

Cooking the Fraud Triangle: A Recipe for Disaster

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Ingredients:

- 2 cups of pressure
- 1 ounce of opportunity
- 2 tablespoons of rationalization

Preparation:

Heat-up the financial pressure at your trusted accounting employee's home resulting from a spouse's layoff. Stir frequently to include late notices, embarrassing dunning phone calls and preliminary foreclosure proceedings. Combine the opportunity presented to this employee by your departmental staff reductions and reduced segregation of duties. Add his/her escalating feelings of exploitation caused by increased responsibilities and hours worked at the same level of pay. Bring to a rapid boil and serve.

This is a recipe for disaster...a series of events and circumstances that lead a trusted employee with no criminal history to commit fraud. And it's on the rise. According to the Association of Certified Fraud Examiners ("ACFE"), the median estimate of what a typical organization lost to fraud in 2006 was 5% of its annual revenues.¹ By 2008, that number had risen to 7%.² The ACFE cautions that even these numbers may be imprecise; many frauds go undetected, amounts cannot be determined, or the victim organizations choose not to report the thefts to authorities.

Many experts agree that there is an inverse relationship between the economy and fraud. As the economy continues to falter, instances of employee fraud begin to rise. So how does a company respond to this escalating threat? Well, the most economical way, is to reduce the risk and prevent it from happening in the first place. How? A good starting point is to understand why it occurs. The classic Fraud Triangle³, developed by pioneering criminologist, Donald Cressey, goes along way in providing a sociological perspective on this recipe; a model which explains "why" essentially good people commit fraud.

According to Cressey, in order for an ordinary person to commit fraud, the "perfect storm" of these three factors must be present:

- Pressure
- Opportunity
- Rationalization

Let's examine each factor in light of the current economic climate.

Pressure:

Lately, everyone seems to know someone who has been recently let go as part of a mass layoff. And if you don't, take a look at Forbes Magazine's "Layoff Tracker" which lists the layoffs at America's 500 largest public companies since November 1, 2008. In addition to the usual suspects in the financial services, housing and auto industries, the group is ever expanding to include more and more diverse public companies. As of January 23, 2009, just over two and a half months since Forbes first started to publish the list, the number of laid off workers at the largest public companies has ballooned to 272,475.⁴

According to the Bureau of Labor Statistics ("BLS") of the U.S. Department of Labor, the number of unemployed workers has increased by 3.6 million people since the start of the recession in December 2007. As of December 2008, the aggregate total of unemployed Americans now stands at a whopping 11.1 million.⁵

This group of 3.6 million "newly" unemployed workers represents a cross section of large and small, public and private companies. Most have been let go as part of a mass layoff "event." The BLS defines mass layoff events as actions involving companies that have had 50 or more people laid off during a 5 week period. They calculate that from December 2007 through November 2008, "the total number of mass layoff events (seasonally adjusted) was 20,712, and the number of initial claims (seasonally adjusted) was 2,108,743."⁶

Many people, living from paycheck to paycheck, are ill-prepared financially for the pressures of a layoff. Typically not anticipated, most do not have a sufficient "emergency fund" set aside. Statistics from the Bureau of Economic Analysis ("BEA") of the U.S. Department of Commerce bear this out. Since the 1980s, personal savings as a percentage of disposal income has continued to slide. In fact, in 2005, the rate dipped negative to -0.4 percent for the first time since 1933.⁷ Following the government's rebate program, there was a slight uptick in the personal savings rate to 2.8 percent in November 2008,⁸ but the BEA cautions that "actual" savings from current income may be near zero or negative when expenditures are financed by borrowing, investments are sold, or savings from previous periods are included.

Cressey, however, defines fraud pressure as a "perceived non-sharable financial need." By that he means that it is not just financial pressure that causes a trusted employee to commit fraud. Clearly, most of us face some sort of financial pressure at some point in our lives yet we don't steal from our employers. Instead, Cressey says, it is the "status-deflating" feelings associated with that financial pressure...the embarrassment of unpaid bills...or the shame associated with the threat of foreclosure...that ultimately are the first component of the triangle.

Opportunity:

As companies continue to layoff workers in an effort to improve their short-term financial position, the remaining staff is frequently asked to do more. Now your accounts payable manager is also reconciling your bank statements. Or, your controller can now approve and add new vendors or has access to payroll. Maybe you have even been forced to make significant reductions in your internal audit group.

Segregation of important duties, checks and balances, monitoring, watchful eyes... all become a thing of the past. Add in a little late night, clandestine “working” hours and you have the perfect opportunity for all sorts of employee fraud.

Rationalization:

In the context of this article, it is fairly easy to see how your trusted employee might attempt to justify committing fraud. Maybe she was just “borrowing” the money and planned on paying it back when her financial situation turned around. Or, she felt entitled to the extra cash for all the extra hours she was working without a commensurate pay increase.

An additional component has even been suggested by the fraud investigation community as the result of the present mass layoff situation. They claim that as a result of the current “layoff culture,” the employees surviving a mass layoff may be left with feeling of insecurity, isolation and hopelessness. They believe that management has created this culture and that it differs markedly from employee induced rationalizations. They even suggest that a fourth “dimension” should be added to the Fraud Triangle. Renamed the Fraud Diamond, this fourth dimension would explain the widespread feelings associated with the phenomena of mass layoffs and the resultant erosion of healthcare and pension benefits.⁹

Clean-up:

What can you do as an employer to prevent this “perfect storm” from happening? A good starting point is to revisit the prevention element of your antifraud program. Knowing the departmental effects of the mass layoff in your organization, a targeted re-assessment of the newly reduced unit, convergence of tasks, job functions and significant accounts will help to identify and determine the significance of those which might be particularly vulnerable to fraud. Then, fix the problem, add the necessary controls, or reduce certain authority or responsibilities. Finally, make sure to re-communicate your code of conduct emphasizing your commitment to integrity and providing practical guidance on hypothetical examples and solutions.

Remember, reducing the “opportunity” for fraud in your organization not only spoils the recipe and hopefully reduces your potential for loss, but it could also prevent Sarbanes Oxley compliance issues associated with inadequate segregation of duties.

¹ Association of Certified Fraud Examiners, 2007 Report to the Nation on Occupational Fraud & Abuse, page 4, <<http://www.acfe.com/documents/2006-rttn.pdf>>

² Association of Certified Fraud Examiners, 2008 Report to the Nation on Occupational Fraud & Abuse, page 4, <<http://www.acfe.com/documents/2008-rttn.pdf>>

³ Donald R. Cressey, Other Peoples Money: A Study in the Social Psychology of Embezzlement, (Montclair, NJ: Patterson Smith, 1973), page 30.

⁴ Klaus Kneale, “Layoff Tracker,” Forbes.com, January 23, 2009, http://www.forbes.com/2008/11/17/layoff-tracker-unemployment-lead-cx_kk_1118tracker.html

⁵ United States, Department of Labor, Bureau of Labor Statistics, The Employment Situation: December 2008, <http://www.bls.gov/news.release/empsit.nr0.htm>

⁶ United States, Department of Labor, Bureau of Labor Statistics, Economic News Release, Mass Layoffs Summary, November 2008, <http://www.bls.gov/news.release/mmls.nr0.htm>

⁷ Marshall B. Reinsdorf, United States, Department of Commerce, Bureau of Economic Analysis, Alternative Measures of Personal Saving, February 2007, http://www.bea.gov/scb/pdf/2007/02%20February/0207_saving.pdf

⁸ Dave Carpenter, Associated Press, “Rainy-day funds grow in stormy economy,” The Houston Chronicle, January 16, 2009, <http://www.chron.com/disp/story.mpl/headline/biz/6216238.html>

⁹ Peter Goldmann, “The New Fraud Triangle: Another Dimension in Employee Fraud Motivation,” Association of Certified Fraud Examiners, July 2008, Fraud Examiner Newsletter, <http://www.acfe.com/newsletters/fraud-examiner.asp?copy=july08-goldmann-column>

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