDIC and the FSLIC changed all of that in 2003 with new KYC regulations subsequent to the passing of the USA Patriot Act of 2001.

The conclusion with regard to fraud is that it is global and can be detected, but not by casual means, and lenders and investors can, and should, take an independent due diligence look at prospective candidates and their management teams, using proven techniques and investigations firms to underwrite a loan or investment. ■



Jerry Oldham

Chairman/CEO
Evergreen, Colorado
T: +1 (303) 670 3443
E: j.oldham@1stWEST.com

Jerry Oldham is co-founder/CEO of 1stWEST Financial Corporation. Prior to starting 1stWEST, he had a senior management background in banking, corporate and real estate finance. He is on the Executive Committee of the Commercial Finance Association and serves as an expert in litigation involving complex corporate finance and lending practice issues.

1stWEST Financial Corporation provides background investigations, asset searches and fraud investigations internationally for the corporate finance industry and other professionals in need of satisfying their background due diligence requirements on prospect companies, principals, senior managers, partners and key management personnel. Founded in 1991, 1stWEST provides information to assist our clients in investment due diligence and underwriting, contract negotiations, litigation resolution and pre-employment require-

ments by providing information to determine the financial character and capacity of the business or person with which they are dealing or employing. In the financial services sector, our extensive experience in background investigations, banking, corporate and real estate finance enables us to provide superior products and service in this area of specialisation. Our clients include market leaders in the corporate finance, legal, accounting and professional services industries. 1stWEST's continued customer satisfaction is a direct result

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