

THE FRAUD PREVENTION CHECK-UP¹

HOW COMPLETING THIS “CHECK-UP” CAN BENEFIT YOUR ORGANIZATION

- It can help your organization survive an increasingly inhospitable business environment. Due in part to a long-term, continuous decline in societal ethics, fraud has infected the majority of organizations like a cancer—killing many of its victims. As with any potentially-terminal disease, the fraud victim’s chances for survival increase if the fraud is detected early. Early detection allows for the fraud to be eliminated before the victim’s profits and reputation are lost and irrecoverable.
- It can greatly increase your bottom line. Fraud is an expensive drain on an organization’s financial resources. Fraud surveys estimate that organizations, on average, lose about 6% of their annual gross revenues to fraud and abuse. Many businesses, such as insurance and credit card companies, have experienced substantial increases in profitability by proactively working to minimize the costs associated with fraudulent activity. Those organizations actively working to eliminate fraud gain a competitive advantage over those who don’t.
- Due to a continuous decline in societal ethics, the question is not “do you have a problem with fraud” but rather “how much are your losses due to fraudulent activity?” Based on our experience as fraud investigators, we find that where there is opportunity, there is fraud. Many organizations unknowingly and unwisely provide key employees or business associates with easy opportunities to commit fraud, who then exploit those opportunities for personal gain. Organizations that do not develop effective fraud prevention programs allow much of their hard-earned profits to be diverted into the pockets of dishonest individuals.
- Completing this “fraud prevention check-up” is the most cost effective way to assess your organization’s vulnerability to fraud. Most organizations score poorly in initial fraud prevention check-ups because they don’t have adequate anti-fraud controls in place. By identifying specific fraud risks early, you are in a better position to manage those risks before the problem becomes big enough to bankrupt your business, such as in the Enron and World Com cases.
- An effective fraud prevention program can help increase the confidence investors, regulators, employees, audit committee members, and the general public have in the integrity of your organization’s financial reports. It could also help to attract and retain capital at more reasonable rates.

• ¹ *Adapted and modified with permission from the Association of Certified Fraud Examiners.*

WHO SHOULD PERFORM THE CHECK-UP?

- The fraud prevention check-up should be a collaborative effort between objective, independent fraud specialists (such as Certified Fraud Examiners) and people within the organization who have extensive knowledge about its operations.
- It is helpful to interview senior members of management as part of the evaluation process. But it is also valuable to interview employees at other levels of the organization, since they may sometimes provide a “reality check” that challenges the rosier view management might present, e.g., about management’s commitment to ethical business practices.

HOW MANY POINTS SHOULD BE AWARDED FOR EACH ANSWER?

- The number of points available is given at the bottom of each question. You should award zero points if your organization has not implemented the recommended processes or controls for that area. You should award the maximum number of points if you have implemented those processes or controls and have had them tested in the past year and found them to be operating effectively. Award no more than half the available points if the recommended process is in place but has not been tested in the past year.
- The purpose of the check-up is to identify major gaps in your fraud prevention program, as indicated by low point scores in particular areas. Even if you score 80 points out of 100, the missing 20 could be crucial fraud prevention measures that leave you vulnerable to major fraud. Accordingly, the only acceptable score is 100 points.

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SCORE / COMMENTS

ORGANIZATION: _____

1) Fraud risk oversight

- To what extent has the organization established a process whereby the board of directors or others charged with governance (e.g., an audit committee) proactively manage fraud risks within the organization?

Score: From 0 (process not in place) to 10 points (process in place but not tested) to 20 points (process fully implemented, tested within the past year and working effectively).

2) Fraud risk ownership

- Has the organization designated a member of senior management as having responsibility for managing all fraud risks within the organization?

Score: Award 0 points if “No” and 5 points if “Yes.”

- Has the organization explicitly communicated to business unit managers that they are responsible for managing fraud risks within their part of the organization?

Score: Award 0 points if “No” and 5 points if “Yes.”

3) Fraud risk assessment

- To what extent has the organization implemented an ongoing process for periodic assessment of the fraud risks faced by the organization?

Score: From 0 (process not in place) to 5 points (process in place but not tested) to 10 points (process fully implemented, tested within the past year and working effectively).

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4) *Fraud risk tolerance and risk management policy*

- Has the organization identified and had approved by the board of directors its tolerance for different types of fraud risks? For example, some fraud risks may constitute a tolerable cost of doing business, while others may pose a catastrophic risk of financial or reputation damage to the organization. The organization will likely have a different level of tolerance for each of these risks.

Score: Award 0 points if “No” and 5 points if “Yes.”

- Has the organization identified and had approved by the board of directors a policy on how the organization will manage its fraud risks? Such a policy should identify the risk owner responsible for managing fraud risks, what risks will be rejected (e.g., by declining certain business opportunities), what risks will be transferred to others through insurance or by contract, and what steps will be taken to manage the fraud risks that are retained.

Score: Award 0 points if “No” and 5 points if “Yes.”

5) *Process level anti-fraud controls/ re-engineering*

- To what extent has the organization implemented appropriate controls to eliminate or minimize through process re-engineering each of the significant fraud risks identified in its risk assessment? Basic controls include segregation of duties relating to authorization, custody of assets and recording or reporting of transactions. In some cases it may be more cost-effective to re-engineer business processes to reduce fraud risks rather than layer on additional controls over existing processes.

For example, some fraud risks relating to receipt of funds can be eliminated or greatly reduced by centralizing that function or outsourcing it to a bank’s lockbox processing facility, where stronger controls can be more affordable.

Score: From 0 (controls not in place) to 5 points (controls in place, tested within the past year and working effectively).

SCORE / COMMENTS

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- To what extent has the organization implemented appropriate controls at the process level designed to prevent and/or detect each of the significant fraud risks identified in its risk assessment? For example, the risk of sales representatives falsifying sales to earn sales commissions can be reduced through effective monitoring by their sales manager, with approval required for sales above a certain threshold.

Score: From 0 (controls not in place) to 5 points (controls in place, tested within the past year and working effectively).

6) Environment level anti-fraud controls

Major frauds usually involve senior members of management who are able to override process-level controls through their high level of authority. Preventing major frauds therefore requires a very strong emphasis on creating a workplace environment that promotes ethical behavior, deters wrongdoing and encourages all employees to communicate any known or suspected wrongdoing to the appropriate person. Senior managers may be unable to perpetrate certain fraud schemes if employees decline to aid and abet them in committing a crime. Although “soft” controls to promote appropriate workplace behavior are more difficult to implement and evaluate than traditional “hard” controls, they appear to be the best defense against fraud involving senior management.

- To what extent has the organization implemented an ongoing process to promote ethical behavior, deter wrongdoing, and facilitate two-way communication on difficult issues? Such a process typically includes:

- Assigning a senior member of management to be responsible for the organization’s processes to promote ethical behavior, deter wrongdoing and communicate appropriately on difficult issues. In smaller companies, this will be an additional responsibility held by an existing member of management.

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- A code of conduct for employees at all levels, based on the organization's core values, which gives clear guidance on what behavior and actions are permitted and which ones are prohibited.
- Training for all personnel upon hiring and regularly thereafter concerning the code of conduct, seeking advice and communicating potential wrongdoing.
- Communication systems to enable employees to seek advice where necessary prior to making difficult ethical decisions and to express concern about known or potential wrongdoing affecting the organization. Advice systems may include an ethics or compliance telephone help line or email to an ethics or compliance office/officer.
- The same or similar systems may be used to enable employees (and sometimes vendors, customers and others) to communicate concerns about known or potential wrongdoing affecting the organization. Provision should be made to enable such communications to be made anonymously
- A process for promptly investigating where appropriate and resolving expressions of concern regarding known or potential wrongdoing, then communicating the resolution to those who expressed the concern
- Monitoring of compliance with the code of conduct and participation in the related training. Monitoring may include requiring at least annual confirmation of compliance and auditing of such confirmations to test their completeness and accuracy.
- Regular measurement of the extent to which the organization's ethics/compliance and fraud prevention goals are being achieved. Surveys of employees' attitudes towards the organization's ethics/compliance program and the extent to which employees believe management acts in accordance with the code of conduct provide invaluable insight into how well the program is functioning.

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- Incorporation of ethics/compliance and fraud prevention goals into the performance measures against which managers are evaluated and which are used to determine performance related compensation.

Score: From 0 (processes not in place) to 15 points (processes in place but not tested) to 30 points (processes fully in place, tested within the past year, and working effectively).

7) Proactive fraud detection

- To what extent has the organization established a process to proactively detect, investigate and resolve fraud-related “red flags?” Such a process should include controls embedded in the organization’s information system that highlight suspicious transactions for investigation and/or approval prior to completion of processing. Other fraud detection methods include computerized e-mail monitoring (where legally permitted) to identify use of certain phrases that might indicate planned or ongoing wrongdoing.

Score: From 0 (process not in place) to 5 points (process in place but not tested) to 10 points (process fully implemented, tested within the past year and working effectively).

TOTAL SCORE (Out of a possible 100 points):

Interpreting the Organization's Score

This fraud prevention check-up provides a broad overview of the adequacy of your organization's fraud prevention program. The important information to take from the check-up is the identification of particular areas for improvement in the organization's fraud prevention processes. The precise numerical score is less important and is only presented to help communicate an overall impression.

The desirable score for an organization of any size is 100 points. Most organizations should expect to fall significantly short of 100 points in an initial fraud prevention check-up. The deficiencies identified do not necessarily represent reportable conditions under securities regulations. However, significant deficiencies should be corrected promptly in order to better safeguard assets and ensure the integrity of financial reporting.

Should you have questions regarding the development, implementation, and ongoing maintenance of effective fraud prevention programs, please contact Jason Olson of Eide Bailly LLP at 952.918.3554 or via e-mail at jwolson@eidebailly.com. Visit our website at www.eidebailly.com/services/forensic for more information regarding the fraud prevention, detection, and investigation services provided by our firm.