Beane Associates News November 2010

A bimonthly collection of news and advice for stakeholders of financially and operationally challenged businesses

Welcome...

You've got to crawl before you can walk, walk before you can run. For more than two years, the nation's economy has been crawling. Now there's some evidence that we may soon be walking again, though it's hardly conclusive.

Vistage International, the CEO membership organization to which I belong, reported recently that its confidence index for the third quarter was 95.1, slightly higher than the second quarter score of 94.4. The gain was small, but still a 12 percent increase over the 84.9 registered in the third quarter of 2009.

CEOs say they have plenty to worry about: increasing health-care costs and limited access to credit could impact corporate bottom lines just as the possible elimination of the Bush era tax cuts could impact their personal bottom lines.

While there's still plenty of uncertainty on the foggy economic horizon, the CEOs surveyed aren't expecting a second recession. They think we're recovering slowly, walking before we run.

In these uncertain times, what can you do to keep your business profitable? One essential measure is to protect yourself against internal fraud. Fraud costs the typical business 5 percent of revenues a year. That can easily spell the difference between profit and loss. In this edition's featured article, Chris Todd details the problem and offers solutions.

We hope you find this article helpful, and we'd be pleased if you forward it to others who might be interested.

For additional information on us, visit
www.beaneassociates.com

Sincerely,
Tom Beane, President CMC CIRA

Tip Sheet

- Develop a written code of ethics that details how the company will conduct its external business dealings and what it expects of its employees.
- Implement a fraud awareness and ethics training program for all employees.
- Create internal checks and balances by segregating responsibilities. Concentrating too many duties under one person multiplies the possibility for trouble.
- Ask your CPA for advice. Besides preparing financial statements, he can offer suggestions to improve your internal processes and controls.

INTERNAL FRAUD, BY THE NUMBERS By Christopher Todd

Numbers sometimes speak louder than words. When we talk about fraud, here are three that stand out: 5, 713 and 18.

First, the 5. According to the Association of Certified Fraud Examiners (ACFE), the typical organization loses 5 percent of its annual revenues to occupational fraud and abuse.

If 5 percent doesn't seem like much, let's put it in big-picture context. As part of the United States' 2009 gross domestic product, 5 percent equals $713 billion. And how much is $713 billion? Enough to run the U.S. Department of Defense during 2008, that's how much.

And the 18? Well, that's the median length of time to uncover a typical case of occupational fraud. In other words, if someone just started stealing from inside your business, chances are you won't figure it out until the 2012 NCAA basketball champion is crowned.

Still, you're probably thinking, there's no way my business can be victimized by internal fraud. Our employees are loyal and trustworthy, they've been with the company for years. They're almost like family.

Here are a few more numbers, taken from ACFE's 2010 report on global fraud: about 50 percent of the identified frauds were perpetrated by employees who had been with the business for five years or more; 85 percent of the perpetrators had no criminal history, and 82 percent had no prior employment punishment or termination. In other words, the statistics indicate that fraud is most likely to be committed by the people you're least likely to suspect.

The ACFE often refers to the "fraud triangle," whose three legs are labeled Opportunity, Financial Pressure and Rationalization. Smaller workforces, breakdowns in internal checks and balances and changes in business models all can create opportunities for fraud. In the current economy, many more employees than usual are feeling financial pressure. When opportunity and financial pressure intersect, it's not hard to develop a rationalization to cheat your boss.

How, then, does a CEO make a business fraud-proof?

It starts with creating and maintaining a work environment based on uncompromising ethical standards. Management must adopt, implement and frequently communicate expectations and policies relating to managing fraud risk. If employees know what's expected, they're less likely to behave inappropriately and more likely to recognize signs of inappropriate behavior in their coworkers.

Employees must feel confident that they can alert management without fear of reprisal if they suspect inappropriate conduct by other members of the team. One of the best approaches is to subcontract to a third-party operator of an independent tip line. The ACFE report notes that the most prevalent method of catching workplace fraud is through an independent tip line. In fact, about 40 percent of all internal frauds first came to light through a tip. Two-

thirds of those tips came from employees; customers, vendors and competitors also provided leads that prompted successful investigations.

The owner or CEO must be personally involved in fraud prevention efforts — not because it looks good but because you're the company's best deterrent.

Take a hands-on approach with all mail from banks and financial institutions. Open them first, look them over, and then carry them back to whoever is responsible for reconciling the statements. Ask questions. Review your payroll logs and lists of vendor payments before checks are issued. Do you recognize all the names? Do the payment amounts appear accurate?

Also, watch out for possible conflicts of interest. Are there family and/or personal relationships linking employees within your business or linking your employees with employees of a supplier or subcontractor? That's not necessarily a problem, but it is something to watch.

The surprise, or random, audit is another effective tool in the antifraud arsenal. Knowing that their work can be checked at any time, without notice, can serve as a powerful deterrent to employees.

Also, make sure every employee takes an annual vacation. When substitutes fill in, it's often easier to spot irregularities that had gone undetected.

Your CPA can also be a valuable resource, providing on-site training in fraud detection and prevention. CPAs can train owners to spot red flags that signal asset misappropriation and corruption, and they can also educate businesses about fraud threats that originate outside the company.

Preventing fraud is hard work. And the businesses that succeed are the ones whose owners set the proper tone and pay attention to the details.

CONSTRUCTION: A FRAUD MAGNET?

Occupational fraud has to be a serious concern for any business, but the potential for abuse is greater in some industries than others. Certain situations make construction an inviting target for fraudsters.

While accounting and bookkeeping functions may be handled at the main office, the real work goes on at job sites and warehouses, where there's typically less supervision than occurs in many other businesses.

In the field, materials and equipment are frequently delivered to the job site, and it's often assumed that everything in the delivery is consumed on site. Is someone responsible for checking that every item on the invoice is delivered, and in the proper quantity? Are supplies and materials secured at the end of the work day? Are materials remaining at the completion of the job returned to a warehouse for future use? Is someone checking the accuracy of any change orders that originate in the field?

Back in the office, the irregular patterns of construction work can make it harder to detect internal fraud. Retailers, restaurants and service businesses, for example, have predictable business cycles and easily identifiable vendors and customers, so spikes in receipts and expenses are easy to notice. In construction,

however, every job is different — and that often means different vendors, different subcontractors, and new names on the payroll. In such situations, it's relatively easy to bury and conceal a fraudulent transaction.

Sometimes, cheating doesn't always show up on the company's books. In one case, a project manager in charge of a major job directed almost all the purchases for supplies to a single vendor — so much so that the vendor rewarded him with a $30,000 car. The company might well have gotten its supplies for a better price from another vendor but, in this case, it was the project manager who reaped the benefit from bulk orders.

Certain construction businesses are susceptible to particular types of fraud. Many of us have heard of paving crews that sometimes finish a day's scheduled jobs with some extra hot mix in the truck. An enterprising driver just might find a homeowner whose driveway could use a new coat of blacktop, and might offer the homeowner a discount for paying cash. Does the payment go back to the company, or does it stay in the driver's pocket?

Owners of concrete or paving businesses should check the hours their trucks and mixers are in use. This work is most often scheduled for the morning; if the trucks are out late in the day, is someone doing work on the side with company materials?

Without proper controls, unscrupulous workers could employ any number of methods to divert materials for other uses.

For more information on occupational fraud and some helpful tools to combat it, visit the website of the Association of Certified Fraud Examiners, www.acfe.com. Click on Fraud Resources to access a fraud prevention check-up, videos, articles and other materials on specific types of fraud and how to combat them.

About Beane Associates, Inc.

Beane Associates, Inc.

Founded in 1984, Beane Associates, Inc. continues to build an impressive track record in helping private and publicly owned companies improve operational effectiveness and profitability during a time of financial challenge. The company has offices in Wilmington, DE, and Atlanta, GA.

22 The Commons, 3518 Silverside Road, Wilmington, DE 19810-4907 Phone: 302.479.5438 Fax: 302.479.5434 www.beaneassociates.com