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The Gauge of Innocence

Fraud takes many forms. Count on all of them to increase this year.

S.L. Mintz

In tough times, companies face plenty of honest challenges, and most managers and staffers rise to the occasion. But inevitably, as pressures multiply, some will cave in and demonstrate poor judgment, or worse. They may blur the lines on revenue recognition, tinker with stock options, abuse reserves, or evade loan covenants. Petty favors from vendors or "innocent" side deals with customers snowball into grand larceny.

Pay cuts, layoffs, diminished morale, and fewer resources devoted to internal controls are among the specific pressures that "open the door to fraud in a down market," says Kerry Francis, chairman of Deloitte Financial Advisory Services, the accounting firm's U.S. fraud investigative arm.

She began emphasizing such concern in early 2009, after a Deloitte survey found that two-thirds of 1,280 financial-services and technology executives expected to see more instances of accounting fraud.

Since Francis first sounded that alert, the downturn has become vastly more severe. Stunning Ponzi schemes at Stanford Group (allegedly) and Madoff Securities have made fraud a key theme of the current economic morass.

CFOs can't be expected to peer into the souls of every employee or business partner, of course, but they do need to be more cognizant than ever of the three sides of the classic "fraud triangle": pressure, opportunity, and the capacity to rationalize. When those elements unite, fraud often erupts.

The perpetrators are frequently those you would least suspect, says Dan Ariely, author of *Predictably Irrational: The Hidden Forces that Shape Our Decisions*. Repeated behavioral testing shows that people cheat if they can get away with it — even smart, Ivy League–educated people with relatively little to gain (see "Thou Shalt Not Commit Fraud" at the end of this article). "The moment you have a fuzzy environment," Ariely says, "the more this can happen." In finance, recessions are very fuzzy. "CFOs are on shaky ground," warns Ariely, "because they are [now] operating in very difficult conditions."

For every case that makes headlines and ends with prosecutions, thousands of garden-variety frauds quietly drain corporate assets. The costs can cripple small and large companies. According to one unscientific estimate — a 2007–2008 survey of certified fraud examiners by the Association of Certified Fraud Examiners (ACFE) — U.S. organizations may lose 7 percent of their annual revenues to fraud, including financial-statement fraud.

Some fraud is flagrant crime, of course, but in other cases it can be thought of as good intentions gone badly awry. "The pressure can be enormous," warns Michael Young, an attorney with Willkie Farr & Gallagher and editor of *Accounting Irregularities and Financial Fraud: A Corporate Governance Guide*. "Insiders don't have crystal balls. All they know is that business has turned south and that that is not what outsiders are expecting. It presents almost a petri dish of temptation to meet expectations through some kind of accounting adjustment." That's often fatal, Young notes, because prosecutors and plaintiffs' lawyers pay close attention to evidence that performance targets or objectives influenced reported results.

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