THE EXIT PLANNING REVIEW™

Issue 260 **July 2, 2013**

Fraud: Do You Know It When You See It?

The subject of employee dishonesty is a delicate one. Owners generally want to trust their employees, and given all the other battles owners fight on a daily basis, they are often not as vigilant as they can or should be. Vigilance requires an investment of time and money in return for an uncertain payoff.

Here's one example of a typical fraud scenario:

Lou Spencer's CFO, Marty Jacks, had been with Lou's company for 15 years. While Lou reviewed company financial reports and often the accounts receivable aging report, he let Marty handle the day-to-day financial operations. To say that Lou was surprised when one of his vendors mentioned that he'd run into Marty on the floor of a Las Vegas casino at 4:00 a.m. would be an understatement. As far as Lou knew, Marty spent every weekend at home or camping with his family.

Rather than confront Marty immediately, Lou casually asked his golf partner (a CPA who also happened to be a Certified Fraud Examiner) about employee theft.

The CPA listed more ways to steal than Lou could imagine, but Lou did remember:

- *Creating fictitious vendors or employees.*
- *Stealing inventory.*
- *Giving oneself undisclosed and unauthorized pay raises.*
- *"Lapping" or taking payment from one customer and applying it to another's account.*

The CPA explained to Lou the three conditions present in any fraud situation: motive, opportunity and rationalization.

"Has anyone run into financial difficulties?" he asked. "Maybe a sick kid? The unemployment of a spouse or even the readjustment of payments on a home loan?" Lou could not think of anyone in those situations.

Lou understood the "opportunity" factor immediately. He admitted that because he trusted Marty implicitly he was not reviewing every report carefully. Marty certainly had opportunity.

Rationalization: Lou was fairly confident that his employees—including Marty—were satisfied with their salary and benefit packages. Except for an occasional afternoon of golf, Lou believed he worked as hard as any of them.

The CPA suggested that before acting, Lou retain a fraud analyst to conduct a fraud audit. At a minimum, Lou should review his financial statements and this time, rather than focus on the decline in revenues, look for any anomaly or anything that "bucks the trend." Lou returned to an empty office to do exactly that.

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The Exit Planning Review™
is published by
Business Enterprise Institute, Inc.

What Lou discovered caused him to call his golf buddy to schedule a meeting about a Fraud Deterrence Audit. Lou swallowed hard as he signed an engagement letter for an audit that would cost his $20M company between $20,000 and $25,000.

After several weeks of review, the CPA laid out the situation for Lou. Marty had a gambling habit (motive). Over the past 18 months, Marty had set up numerous bogus vendor accounts and had siphoned off almost $1 million to these accounts (opportunity). When Marty started pulling small amounts of cash out without Lou noticing, Marty decided that since Lou didn't miss the cash, Lou could do without it (rationalization).

Armed with the facts, Lou fired Marty. There was no way to recover the money, so Lou and the Fraud Examiner concentrated instead on ways to prevent this scenario from reoccurring.

We asked Edward Bortnick, a CPA, Certified Fraud Deterrence Analyst and Certified Financial and Forensic Accountant, and Certified Valuation Analyst from Rockville, Maryland for his best fraud prevention advice.

"First, look for any anomalies in the company's financial reports. Are there exceptions to trends over time?" To do this, Bortnick suggests preparing two Excel worksheets.

- On the first spreadsheet, enter the last five years' income statements expressed both in dollars and as a percentage of gross revenues. Using that report, investigate any significant changes in income as well as significant changes in the expenses as a percentage of income.
- On a second spreadsheet enter your company's balance sheets for the past five years. Using this report, compute the accounts receivable turnover and collection days for each year as well as inventory turnover. Again, investigate any significant changes.

"Second, change the schedule for running and reviewing reports. Lou's new CFO (hired only after a thorough background check) should provide Lou with reports on a weekly, rather than monthly, basis."

"Third, owners should carve out time to carefully review those reports without distraction."

"Fourth, owners should ask their CPAs to conduct a quick 'Financial Statements 101' course," says Bortnick. Many owners think they know how to read these Statements, but CPAs can teach owners what to look for and what the numbers mean.

Bortnick explains that, "Fraud Examiners will propose a number of changes tailored to a particular company and can follow up periodically to make sure that all changes have been implemented and that there are no new opportunities for fraud."

"These are a few of the tools," says Bortnick, "that can be used to monitor your operations and help detect whether anomalies are due to employee dishonesty or changes in your company's operations. I suggest that owners contact their accountants (or forensic accountants) to help develop systems and forensic tools that owners can use to deter fraud and manage—financially—business operations."

"Finally, if an owner sees anything he or she does not understand or that seems unusual," Bortnick advises, "dig deeper. Doing so might just save the company."

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