



How SMEs can reduce the Risk of Fraud

Limiting Fraud Risk –
What SMEs can do

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Chapter 1: Introduction

Fraud is a major challenge and risk facing companies, governments and organisations. Each year, huge sums of money are lost because of the wide scale occurrence of fraud in addition to the high profile cases highlighted in the media. Fraud's impact is widely felt by employees, by other stakeholders, and ultimately on business performance. Fraud can produce serious consequences for businesses performance and in the long run even lead to insolvency or business failure.

The cost of fraud to Small and Medium-sized Enterprises (SMEs) is not easy to quantify, as many cases are either undetected or unreported. However, the total amount of reported fraud is increasing in most countries. Furthermore, large fraud cases like Enron, Worldcom, and more recently Parmalat, had a ripple economic effect on SMEs, especially those which were their stakeholders, such as customers or suppliers.

Employees perpetrate most fraud cases – an Ernst & Young global survey¹ suggests that in around 85 percent of cases the most costly fraud is that of employees. Fraud caused by businesses themselves is also increasing and often relates to fraud perpetrated by: owners, management and others charged with monitoring and supervision. Despite this, fraud is often an unmanaged risk. Apathy is part of the problem – many organisations are not doing enough to prevent and report fraud or to set the proper tone at the top, creating and maintaining a culture of honesty and ethical behaviour.

This publication is a guide to help limit the risk of fraud in SMEs, analyses its impact, provides practical suggestions to identify, detect and prevent fraud and recommends implementing internal control systems tailored to specific needs. Cases studies are provided to illustrate the range and nature of fraudulent activity.

¹ Ernst & Young, "Fraud the Unmanaged Risk" 8th Global Survey 2003

CHAPTER 2: FRAUD AND ITS RELEVANCE TO SMES

2.1 Fraud definition

There is no single legal definition of fraud in the European Union as it varies between Member States. Generally, fraud can be commonly defined as any action deliberately and dishonestly committed to obtain an advantage, which causes a loss to another party. More specifically, International Auditing Standards (ISAs), which are expected to become mandatory for statutory audit in the EU², provide the following definition of fraud: “The term ‘fraud’ refers to an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage”³. In this paper, theft is considered to form part of fraud.

As regards the scale of the problem, fraud occurs outside the normal range of economic statistics. Nevertheless, it is certain that fraud is increasingly becoming a significant issue as shown by the EU media and the attention many governments in the EU are giving this issue. There are numerous possibilities to commit fraud including fraudulent financial reporting and intentional misstatements but also computer and Internet fraud. This paper will focus only on those types of fraud most relevant to SMEs.

CASE STUDY A

A TYPICAL CASE OF FRAUD IN A SME, DISCOVERED DURING A STATUTORY AUDIT

In a medium-sized German enterprise producing office furniture, senior personnel was under excessive pressure to meet financial targets, in particular sales targets set by the owner manager. In order to meet these targets and improve their personal career, senior staff members decided to overstate revenues by recording significant fictitious revenues during the last quarter of the year.

The enterprise was subject to mandatory statutory audit for the first time as it exceeded the relevant criteria of Art. 267 of the German Commercial Code. As part of the statutory audit, the appointed auditor performed substantive analytical procedures relating to revenues using disaggregated data and compared current revenues reported by month and product line with data of comparable prior periods.

In that way the fraudulent financial reporting was discovered.

A statutory audit will however not guarantee the detection of fraud since its objective is not the detection of fraud. Forensic audit, a form of voluntary audit, focuses specifically on the detection of fraud.

² As stated in article 26 of the Draft 8th Company Law Directive.

³ ISA 240 revised: The auditor’s responsibility to consider fraud in an audit of financial statements, 2004, Appendix III contains a summary of ISA 240.

2.2 Reasons for committing fraud

There appears to be no single reason behind fraud, which makes it difficult to control: motivation can be based on multiple factors, mostly on greed or some kind of perceived need.

The following factors can be taken into account in considering the reasons for committing fraud:

1. Some people will start with the intention of committing fraud, while others may only turn to fraud when their personal circumstances become difficult or where sufficient pressure has been imposed on them;
2. The potential motivation of fraudsters can vary and includes the conditions under which they can rationalise their prospective crimes as ‘necessary’, especially where done for the firm, or ‘harmless’, because they believe the entrepreneur can absorb the impact, or ‘justified’, where they feel mistreated for example when there is a perception that a colleague has been unfairly promoted or paid. Greed is however the most common reason for committing fraud;
3. The expected and actual risk of discovery can also lead to fraud: a perception of a very low risk and very few possibilities of being discovered may help breed fraud. In some organisations it is easy for an employee to abuse his position: lack of policies and inefficient systems of internal control (or a lack thereof) will make an organisation more susceptible to fraud;
4. The pressure to achieve an expected earnings target can lead management to commit fraudulent financial reporting, particularly since the consequences for failing to meet financial goals can be significant;
5. The lack of a proper example by the management or owner by setting the tone at the top and by imposing a culture of honesty and ethical behaviour;
6. The existence of national and international criminal networks can increase the risk of fraud.

Fraud involving one or more members of management or those charged with governance is referred to as “management fraud;” fraud involving only employees of the entity is referred to as “employee fraud”. In either case, there may be collusion within the entity or with third parties outside of the entity.

In the paper two types of intentional misstatements are addressed: misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

2.3 Fraud and Theft by Misappropriation of Assets

In SMEs the opportunities for employees to perpetrate fraud and theft by misappropriation of assets can be greater than in larger organisations, mainly owing to the lack of a sophisticated internal control system. There is also a tendency in SMEs towards a higher level of trust between people and it is often the case that the owners or managers do not consider the possibility of being defrauded. Employees are more likely to abuse their position where they have unsupervised responsibilities and work in isolation or when the proper ethical culture or tone at the top is missing. However, misappropriation of assets can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect.

The most frequent type of employees' fraud and theft is misappropriation of assets by *falsifying expense reports*. Examples include:

- Car mileage and taxis: inflated amounts
- Train/ plane tickets: purchased cheaply, but claimed at full price
- Hotel: claimed but not incurred
- Private expenses: private expenses claimed as business expenses

Another kind of fraud which may be committed by employees is the *theft of small unit-value objects*, such as making personal long distance phone calls at the enterprise's expense.

When done regularly and left uncontrolled, such kind of thefts can amount to significant losses for the entrepreneur. There can be the detrimental impression amongst the employees that thefts of minor value items are tolerated and that the business can easily absorb the impact.

Misappropriation of assets is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing or have been pledged without proper authorisation.

2.4 Misstatements resulting from fraudulent financial reporting

The term 'management fraud' can be referred to as fraud committed by one or more members of management or those charged with governance (monitoring and supervision), in SMEs often the owner himself. As mentioned above, managers may be induced to fraud in order to maximise compensation based on performance or to meet market expectations. In smaller entities where the owners are also the managers, they may be motivated to reduce earnings by a material amount to minimise tax or to inflate earnings to secure bank financing.

The most common kind of fraud perpetrated by management or owners is fraudulent financial reporting, which involves⁴:

- Intentional misstatements;
- Overriding controls.

Intentional misstatements include omissions of amounts or disclosures in financial statements or other statements to deceive financial statement users (sometimes called 'window dressing'). They may be accomplished by the following:

- Manipulation, falsification, or alteration of accounting records or supporting documentation based on which the financial statements are prepared;
- Misrepresentation in, or intentional omission from, the financial statements or events, transactions, or other significant financial information;
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure;
- Social security undeclared or hiring of employees on the black market.

Fraudulent financial reporting by overriding of controls can be perpetrated using techniques such as:

⁴ ISA 240 revised: The auditor's responsibility to consider fraud in an audit of financial statements, 2004, Appendix III contains a summary of ISA 240.

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- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives;
 - Inappropriately adjusting assumptions and changing judgements used to estimate account balances;
 - Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period;
 - Concealing or not disclosing facts that could affect the amounts recorded in the financial statements;
 - Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity;
 - Altering records and terms related to significant and unusual transactions.

CASE STUDY B

FRAUD COMMITTED BY OWNERS, DISCOVERED DURING A VOLUNTARY FORENSIC AUDIT

Alimentos, SA is a Portuguese limited partnership operating in trading of tinned and other non-fresh food. Alimentos, SA has two Portuguese managing partners, Mr. V. Silva and Mr. J. Gomes, close friends, and one English investor partner, Mr. J. Smith. While Mr. V. Silva concentrates his efforts on selling and acquiring new customers, Mr. J. Gomes dealt with financial issues, including credit collection, tax and accounting. In 2000, the first year of the business, the sales were around € 1.000.000. Four years later sales rose to € 5.000.000 and the three partners were very satisfied with the potential of the business.

Although in high growth situations it is not uncommon for SMEs to experience cash flow problems, Alimentos SA showed cash-flow problems of a size that were unexpected. The basic financial statements (prepared for tax and legal purposes) showed a rise in sales, receivables and profits accompanied by an increase of operational debt. Mr. V. Silva was surprised by the high value of receivables as he was informed that customers were meeting payment agreements on time.

Because of the continuous deterioration of the financial situation, by the end of 2004 Mr. Smith suggested a voluntary audit with one main target to find the reason for the cash-flow problems.

In early 2005 a copy of the preliminary audit report was distributed to the partners. It was discovered that Mr. J. Gomes, with the help of his accounting assistant, was deceiving his other two partners. Cheque payments from customers received by Mr. J. Gomes were deposited in Alimentos SA bank account. However, they were recorded by the accounting assistant as a loan from Mr. J. Gomes rather than customer payments. Subsequently Mr. J. Gomes was repaid the fictitious loan.

As a result the financial statements did not show any reduction in receivables from customers as no payment from customers had been recorded. The impact of fraud was business failure. The partners faced legal procedures in the Portuguese courts.

2.5 Fraud by external parties

2.5.1 Fraud due to stakeholder agreements (collusion)

Fraud perpetrated by external parties can involve the participation of the owner or management and the employees: it is perpetrated by fraudulent agreements with stakeholders of the business, like customers or suppliers. Again, this can cause significant losses to the business and usually leads to poor financial performance or business collapse if it is not detected in good time.

This kind of fraud can happen when the employee or management colludes with a supplier, for example where the actual quality or price of the delivery is lower than that indicated by the invoice, and the employee or management is paid a 'kickback'. Similar agreements can be made by an employee and a customer, with the latter receiving more goods or services than stated on the invoice, in return for a fee paid to the employee participating in the fraud.

2.5.2 Credit and customer card fraud

In some countries credit and customer card fraud on the web is another kind of fraud by external parties which can especially hit SMEs hard. This is the case when SMEs, having processed credit card transactions and having authorised them, around one month later receive charge-back letters saying that the money must be refunded, because the genuine cardholder never sanctioned the payment. SMEs are facing a huge challenge as they can be up against a well-organised and determined criminal fraternity.

Any attempts to halt fraud have to be handled carefully because the retailers do not want to inadvertently publicise ways in which sites can be defrauded. However, there are a number of ways to minimise online fraud and therefore ensure customer confidence. SMEs can prevent financial criminals operating by ensuring that they hire the appropriate expertise to develop their accounting and information technology (IT), as well as using the latest IT technology such as firewalls to prevent potential frauds.

CASE STUDY C

CREDIT AND CUSTOMER CARD FRAUD

Peter Jenson, sales manager of Fast Games, UK, which sells computer games, knows only too well what impact fraudulent orders can have on an e-business. Last year, the family-run business almost went bankrupt. Over the important Christmas trading period, Fast Games received €47.000 of orders created by credit and customer card fraud. The volume of orders received meant the enterprise had to borrow money to fulfil them. Servicing the fraudulent orders was a hugely stressful experience, particularly because order fulfilment was jeopardised as the business used all of its available credit at one point.

Another example was an individual buying goods using a stolen credit card and arranging for them to be sent to the address of a freight forwarding enterprise, from where they would be forwarded to the buyer. The company not only lost money but also could not recover its goods.

2.6 Non-financial effects of Fraud

Regardless of the nature of fraud (by employees, managers or owners or external parties), its final outcome will always be financial loss. However, there can be significant non-financial effects as well.

Fraud can damage trust between the business and its most important stakeholders, which impacts on its perceived reputation. For those SMEs which are dependent on a sole customer or supplier (or very few of them), damage to reputation could lead to loss of a major source of revenue, especially in the case of SMEs operating in a severe competitive environment.

Those committing fraud will likely face criminal charges, loss of their job and probably find it more difficult to secure other employment.

Some types of fraud, or a high incidence of fraud in an organisation, can have a demoralising effect on other employees and create an atmosphere of distrust. This would inevitably impact on their performance and customer service.

On a wider level, fraud can have a serious effect on competitiveness. If there is any cultural tolerance of fraud, in the end it can damage the economy of the region and the market in which the fraudulent business operates.

CHAPTER 3: IDENTIFYING FRAUD

3.1 Bypassing Controls

No system is completely ‘fraud proof’, since there are always ways to bypass controls. In the case of SMEs, fraud is equally likely to happen as in larger enterprises, as the organisational structure is less complex, often with no written procedures and policies and an insufficient internal control system.

Many fraud cases are discovered accidentally, for example because of information received from former employees or spurned partners. SMEs should set up policies and procedures to identify fraud risk at its earliest stages.

However, when fraud risk is identified, it can be effectively minimised. Advice could be sought from professional advisors, for example of professional accountants, not only when the business has already experienced significant financial losses for which no reasonable explanation can be found, but also in advance, in order to proactively prevent it from happening. Professional accountants can play a key role in the discovery of fraud, since they have the skills and the ability to detect irregularities under which fraud could be concealed.

Many SMEs are not subject to statutory audit by law. However, some of them go for a voluntary audit of financial statements, to enhance the credibility of the company’s financial reporting, especially from the perspective of banks. Such a statutory audit might be instrumental in identifying and deterring fraud. A statutory audit will however not guarantee the detection of fraud since its objective is not the detection of fraud. Forensic audit, a form of voluntary audit, focuses specifically on the detection of fraud. Appendix I provides examples of circumstances indicating for professional advisors the possibility of fraud in the financial statements.

Fraud risk within an organisation may be identified by looking for:

- General fraud risk indicators (section 3.2);
- Specific fraud risk indicators (section 3.3).

3.2 General fraud risk indicators: unethical culture and lack of internal procedures and controls

Indicators of fraud risk can be found within the organisation itself and include an unethical culture lack of procedures, and lack of proper tone at the top.

Many business decisions have a moral dimension as well as a technical or commercial one. Ethical and honest behaviour by SME managers or owners and employees must govern and inform everyday decisions. There is a higher chance of ethical behaviour in the work place where there is a culture of honesty and ethical behaviour. A general climate of dissatisfaction among employees can precipitate fraudulent activity: discrimination and disgruntled employees will be more likely to perpetrate fraud.

In addition to that, if there is no policy statement outlining the consequences of (small) thefts perpetrated by employees, people will be more likely induced to perpetrate fraud: absence of written procedures and systematic control systems can present significant opportunities for fraudulent activities as employees have no explicit rules to follow.

Failure of management to make a clear commitment to implementing and communicating a sound framework of internal control can also be an indicator of fraud risk. Whenever roles and responsibilities are not clearly defined and attributed, it is easier to commit fraud without anybody noticing. Lack of delegation of responsibilities can also sometimes represent a warning sign of fraud risk.

3.3 Specific Fraud Risk Indicators

Specific events may be symptomatic of fraud and therefore ought to be reported to the entrepreneur directly or through his business advisor.

Below some examples of risk factors or fraud risk indicators specifically related to the types of fraud considered in chapter 2 are provided. This is not meant to be an exhaustive list but it represents selective examples. It does not include risk factors for SMEs listed on a stock exchange.

Risk Factors Relating to Fraud by Management or Owners (Fraudulent Financial Reporting)

Incentives/Pressures⁵

Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by) the following:

- High degree of competition or market saturation, accompanied by declining margins;
- High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates;
- Significant declines in customer demand and increasing business failures in either the industry or overall economy;
- Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent;
- Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth;
- Rapid growth or unusual profitability especially compared to that of other companies in the same industry;
- New accounting, statutory, or regulatory requirements;
- Bonus schemes based on earnings or profits may lead to manipulation of figures.

There is excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals.

Opportunities⁶

The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

- Significant related-party transactions not in the ordinary course of business or with related entities not audited or audited by another firm;

⁵ ISA 240 revised: «The Auditor's responsibility to consider fraud in an audit of financial statements» – Appendix 1 – 2004, selected points.

⁶ Idem

- Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate;
- Significant, unusual, or highly complex transactions, especially those close to period end that pose difficult “substance over form” questions;
- Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist;
- Use of business intermediaries for which there appears to be no clear business justification;
- Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.

*Attitudes/Rationalisations*⁷

- Ineffective communication, implementation, support, or enforcement of the entity’s values or ethical standards by management or the communication of inappropriate values or ethical standards;
- A practice by management of committing to creditors, and other third parties to achieve aggressive or unrealistic forecasts;
- Management failing to correct known material weaknesses in internal control on a timely basis;
- An interest by management in employing inappropriate means to minimise reported earnings for tax-motivated reasons;
- The owner-manager makes no distinction between personal and business transactions.

Annex I provides examples of circumstances that may indicate the possibility that the financial statements may contain a material misstatement resulting from fraud.

Risk Factors Relating to Fraud by Employees and External Parties

*Incentives/Pressures*⁸

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.

Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets.

*Opportunities*⁹

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- Large amounts of cash on hand or processed;
- Inventory items that are small in size, of high value, or in high demand;
- Easily convertible assets, such as bearer bonds, diamonds, or computer chips;

⁷ ISA 240 revised: «The auditor’s responsibility to consider fraud in an audit of financial statements» – Appendix 1 – 2004

⁸ Based on ISA 240 revised: «The auditor’s responsibility to consider fraud in an audit of financial statements» – Appendix 1 – 2004

⁹ Based on ISA 240 revised: «The auditor’s responsibility to consider fraud in an audit of financial statements» – Appendix 1 – 2004

- Fixed assets which are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- Inadequate segregation of duties or independent checks;
- Inadequate oversight of senior management expenditures, such as travel and other reimbursements;
- Inadequate management oversight of employees responsible for assets, for example, inadequate supervision or monitoring of remote locations;
- Inadequate job applicant screening of employees with access to assets;
- Inadequate record keeping with respect to assets;
- Inadequate system of authorisation and approval of transactions (for example, in purchasing);
- Inadequate physical safeguards over cash, bank accounts, investments, inventory, or fixed assets;
- Lack of complete and timely reconciliations of assets;
- Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns;
- Lack of mandatory vacations for employees performing key control functions;
- Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation;
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes/Rationalisations¹⁰

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets;
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies;
- Behaviour indicating displeasure or dissatisfaction with the entity or its treatment of the employee;
- Changes in behaviour or lifestyle that may indicate assets have been misappropriated;
- Tolerance of thefts of minor value items.

¹⁰ Based on ISA 240 revised: «The auditor's responsibility to consider fraud in an audit of financial statements» – Appendix 1 – 2004

CHAPTER 4: HOW TO PREVENT FRAUD

It has already been mentioned that no system is completely ‘fraud proof’. However, this does not mean that nothing can be done to prevent fraud; on the contrary, measures can be taken not only to combat fraud once it has actually taken place, but also to limit the risk of fraud in the first place.

Measures to prevent fraud are taken in each EU Member State by national governments. This publication does not attempt to illustrate these. Instead it gives an overview of the measures taken at EU level (section 4.2) and, first and foremost, it outlines what can be done at the SME level itself.

Entrepreneurs should put in place the most effective measures to limit the risk of fraud and to create a culture of honesty and ethical behaviour. Practical examples are provided below for entrepreneurs willing to fight fraud.

Professional advisors can assist in designing and implementing anti-fraud measures.

4.1 What can be done by the entrepreneur to prevent fraud

Entrepreneurs should implement measures in order to minimise the risk of fraud. Such measures establish the ethical culture, identify risk areas, establish policies and procedures and facilitate whistleblowing. Many entrepreneurs may find that they need to take advice in developing these management and internal control procedures.

4.1.1 Ethical culture – Ethical standards in the working environment

The primary responsibility for the prevention of fraud and error rests with those charged with the monitoring and supervision, or the owner and the management of the company. They need to set the proper tone, create and maintain a culture of honesty and ethical behaviour and establish appropriate controls to prevent and detect fraud and error within the company. Management fraud is often even harder to detect than employee fraud since those charged with governance and management are often in a position that assumes their integrity and enables them to override the formally established control procedures. It is therefore important that management, with the oversight of those charged with governance, place a strong emphasis on fraud *prevention*, which may reduce opportunities for fraud to take place, and fraud *deterrence*, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a culture of honesty and ethical behaviour. Such a culture, based on a strong set of core values, is communicated and demonstrated by management and by those charged with governance and provides direction to employees as to how the entity conducts its business.

Ethical attitudes within an organisation at all levels lay the foundation for a low-risk environment, while non-ethical behaviour sets the basis for fraud.

Therefore, the first step to reduce the risk of fraud is to develop a culture of honesty and ethical behaviour. The International Federation of Accountants (IFAC) Code of Ethics Part C applicable to Employed Professional Accountants could be taken as a reference and be applied to other parts of the financial reporting chain such as entrepreneurs themselves. Entrepreneurs should take the time to implement high ethical standards in their business. Creating a culture of honesty and ethical behaviour

includes setting the proper tone; creating a positive workplace environment; hiring, training and promoting employees; requiring periodic confirmation by employees of their responsibilities and taking appropriate action in response to actual, suspected or alleged fraud. The outcome will be beneficial as all stakeholders (employees, customers, suppliers and banks) recognise they are dealing with a trustworthy organisation.

A culture of honesty and ethical behaviour only works if the business complies with all legal requirements. If the business is acting against the law, the entrepreneur cannot expect the employees to be honest: that is why the entrepreneur should avoid any actions which could bring the business into disrepute.

Once detected, fraud needs to be prosecuted since prosecution and conviction are major deterrents to fraud. Prosecution and conviction imply readiness on the part of the business not to sweep matters under the carpet, and to be up-front in reporting fraud to the appropriate authorities.

A clear *policy statement on business ethics* should be prepared, in order to ensure that everybody within the organisation acts with integrity towards colleagues, staff, clients, suppliers and banks. A clear channel for reporting fraud should be provided as well.

It is essential to raise *awareness of risk* of fraud in the business, in order to make people alert and active in fraud prevention. Raising risk awareness can be done by making all the stakeholders aware that the enterprise has an anti-fraud policy and formal procedures. The stakeholders should also be aware of the serious consequences which would arise for those who commit fraud and receive information on their role in preventing it both in general terms and specific threats to their area of the business.

4.1.2 Identification of Risk Areas

An important part of re-enforcing the culture of honesty and ethical behaviour is having a structured approach to managing risk. Each type of organisation has specific risks which need to be identified in order to establish appropriate controls.

The identification of risk areas depends on the size and type of business. Identifying areas that are potentially vulnerable can be a significant exercise depending on the business involved. A professional advisor could assist in prioritising risk and challenging their assumptions of key risks areas.

4.1.3 Set up of Policies and Procedures

A sound internal control system represents one of the most efficient ways to detect and prevent fraud within an organisation. SMEs should set up equally effective though often less sophisticated internal control systems as for larger enterprises, mainly by means of documenting basic policy statements and procedures (ideally by a small team and not by one person only, the so called “Four Eyes” principle) and distributing them to all employees. The entrepreneur should ensure that the organisation’s aims and policies are clearly stated and communicated.

The policy statement of an enterprise should include a mission statement and ethical rules and clearly indicate the consequences for those who perpetrate fraud and how suspected fraud can be reported. The entrepreneur can appoint one person to whom fraud has to be reported and communicate their appointment throughout the organisation. This could also be somebody outside the organisation.

In addition to the policy statement, the enterprise should have procedures including a clear description of core business processes (inventory, production cycle, purchase/sale cycle and banks). Each key phase of these processes should be briefly described so that appropriate division of responsibilities, authorisation requirements and checkpoints are clearly stated.

Division of responsibilities

Each role within the enterprise should be clearly identified and assigned. In small organisations one person frequently has multiple roles. The basic principle of segregation of duties should to the extent possible be applied, for example goods should not be ordered and be paid for by the same person. Where a segregation of duties is not possible compensating controls need to be introduced.

It is important that both the entrepreneur and employees are fully aware of the roles of their colleagues. This not only ensures that the operation of the business is efficient and effective, but also makes it easier to spot possible fraud or collusion attempted.

Authorisation requirements

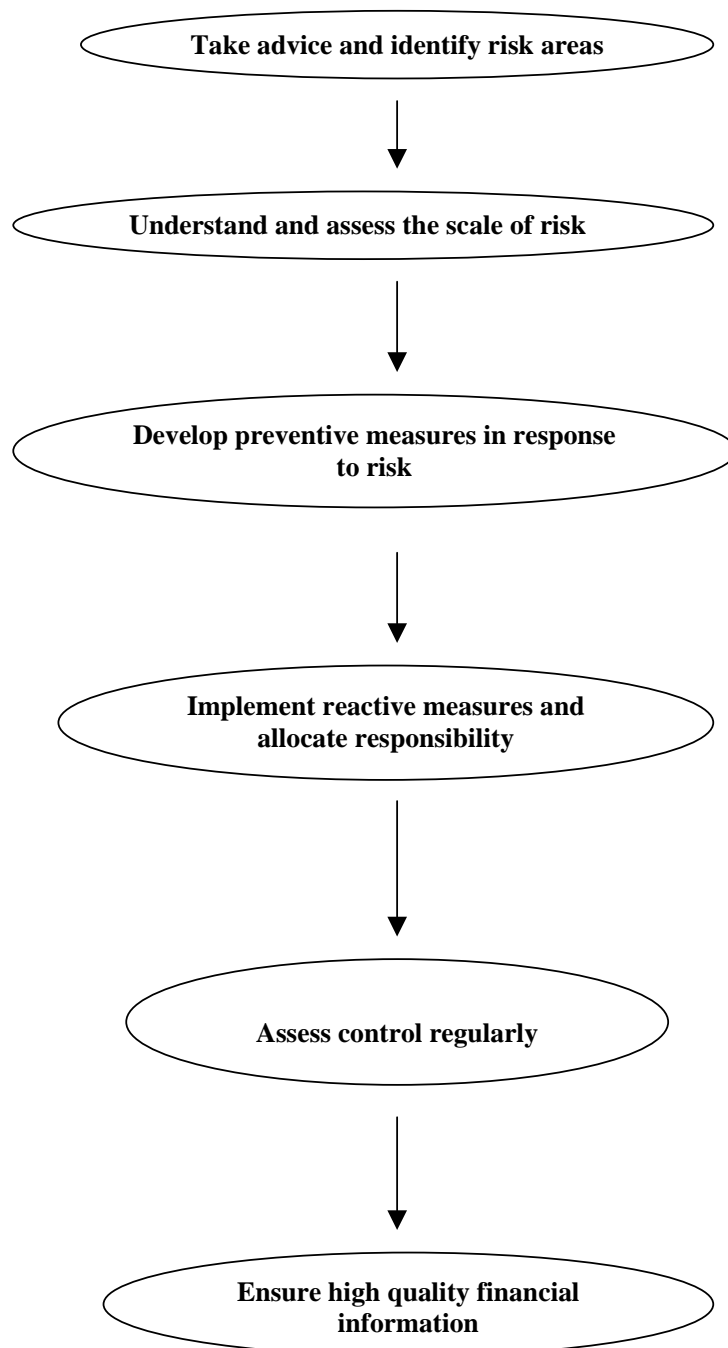
For each important business process which involves cash payments and collections, there must be an authorisation signature. Orders to suppliers, invoices to be paid and any bank operation must be authorised by appointing a signature from the entrepreneur or the delegated person. A stamp with the date should be added under the signature.

Checkpoints

The policies and procedures are inadequate if there are no controls in place to ensure that they are respected.

Checkpoints should therefore be set. A person should be appointed to check that authorisation requirements have been respected. It can be either the entrepreneur, somebody the entrepreneur trusts, or an external advisor. Such a checking could take place on a sample basis.

Identification and management of risk areas in SMEs



4.1.4 Whistle blowing

In some cases, fraud can be suspected or identified by colleagues. It is very important to encourage such people to speak out, in order to be able to stop fraud. At the same time, it should be ensured that people who report fraud do so in good faith and have real proof.

As mentioned before, a channel for reporting suspected fraud should be provided by SMEs policies and procedures. It should be ensured that those who report fraud in good faith are not harassed or victimised by the perpetrators of the fraud - their identity should be protected, if necessary. It is also important that fraud reporting should not be financially rewarded, as that may create incentives to report fake fraud cases with the aim of obtaining recompense.

Fraud should be reported by employees to the entrepreneur, or to the appointed person. In the case of fraud being discovered by the entrepreneur, a sound practice would be to consult with a professional advisor, such as an accountant to decide together on the appropriate measures to take.

4.2 What is being done at European and international level

Several measures have been taken at European level to fight fraud. Among the most relevant is the creation of the European Office for the Fight against Fraud and the Financial Action Task Force on Money Laundering.

4.2.1 OLAF (European Anti-Fraud Office)

The European Anti-Fraud Office was created in 1988; it was known at that time as UCLAF, but has changed its name into OLAF (Office Européen de Lutte Anti Fraude) since 1999.

OLAF has administrative powers within the EU and produces investigation reports for prosecutors and disciplinary authorities. It is not a law enforcement body, but represents a combination of institutional status, operational role and policy role, and is independent from the Commission. OLAF co-operates with Europol and Eurojustice. Most of its activities (70%) consist of investigation; other working areas are represented by administration, policy making, infrastructure, follow-up and representations.

4.2.2 FATF (Financial Action Task Force on Money Laundering)

In the field of business fraud, money laundering is increasingly becoming a significant issue, not only for large firms, but for SMEs as well. It can be defined as the processing of criminal proceeds to disguise their illegal origin. When a criminal activity generates substantial profits, the individual or group involved must find a way to control the funds without attracting attention to the underlying activity or the persons involved. Criminals do this by disguising the sources, changing the form, or moving the funds to a place where they are less likely to attract attention. Estimates suggest that a significant percentage of all money in circulation, worldwide, could be 'dirty' money¹¹.

¹¹ Anti-Money Laundering (2004), What every accountant should know, CIMA
(<http://www.cimaglobal.com/main/resources/developments/money/>)

The 2005 Third ‘Anti-Money Laundering Directive’ 2001/97/EC scope covers the financial sector as well as lawyers, notaries, accountants and other independent legal professionals, when participating in financial or corporate transactions, including providing tax advice¹², and real state agents, casinos, trust and company service providers.

In the field of SMEs, the most common money laundering acts are represented by embezzlement, insider trading, bribery and computer fraud schemes. They can produce large profits and create the incentive to “legitimise” the measures obtained through money laundering.

In response to the mounting concern about money laundering, in 1989 the G-7 Summit in Paris established the Financial Action Task Force on money laundering (FATF) to develop a co-ordinated international response. One of the first tasks of the FATF was to develop Recommendations - 40 in all - which set out the measures national governments should take to implement effective anti-money laundering programmes.

Members of the FATF include 33 countries and jurisdictions – including the major financial powers of Europe, North and South America, and Asia – as well as the European Commission and the Gulf Co-operation Council. The FATF works closely with other international bodies involved in combating money laundering.

By its very nature, money laundering occurs outside of the normal range of economic statistics. Nevertheless, as with other aspects of underground economic activity, rough estimates have been put forward to give some sense of scale to the problem. The International Monetary Fund, for example, has stated that the aggregate size of money laundering in the world could be somewhere between two and five percent of the world’s gross domestic product.

¹² In 2004, following the Recommendations of FAFT, the European Commission launched a proposal for a new Anti-Money Laundering Directive “Proposal for a directive of the European Parliament and of the Council on the prevention of the use of the financial system for the purpose of money laundering, including terrorist financing”, which allows Member States to adopt stricter legal provisions to prevent Money Laundering, replacing Directive 2001/97/EC amending Directive 91/308/EEC on prevention of the uses of the financial system for the purpose of money laundering. The ECOFIN Council has adopted the third Anti-Money Laundering Directive on 7 June 2005, after approval by the European Parliament on 26 May 2005.

CHAPTER 5: RECOMMENDATIONS

It is crucial that the manager or owner sets the proper tone at the top, creates and maintains a culture of honesty and ethical behaviour, and establishes appropriate controls to prevent and detect fraud within the company. In establishing such a culture the risk of fraud can be reduced.

The IFAC Code of Ethics Part C applicable to Employed Professional Accountants can be one source for ethical standards and be applied to other parts of the financial reporting chain.

The set up of policies and procedures under a “Four Eyes” principle (involving more than one person) is a crucial part of any set of fraud prevention measures addressing:

- Division of responsibilities;
- Authorisation requirements;
- Check points;
- Whistle blowing.

Professional advisors can play a role in identifying and implementing the appropriate controls and anti fraud measures. Professional accountants typically act as business advisors to SMEs and can play a crucial role in advising on such controls and measures.

APPENDIX I: EXAMPLES OF CIRCUMSTANCES INDICATING THE POSSIBILITY OF FRAUD IN THE FINANCIAL STATEMENTS¹³

The following are examples of circumstances that for a professional advisor may indicate the possibility that the financial statements contain a material misstatement resulting from fraud.

Discrepancies in the accounting records, including the following:

- Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or entity policy;
- Unsupported or unauthorised balances or transactions;
- Last-minute adjustments that significantly affect financial results;
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorised duties;
- Tips or complaints to the auditor about alleged fraud.

Conflicting or missing evidence, including the following:

- Missing documents;
- Documents that appear to have been altered;
- Unavailability of other than photocopied or electronically transmitted documents when documents in original form are expected to exist;
- Significant unexplained items or reconciliations;
- Unusual balance sheet changes, or changes in trends or important financial statement ratios or relationships, for example receivables growing faster than revenues;
- Inconsistent, vague, or implausible responses from management or employees arising from inquiries or analytical procedures;
- Unusual discrepancies between the entity's records and confirmation replies;
- Large numbers of credit entries and other adjustments made to accounts receivable records;
- Unexplained or inadequately explained differences between the accounts receivable sub-ledger and the control account, or between the customer statements and the accounts receivable sub-ledger;
- Missing or non-existent cancelled checks in circumstances where cancelled checks are ordinarily returned to the entity with the bank statement;
- Missing inventory or physical assets of significant magnitude;
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies;
- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated;
- Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments.

¹³ ISA 240 revised: «The auditor's responsibility to consider fraud in an audit of financial statements» – Appendix 3 – 2004

Problematic or unusual relationships between the auditor and management, including the following:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought;
- Undue time pressures imposed by management to resolve complex or contentious issues;
- Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management;
- Unusual delays by the entity in providing requested information;
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques;
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel;
- An unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable;
- An unwillingness to address identified weaknesses in internal control on a timely basis.

Other includes the following:

- Unwillingness by management to permit the auditor to meet privately with those charged with governance;
- Accounting policies that appear to be at variance with industry norms;
- Frequent changes in accounting estimates that do not appear to result from changes circumstances;
- Tolerance of violations of the entity's code of conduct.

APPENDIX II: FRAUD AND THE ROLE OF THE AUDITOR

The primary responsibility for the prevention and detection of fraud rests with both those charged with governance and management of the entity. However, when the entity has appointed a statutory auditor, he will consider the risk of material misstatement in the financial statement due to fraud. The International Standard on Auditing (ISA) 240 “The auditor’s responsibility to consider fraud in an audit of financial statements” is the established international standard which provides guidance on the auditor’s responsibility in this respect. The content of this standard is described in paragraph 2 of its introduction:

“This standard:

- Distinguishes fraud from error and describes the two types of fraud that are relevant to the auditor, that is, misstatements resulting from misappropriation of assets and misstatements resulting from fraudulent financial reporting; describes the respective responsibilities of those charged with governance and the management of the entity for the prevention and detection of fraud, describes the inherent limitations of an audit in the context of fraud, and sets out the responsibilities of the auditor for detecting material misstatements due to fraud;
- Requires the auditor to maintain an attitude of professional skepticism recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor’s past experience with the entity about the honesty and integrity of management and those charged with governance;
- Requires members of the engagement team to discuss the susceptibility of the entity’s financial statements to material misstatement due to fraud and requires the engagement partner to consider which matters are to be communicated to members of the engagement team not involved in the discussion;
- Requires the auditor to:
 - Perform procedures to obtain information that is used to identify the risks of material misstatement due to fraud;
 - Identify and assess the risks of material misstatement due to fraud at the financial statement level and the assertion level; and for those assessed risks that could result in a material misstatement due to fraud, evaluate the design of the entity’s related controls, including relevant control activities, and to determine whether they have been implemented;
 - Determine overall responses to address the risks of material misstatement due to fraud at the financial statement level and consider the assignment and supervision of personnel; consider the accounting policies used by the entity and incorporate an element of unpredictability in the selection of the nature, timing and extent of the audit procedures to be performed;
 - Design and perform audit procedures to respond to the risk of management override of controls;
 - Determine responses to address the assessed risks of material misstatement due to fraud;
 - Consider whether an identified misstatement may be indicative of fraud;
 - Obtain written representations from management relating to fraud; and
 - Communicate with management and those charged with governance;

- Provides guidance on communications with regulatory and enforcement authorities;
- Provides guidance if, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit; and
- Establishes documentation requirements.”

The full text of the ISA is available in the “Handbook of International Auditing, Assurance, and Ethics Pronouncements” issued by the International Federation of Accountants (IFAC) and is available on the IFAC website “www.ifac.org”.

APPENDIX III: REFERENCES

European Office for the Fight against Fraud
http://europa.eu.int/comm/anti_fraud/

Financial Action Task Force on Money Laundering
<http://www.fatf-gafi.org>

IFAC – International Federation of Accountants
<http://www.ifac.org/>

OLAF – European Anti Fraud Office
http://europa.eu.int/comm/anti_fraud/index_en.html

Fraud Advisory Panel
<http://www.fraudadvisorypanel.org/>