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Minimizing Fraud During a Boom Business Cycle

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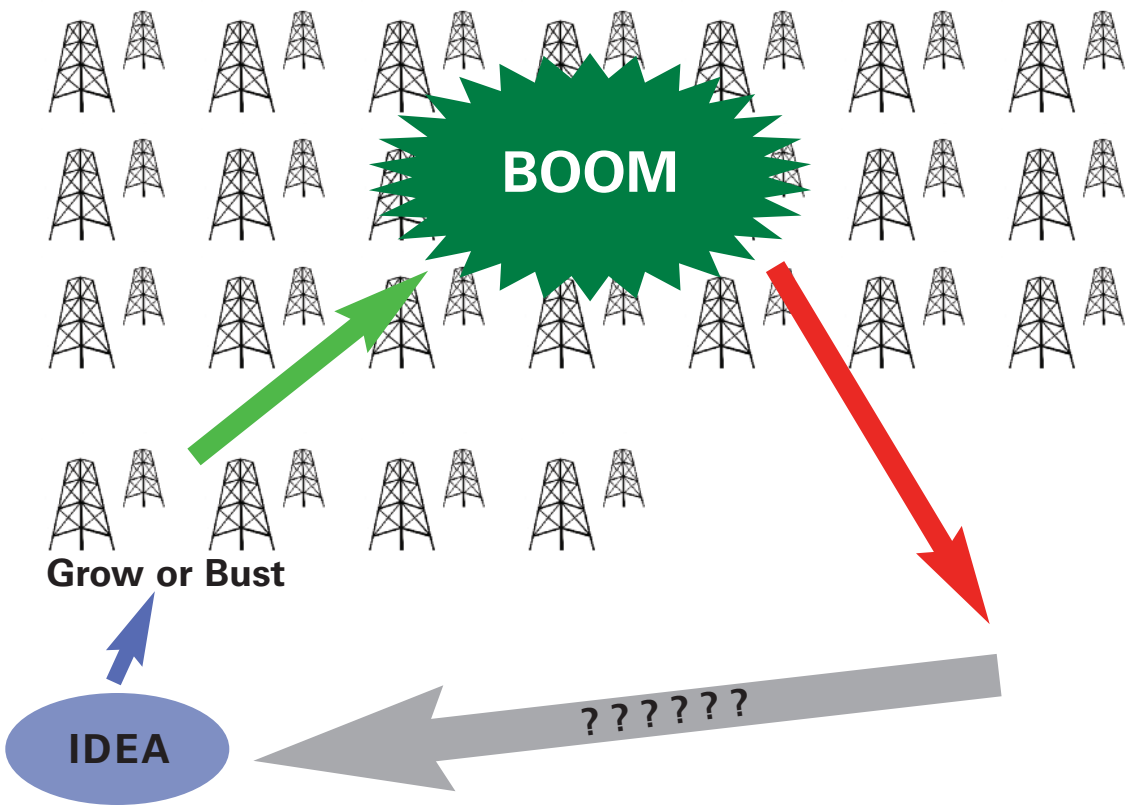
EXECUTIVE SUMMARY

Companies need to be alert to potential opportunities for fraud to be committed and aware of any outdated internal controls, processes, and procedures. Good internal controls are one of the best fraud-prevention methods.

Rapid growth such as that currently in the oil and gas hydraulic fracturing (or fracking) industry can be both newsworthy and profitable. The excitement surrounding the accelerated economic growth of the Eagle Ford Shale project in Texas provides an excellent example. By the end of 2011, digital and print media outlets were covering the project extensively. At that time, the Center for Community and Business Research estimated that Eagle Ford business activities supported 38,000 full-time jobs and had an estimated economic impact of slightly less than $20 billion in 14 Texas counties. By the end of 2013, the project was supporting approximately 155,000 full-time jobs, had an estimated economic impact of $87.8 billion in 21 counties, and had professionals projecting continued growth decades into the future.[1] Most current reports about the impact of fracking in the Eagle Ford Shale project and other locations still portray a promising economic future, but history provides many reminders that projections of corporate profits and national economic growth can be as fluid and vaporous as, in this case, the natural products being extracted.

Boom-to-bust cycles reflect periods of economic strength, prosperity, and growth followed by periods of recession, hardship, and contraction. Boom-to-bust cycles similar to the one the fracking industry is experiencing are relatively common

Figure 1: Business Cycle of a Boom-to-Bust Company



and can affect businesses operating in virtually any industry. Indeed, they have affected the hotel, airline, automobile, real estate, credit card, tourism, and even pornography industries. The rapid growth and, later, contraction of companies in a boom-then-bust period can cause unique challenges in managing company resources, developing and implementing reliable internal controls, and ensuring dependable, accurate reporting.

Many companies have lost the hard battle of boom-to-bust, but others have managed to survive and continue operating after economic conditions have returned to a less volatile state. The rapid explosion of growth in a boom company creates varied challenges that can actually lead to conditions that act as a miniature incubator for fraud development. Having so many changes occur in such a short time span creates an almost perfect laboratory environment with exponential growth in the potential for fraud.

Unfortunately, many managers who are balancing the demands of rapid growth do not discover that fraud is occurring until the bust phase of the cycle has begun and embezzlement of many dollars or assets has taken place. Indeed, studies have shown that fraud often occurs during a boom period, but the company finds it only during the later bust phase as the business contracts.[2] Perhaps when a company is doing well, it is often easy to overlook the fact that assets are being lost to fraud and theft. Therefore, managers need to protect against fraud while the boom phase is still under way. This article addresses these issues and uses the Eagle Ford Shale project to illustrate ways in which companies experiencing extensive and rapid growth can improve internal controls to minimize fraud.

Boom-to-Bust Cycles and Fracking

In many boom-to-bust industry sectors, the business life cycle is quite different from that of a more traditional company. Companies generally move at a steady pace among the start-up, growth, expansion, maturity, and transition or dissolution phases. As Figure 1 shows,

in boom-to-bust companies the following happens:

- A company recognizes an idea and acts on it quickly;
- Irrational exuberance in the marketplace embraces the idea, which causes a rapid explosion of positive business activity;
- Market rationality takes hold, or another boom idea occurs; and
- Activity sharply contracts, leaving depressed prices, limited capital market access, and economic downturn for the company and industry. Sometimes recovery takes place after the passage of time provides a level of modification of the original idea.

Few industries, however, have experienced the continual boom-to-bust-to-boom cycle of the energy industry. Whether the energy segment is coal, natural gas, oil, wind, solar, electric, or green, the cycle has been ongoing, driven by supply-and-demand volatility; rapid changes in improved and, in some instances, failed technology; and the introduction then disappearance of tax incentives that cause companies to modify their business transactional and strategic pursuits or divestitures. Table 1 describes some boom-to-bust cycles in the shale energy sector.

A recent entrant into the energy industry is hydraulic fracturing, a process in which water and chemicals are blasted into shale to extract oil and gas. This process is definitively in a boom phase: The Energy Information Administration (EIA) estimated the proportion of total natural gas produced from shale would increase from 23% in 2010 to 46% by 2035.[3] Although this resource extraction process is in the early stages of exploration and development around the world, major industry players, such as Chevron, are currently acquiring shale acreage outside the United States. Already this extraction technology has created thousands of jobs and has enhanced economic growth in Colorado, Louisiana, North Dakota, Ohio, Pennsylvania, Texas, and Wyoming. Pennsylvania's Department of Labor and Industry, for example, reported that fracking activities created 72,000 jobs in little more than a year. Fracking also is the primary reason for North Dakota's unemployment rate standing at the lowest rate in the nation for more than 69 consecutive months.[4] But fracking also has become controversial, and New York recently banned it.

Organizational Changes in a Boom Industry and Internal Control Effects

An industry boom creates a wide variety of internal changes in the organizations composing that industry sector. Such changes typically involve corporate strategy and policies/procedures redesign, extensive personnel modifications, technology and asset acquisitions, revenue and expense transaction adjustments, and, possibly, a cultural transformation. Companies operating in a booming industry typically experience massive employment, technology and information security, and fixed asset and revenue and expense changes that naturally affect the internal controls previously in place. Variations also may take place in the organizational culture through increased pressure for performance or for greater creative risk taking. Such significant internal environment modifications will affect the organization's business model, risk and assessment of that risk, reporting lines, and monitoring abilities. Externally, a company in a boom environment needs a larger, more flexible supply chain from which to obtain necessary inputs.

Each change may exacerbate organizational stress in individuals, and this stress may raise the potential for organizational fraud risk and vulnerability or opportunity. In a boom environment, changes may be imposed or implemented rapidly, but management must actively acknowledge that all changes must be reviewed after enactment for across-the-board effectiveness, efficiency, and due operational care. A company may need to make alterations on an after-the-fact basis if the results are not necessarily those it desired.

Companies often overlook internal controls (ICs) in such a dynamic, fluid environment. An organization uses internal controls to provide reasonable assurance in the following categories: (1) reliability of financial reporting, (2) effectiveness and efficiency of operations, and (3) compliance with applicable laws and regulations. Within the overarching constraint of cost-benefit analysis, ICs provide a predicted level of asset protection and policy and procedure compliance. But because an organization's operating environment is intricate and in constant flux, internal controls that worked at one point may not be appropriate at another point.

Given the potential for change, it is critical to identify the conditions that might allow a fraud to become

Table 1: A Sample of Past and Present Shale Oil Cycles

Began	Location	Ended or Current Status
Pre-WWI (spurred by U.S. government's interest in potentially inexpensive fuel)	Californina, Utah, Wyoming, and the Western Slope of Colorado	Ended in mid-1920s with the Teapot Dome Scandal (first recorded scam related to shale oil investment).
Early 1970s	Western Slope of Colorado, then across entire length of Rocky Mountains, touching 200+ towns in Colorado, Utah, Wyoming, and Montana	On "Black Sunday," May 2, 1982, Exxon's board of directors shut down operations on what was then the largest construction project in the world—a commercial shale oil plant funded by a consortium of different companies headed by Exxon—known as the "Colony Project."
Federal government-funded drilling ran from the early 1970s to mid-1980s. Nongovernmental investment started in 2007.	Western Pennsylvania and parts of New York (Marcellus and Utica shale land)	As of 2013, citizens of these areas are seeing their dreams of prosperity tumble into (undeveloped) dirt, and environmental lawsuits are flourishing.
Early 2000s	Southern California (Monterey Shale); discussion of 512,000 to 2.8 million jobs from 2015 to 2020, with $25 billion added to California's coffers	To date, though this reserve is considered one of the largest in the U.S., no commercially viable well has yet been drilled.
First drilled in the 1950s but not considered economically viable until 2008 due to technological changes (fracking)	North Dakota (Bakken Shale Oil Region); has given the area the lowest unemployment rate in the nation even with a mushrooming population; almost a 50% increase in new businesses since 2009 (compared to 3% nationally); and area bank deposits up more than 20%	By 2010, production levels were outstripping shipping capacity. Current new drilling sites are being started on a regular basis as oil companies race to lock in previously signed oil leases before they expire (once drilling starts, a lease typically cannot expire).
Relatively low activity and low investment until 2008, then commercial investment, drilling, and production exploded to current levels	Central and South Texas (Eagle Ford Shale); unprecedented community growth (e.g., Corpus Christi had $20+ billion in new investment in 2012)	Currently, the Eagle Ford is the most active shale play in the world with more than 240 rigs running.

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viable and develop so the company can nullify them to the extent possible by instituting better IC processes. For example, when dealing with internal controls in a rapidly growing firm, it is common to find that managers may believe that previous system controls are still effective, yet the reality is that old controls may be

unreliable or missing. For example, a new computer system may fail to adequately segregate programming and system operation functions, yet in the rush to meet deadlines and goals, the manager in charge may not recognize that this is an issue.

Now let's look at the issues companies face related to employment, technology and information, revenues and expenses, fixed assets, and organizational culture.

Employment

Any company facing an economic boom recognizes the need to hire new employees, generally at all different skill levels, and hiring needs often are imminent. For example, shale gas activity is spurring a demand not just for the typical oil and gas jobs of drillers and geologists; it is a direct driver of increased job opportunities in an array of professions from software engineers to wildlife experts.[5] In such circumstances, there may be a high probability of modifying some existing personnel policies for the sole purpose of expediencies of recruitment. Additionally, depending on the boom business's location, the local workforce may not be large or diverse enough to fill the open employment opportunities, thereby creating the necessity to expand the recruitment search region and possibly the need to improve the employment incentive package.

One standard IC is specification of new-hire job functions so that personnel qualifications can be matched with organizational positions. Companies with looming hiring needs should stringently specify the differences between required and desired hiring characteristics and maintain rigid oversight. No downward modifications should be allowed for required characteristics, whether those are academic, professional, experience, drug testing, or background. Ignoring job requirements puts the organization at risk of placing a person in a position for which he or she is unsuited or incompetent.

An employee being unsuited for his or her position raises the possibility of charges of negligent hiring, which refers to the employment of an individual by an employer who knows, or should have known, that the individual had a character trait or prior conduct that would cause risk or harm to others while that employee was carrying out his or her responsibilities. The Eagle Ford Shale project has pushed salaries for needed commercial truckers to $80,000 per year with the promise of tens of thousands of additional shale field jobs. Employers hiring for the region, however, say they are rejecting up to 40% of all shale job applicants because they cannot pass pre-employment drug tests. While such a situation has not been a problem with engineering or other professional position applicants, it is recognized as a major problem among applicants for rig worker and trucker jobs.[6]

Without internal controls firmly in place to verify there are no evident deficiencies or fraudulent personnel credentials with regard to new and current employees, boom companies could face the fate of Dunaway Timber Co. In *Reagan v. Dunaway Timber Co*., the judge awarded a victim's family $7 million in damages after a truck driver for Dunaway killed the victim. The company failed to do an appropriate background check that would have revealed two license revocations for driving while intoxicated.[7]

When a company violates the ICs related to the hiring process, the potential for fraud increases. Consider the negligent hiring in the *Mycom v. Persona* case in which a temporary employment agency had to settle with a client firm after stating that temp workers were "thoroughly referenced and screened."[8] Unfortunately, the company did not do a background check on a temp worker with a history of theft. Placed in a position of trust, this temp employee embezzled funds at the temp job site.

Incompetent employees may be more likely to engage in fraud to cover up errors, override internal controls because of management pressure, or ignore separation of duties because of a need to rely on someone else to get the job done. Additionally, employees who are less than competent for the positions in which they find themselves may become disgruntled and unable to cope with job pressures. Unhappy employees are "more likely to lash out against their employers" and possibly engage in revenge activities that could include misappropriated assets or sabotage.[9]

Although background screening is an essential internal control when hiring, using a criminal background check as a basis for treating a Title VII-covered individual differently can potentially result in discrimination charges. Title VII prohibits discrimination on the basis

of race, color, religion, sex, or national origin. The use of criminal records as a basis for excluding candidates from employment consideration has been found to have a disparate impact on Title VII-protected candidates.[10] Therefore, a company should make an individualized assessment of the nature of the job before engaging in a criminal background check.

Employers should be prepared to demonstrate that there is a business necessity that precludes hiring the applicant with a criminal record or that the nature of the crime committed would prevent the applicant from being effective in the position. The employer also needs to consider the type of crime and how long ago it occurred. Thus, an essential IC makes a connection between a specific criminal offense, including drug use, and reasons that would disqualify the candidate for a particular job. Recognizing the types of fraud that individuals can commit in various positions allows an employer to assess the potential for linkages between prior criminal activities and possible future fraud opportunities, thereby creating valid criteria for disqualifications.

Technology and Information Security

In a boom cycle, a whirlwind of activity confronts an organization, and many attempt to tame the resulting chaos with technology. It is common for technology upgrades in a rapidly growing company to affect accounting and/or inventory systems, communication channels for an ever-increasing number of employees, network expansion, and, in some industries, modified production lines to increase capacity and throughput. Business-to-Business (B2B) customer and supply chain technology upgrades also are common. Every technological change fosters the potential for compromised data integrity, hardware and software incompatibility with the organization's legacy system, inappropriate access by employees to information, and the potential for security breaches caused using outdated security standards.

For the oil and gas industry, the theft of intellectual property—such as financial details, trade secrets, industrial designs, and copyrights—can make or break a company. An Internet search or job-posting search of current job listings for information security specialists, specifically for Eagle Ford operations, brings up a long list of professionals needed in this area. The fact that litigation experts already are targeting their advertising to Eagle Ford employers and investors highlights the risks inherent in technological assets.

The rapid expansion of a boom business often creates internal control weaknesses in the organization's computer and management information systems. One of the first difficulties often relates to the personnel factor: Newly hired technology and information security employees may not have the appropriate work credentials. But even with knowledgeable employees, the massive technology changes that typically occur in a boom business provide the opportunity for a single employee to become the technology guru and develop a monopoly of knowledge. Such an individual could manipulate the technology and circumvent any related ICs without detection. Even without any such employee transgressions, the company is vulnerable if the employee becomes ill or leaves the firm.

Modifications to existing computer systems generate a host of IC issues. Legacy IT systems from the pre-boom days may be disparate or found to be duplicative, contradictory, or insufficient when combined with the needed new hardware or software to conduct the influx of new business. Business expansion may be motivation for managers to move toward paperless offices—possibly because of space restrictions or a greater recognition of the benefits of being green.

If hard documents become virtually nonexistent, the need for offsite backup becomes even more critical than is typical. In a rush to obtain such offsite backup, management may do so with little determination of data accessibility, access risks, or potential need for real-time rather than batch backup. Incompatible or untested data restoration processes or periodic batch-based backups may mean that the data managers thought was protected is woefully incomplete or inaccessible. Although a company has established a data backup internal control, the efficacy of that system is limited, and the IC will fail in its purported objectives.

In addition, system upgrades and software modifications often render existing documentation obsolete. A lack of accurate supporting documentation means that there might be an inability to describe underlying processes, follow transactions from start to finish, or identify individuals who should or should not interact

with the system and its data. Documentation is designed to indicate the ICs operating within a system. Undocumented system changes may relegate the ICs to history and to managerial imagination—together generating organizational fraud opportunities.

Fixed Assets

A boom in business activity generally creates the need to purchase additional assets to meet demand—some of which may be different from those previously needed. In 2010, the companies involved in Eagle Ford Shale had an average daily production of a mere 15,163 barrels of oil. By early 2014, an industry analyst announced the number had reached one million barrels per day with reported expectations of breaking the 1.5 million-barrels-per-day mark in 2015. And growth in the Eagle Ford Shale natural gas production figures (measured in cubic feet per day) are also impressive—an increase by 343% in the past seven-and-a-half years.[11] This colossal increase in daily oil and gas production in such a short time span is possible only with a huge investment in fixed assets.

Companies experiencing dramatic growth such as this may need new leases to add more fixed assets in order to handle the increased business activities. Also, purchasing-agent buying power may have to be increased exponentially and new support put in place to help agents bombarded with requests for relationships with new suppliers. The preponderance of acquisition needs could overwhelm the purchasing system that was in place prior to the boom, and, as with hiring needs, the company may make concessions to speed up purchasing processes and reduce backlogs.

Although precise figures on total asset purchases are not available for specific companies, a 2014 Grant Thornton (GT) survey of upstream U.S. energy companies stated that "When asked what are the plans for capital spending in 2014 vs. 2015 for U.S. expenditures, 67% of the respondents expect to boost expenditures up to 20% or more in the coming year. Just 18% forecast no change, and only 5% expect a decrease." Looking back just one year, one of the noteworthy changes in the annual GT survey responses from 2012 to 2013 was the increase in U.S. year-end average total assets from $1.6 billion to $4.7 billion.[12]

A high probability exists that many of those dollars go to acquire hard assets of boom businesses. For instance, companies identified some planned expenditures in relationship to shale gas activities:

- Formosa Plastics—$1.5 billion on an ethylene plant and downstream assets in Texas;
- Nucor—$750 million on a direct-reduced iron facility in Louisiana, with a permit received for a second facility;
- U.S. Steel—$95 million on an Ohio plant for shale gas extraction; and
- Vallourec—$650 million on an Ohio plant for steel pipe for companies extracting shale gas.[13]

Because fixed assets may represent a substantial proportion of an organization's resources, effective internal controls must exist to protect those assets at the time of acquisition, usage, and disposition. One area in which these controls are essential is purchasing: The sheer dollar amount and volume of needed asset acquisitions raise the likelihood of improper asset requisitions or transfers, not to mention the boundless potential for bribes or illegal gratuities from vendors, overbilling for purchases with the opportunity for kickbacks, and contractor bid-rigging schemes. Additionally, the never-ending lease contracts for land or other hard assets provide endless situations in which corruption could proliferate. The need for segregation of duties among the requisition, purchasing, and receiving areas is paramount. Moreover, a critical part of fraud reduction is attentiveness to detail: Unauthorized asset purchases can be completed successfully simply because "the person with approval authority is inattentive" or (going back to basic personnel issues) that person must rely on "subordinates' guidance in purchasing matters."[14]

To protect these assets, it is important to consider the inherent risk associated with them. Inherent risk exists prior to implementing internal controls. For example, some fixed assets, such as oil rigs and buildings, are less subject to theft or fraud so are inherently less risky than certain other fixed assets, such as office equipment and vehicles. Nevertheless, all fixed assets need physical safeguard ICs that minimize access to valuable and vulnerable resources.

Unfortunately, the effectiveness of many physical

safeguards deteriorates over time because of trust among individuals who work closely together or because of simple carelessness. They leave locks unlocked or place keys in easily extracted hiding places. They turn off cameras or do not observe them. On the surface, the safeguards appear to be in place. Only by asking to enter the locked warehouse space or view camera footage of a restricted area will a company find the controls' ineffectiveness. Inappropriate access to valuable assets—especially when there is a continually changing group of personnel because of massive hiring activities—provides the opportunity for asset theft or misuse.

A final asset issue relates to valuation. In the fracking industry, questions may arise about how much the land containing the gas is worth or how much gas the land contains, which then affects the worth of that natural resource. With the massive increase in the number of shale projects and shale project operators, caution should be a key word in assessing individuals' credibility.

Various parties have the potential to inflate reserves and value land inappropriately. One Texas energy consultant called the industry a Ponzi scheme that overhypes shale gas quantities to recover company funds invested in drilling and leases. That consultant also noted similarities between current fracking industry conditions and the subprime mortgage market just prior to its meltdown.[15] Because gas reserves are only an estimate, dishonest persons have an opportunity to overstate value when engaging in borrowing activities, selling organizational shares, or extending drilling leases to subcontractors. On the other hand, a company could underestimate reserves to diminish prices it pays to landowners for purchases or leaseholds.

Revenues and Expenses

A business boom will cause massive increases in revenues and expenses, which will influence accounts receivable processes, including customer verification, debt collections, and write-off procedures; cost-of-goods-sold calculations; and asset prepayments. The boom may also affect deferred revenues or contingent liabilities. Changes in numerous accounting estimates such as asset lives, bad-debt estimates, or pension liabilities may result from new activity, customers, and personnel. The changes that occur in the revenue and expense processes of a boom business often create unclear lines of authority, unfamiliar cost allocations, and unknown modifications in accounting estimations.

Each time a company changes a process or procedure, established ICs may become ineffective. In the rush to establish new customers in a timely manner, a business may extend credit without proper review. A firm may try to pump up profitability to look better to creditors so it can increase organizational lines of credit to support asset acquisitions. To accomplish this, it may need to make adjustments to reduce expenses: Lengthening asset lives, increasing estimates of asset salvage values, and underestimating the potential for uncollectible accounts have been tactics to grow businesses rapidly. A company also may modify cost allocations improperly. For instance, output-based payments to landowners could show a lower-than-realistic output to minimize the payment. Many landowners who have leased mineral rights may be thrilled to be receiving large checks from the fracking company and not realize that such checks should actually be substantially larger.

High-growth companies need available and reliable sources of input factors as well as efficient and cost-effective distribution outlets. Because the new, fast-growing business might be an unknown quantity, its place in the supply chain infrastructure may be weak and make it difficult to identify or select necessary upstream and/or downstream market participants such as providers, vendors, or possibly even consumers. Controls related to purchasing contracts, inventory purchasing quantities, or conflict-of-interest statements may be lacking or inadequate. Alternatively, if the growth company is in a new type of business or is generating a new type of product, the necessary supply chain may not be wholly formulated or functioning.

Preventing vendor fraud is a major issue for all companies, especially those in rapid-growth mode. Case reports relating to this topic are very common in the oil and gas industry. The active Eagle Ford Shale development currently covers a 30-county area in South and Central Texas where both gas and oil drilling and production operations are expanding at a pace beyond expectation.

The industry's explosive growth and fragmented work environment make oil and gas firms easier targets for vendor fraud. In a 2012 case, a contract field technician used a chain of job agencies to create fake employees, steal more than $1 million from a reputable oil company operating outside the Eagle Ford region, and evade prosecution.[16] As in typical scenarios of this sort, line managers did not certify timesheets and secure and verify identification documentation, and the firm's local branch relied fully on the credibility of a vendor with whom it had limited prior exposure.

Internal controls for all projects should include the preparation of time assessments and budgets to ensure that revenues and expenses stay within expectations. A firm should limit its exposure to vendors with which it has had no prior connection and be vigilant of management and procedure changes within vendors with which it has a long, extensive relationship. False reporting, manipulated records, embezzlement, and forgery risks run high as firms experience atypical growth patterns in their operations.

Organizational Culture

When an organization booms, expectations of profitability typically are raised, and, simultaneously, employees—especially those in managerial positions—want to feel the residual effects of such profitability. Business booms often lead to primarily executive, but sometimes rank-and-file, compensation packages based heavily on stock options, which we saw during the boom in the technology industry in the late 1990s.[17] Stock option packages, in turn, place some level of pressure on the individuals who receive those options to maintain or increase organizational bottom line performance. "In a corporation, the focus on performance is perhaps the most important dimension of its culture."[18]

In previous boom periods, managers with high levels of incentive compensation often have focused on maximizing share prices to the detriment of the company's longer-term profitability.[19] Incentive-based compensation can underlie this sort of behavior because share price is tied directly to organizational profitability, which is tied to incentive compensation. Such a circular process can create a culture focused solely on a financial performance measurement, thereby excluding other important business factors such as customers, employees, operational quality, speed, and sustainability, which are necessary for long-term organizational survival and value.

Mergers and acquisitions—both of assets only and of entire operations—are happening regularly in the booming Eagle Ford Shale business environment. For instance, in 2009, Exxon Mobil Corporation acquired XTO Energy, a Texas-based oil and gas producer, in a $41 billion acquisition. In 2011, Australian mining company BHP Billiton agreed to acquire Houston-based oil and gas explorer Petrohawk Energy, a major player in the Eagle Ford area, in an approximate $15 billion transaction.[20] In early July 2013, EXCO Resources, Inc. completed an approximate $1 billion aggregate purchase from Chesapeake Energy Corporation that included more than 55,000 acres, 94 producing wells, and an additional 300 identified future drilling locations.[21] EXCO plans to partner with other entities to drill and develop many of the undeveloped locations. Each event of this type requires a full evaluation of internal controls in place for both operations as the engagement moves through to its end.

The meshing of current ICs with any potential adjustments necessitated by such formidable expansions requires close oversight so that managers do not overlook components or needlessly duplicate them. In addition, established ICs become stretched and tested as new regulatory compliance strategies come into play when a company moves from possibly being only an upstream operation to being a midstream, downstream, or segment combination in the oil and gas industry.

Tips for Reducing Fraud Opportunities

Opportunities to commit fraud can arise in all organizations, but, because of massive operational and structural changes, they are especially prevalent in those companies experiencing boom economic circumstances. Given that companies cannot eliminate the pressures and incentives of fraudsters to commit fraud, managers need to work diligently to reduce the opportunity for fraud to occur. To do so, they should adopt the ABCs of prevention concepts in Figure 2.

Ascertain

Managers must be aware of the types of fraud opportunities that can arise in boom organizations. The three primary fraud schemes to protect against are asset misappropriations, corruption, and financial reporting irregularities. To protect the organization from fraud, managers must assess the specific organizational risk environment and the cost/benefit relationships.

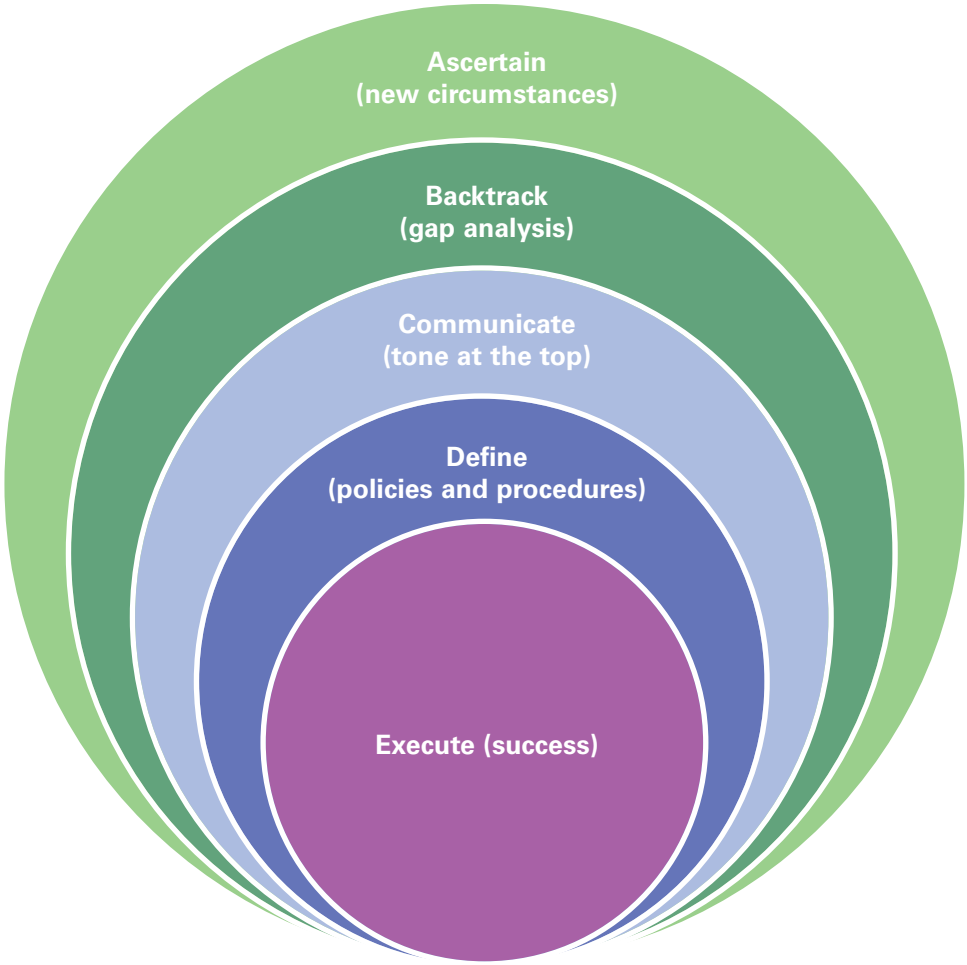
Backtrack

Simply knowing that fraud may occur does not keep the problem from occurring. Managers need to review and understand old controls, policies, and personnel duties to determine if they are still effective or if new circumstances require changes. Being aware of what could happen and the new circumstances and comparing those with old circumstances and controls provides a gap analysis that can highlight potential problem areas. Stacking new controls on top of old policies is a recipe for inconsistency, incompatibility, and inefficiency—not to mention an invitation to fraud opportunities!

Communicate

Tone at the top is crucial. Managers must communicate to all personnel at all organizational levels that the company has zero tolerance for any type of occupational

Figure 2: The ABCs for Reducing Fraud Potential



fraud or abuse. They should establish a code of ethics, detail penalties for violations, and encourage whistleblowing when employees see improper activities. Communications should also explain why zero tolerance for fraud is necessary: Personnel may be much more likely to conform to workplace requirements and comply with internal controls if they understand that compliance will help the organization maintain its upward economic trajectory.

Define

Development of internal controls first requires a detailed analysis of prevention and detection activities and then thorough specifications of the needed controls. Managers must enumerate internal controls in detail relative to physical safeguards; personnel, customer, and vendor reviews; conflict-of-interest policies; purchase amount caps; and segregation of duties. Because of the potential for problems if personnel compensation is tied to the organization's fiscal performance, managers must be sure to set reasonable quarterly or annual financial targets. Overly optimistic goals could create an incentive to "cook the books" in relation to transactions, account balances, or disclosures.

Execute

Companies must not short-circuit internal controls simply for the sake of expediency. They should limit vendors to a reasonable number (based on needs of the specific situation) and make certain that the choices meet company requirements. They also should structure incentive-based compensation for managers and financial reporting staff so that multiple measurements (financial and nonfinancial) evaluate performance. In addition, companies must enforce penalties for code-of-conduct violations and make sure to monitor internal controls for compliance and effectiveness because external and internal changes transform business operations. They also need to establish an anonymous tip line for whistleblowers. When it is financially possible, companies should institute an internal audit department and mandate external audits. And they should use credentialed professionals to assess reserves and be willing to share the reports of those reserves with all concerned parties.

Achieving Financial Success

Organizational growth and prosperity produce numerous opportunities for corporate success but also engender a high level of organizational stress because of the need to transition through a massive change process as well as deal with a lack of knowledge about how people will function, how to reconfigure jobs, or how to modify skills needs in the new business environment. Every organizational situation involving change increases stress, and the larger the change, the greater the stress.[22] Even the best leaders cannot eliminate the stress—they simply can recognize it and try to manage and respond in an effective and communicative fashion. To minimize stress in others, leaders must exhibit a positive attitude, sound judgment, creative responses to new situations, and courage in the face of unknown circumstances. In other words, it is particularly important in boom times that leaders set a positive organizational tone—one that permeates the cultural fabric of the organization.

The saying "what goes up must come down" is true, but boom companies do not need to come down in flames of ruin because of organizational fraud and abuse. Fraud most commonly occurs as the boom phase is nearing an end.[23] But recognizing the ABCs of prevention can help boom organizations be alert to fraud opportunities, aware of outdated internal controls, and attentive to the details necessary to sustain an upward course to financial success. Then through continual oversight, they can mitigate the potential for fraud. ■

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