

# Catalyst

A topical newsletter for privately held businesses

Spring 2009

With such a wealth of topics for privately held businesses to choose from, it's often difficult to pick just one central theme to spotlight in Catalyst. With the month of March designated by Canada's Competition Bureau as Fraud Awareness Month, we jumped at the chance to delve into such a relevant and timely topic—especially given the current state of the economy.

The mechanisms of fraud—motivation, opportunity and rationalization—are constantly present, even during times of prosperity. In times of economic downturn, they become even more readily apparent. The need to maintain lifestyles set during the good times (motivation), combined with decreases in staffing (opportunity) and measures to cut costs (rationalization) provides a recipe for increased fraud to almost any organization.

A 2007 study by the Association of Certified Fraud Examiners estimated that financial losses due to fraud to Canadian businesses amounted to roughly 5% of their annual revenue. The median size of the fraud in the study was \$187,500 and

over 25% of the frauds resulted in losses of at least \$1 million. Of the fraud cases reviewed, the results also showed that private companies were more affected than public companies—38% versus 24%, respectively.<sup>1</sup> With profit margins of many privately held businesses being squeezed by the global credit crunch, the effect of such an event could be devastating to the future of any organization. In this issue,

- we speak with Detective Sergeant Jim Farrell of the Toronto Police Fraud Squad for his perspective on fraud in times of economic uncertainty;
- Grant Thornton LLP forensic accounting and investigative services partner Derek Malcolm comments on how organizations can protect themselves from the illusion of fraud;
- we discuss the increasing significance of “e-discovery”; and
- Detective Sergeant Jim Farrell offers some tips on how we, as individuals, can reduce the risks of fraud.

While we hope that neither you nor your business will ever fall victim to fraud, history and experience has taught us that

no one is immune. In 1602, Sir Edward Coke said “Fraud and deceit abound these days more than in former times.” We wonder what he would say if he were around today?

**David Elzinga**

National Leader, Forensic Accounting and Investigative Services, Grant Thornton

<sup>1</sup> Dr. Dominic Peltier-Rivest and the Association of Certified Fraud Examiners. Detecting Occupational Fraud in Canada. 2007. <http://www.acfe.com/documents/rtn-canadian.pdf> (accessed February 20, 2009)

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# Fraud awareness during economic uncertainty

**Fraud Awareness Month is a national campaign focused on educating Canadians on how to protect themselves from fraud. Businesses and individuals should know how they can protect themselves in an economy that appears to be a magnet for fraud.**

David Malamed and David Elzinga, Partners, Forensic Accounting and Investigative Services, Grant Thornton, recently met with Jim Farrell, Detective Sergeant of the Toronto Police Fraud Squad, to gain his perspective on fraud prevention in the current economy.

**In the last few months, there seems to have been a significant increase in fraud incidences reported by the media. Is this due to the economic downturn?**

**Jim:** While I can't comment on the direct correlation between the current economic situation and the apparent increased incidences of fraud—at least as reported in the media—I can tell you that fraud exists in both good and bad times. What appears to happen during worsening economic times is that previous occurrences of fraud become easier to identify while at the same time, missing funds connected to the fraud are noticed earlier. Individuals may have increased financial pressures caused by increased debt incurred during booming economic times as well as a greater expectation of lifestyles created during those times. These may factor into an increase in fraudulent activity.

**Has the Toronto Police Fraud Squad had an increased number of fraud complaints in the last year?**

**Jim:** In 2008, the corporate sector experienced a 40% increase in arrests made, with a 68% increase in charges laid. We're anticipating a further increase in complaints and investigations due to the deteriorating economy, however, it may take several months for the full impact to be felt.

**Have you noticed any fraud-related themes in the last few months?**

**Jim:** Employee theft, mortgage fraud, identity theft, internet fraud and investment fraud seem to be some recurring themes. Recently we have seen several instances of "affinity frauds," where fraudsters are targeting cohesive groups of people based on their profession, ethnic, religious and other affiliations.

This appears to be happening because the fraudster is able to quickly elicit the trust that comes from being a member of these groups. I am not sure that I can draw a direct correlation to the worsening economy to any one specific type of fraud, however, it is clear that computer assisted frauds continue to increase as a result of their anonymity and sophistication.

**So much of an organization's operation is dependent on IT systems. What should they be doing in this regard?**

**Jim:** In a credit crunch, where organizations are looking to reduce overhead, it's prudent to protect electronic information the same way they would any other valuable asset. Storing customer data on secure software, encrypting confidential information and saving data on networks should be standard. Avoid storing information on hard drives and removable media to further reduce the risk of information winding up in the wrong hands.

**What can organizations do to identify areas within their businesses as being potential fraud risks?**

**Jim:** No organization will ever be fraud-proof, but they can establish criteria for each area of their business to assess the risk of fraud. Key areas to focus on include: human resources, IT security, purchasing, payables and receivables. It surprises me how often a more stringent background check prior to employment could have prevented the incident. In addition, organizations often forget to ensure that even the most basic checks and balances are in place—giving employees the opportunity to circumvent controls to commit the fraud.

**What advice do you have for an organization that is, or thinks they are, a victim of fraud?**

**Jim:** Invariably, an organization will become a victim of fraud. When that happens, the first thing that needs to be done is to stop the fraud from continuing and then act quickly to secure the necessary evidence. This will require expertise from lawyers, IT specialists familiar with the handling of electronic evidence as well as forensic accountants. Once the necessary information has been secured and analyzed—and it's concluded that a fraud has been committed—the organization may wish to make a criminal complaint to the police.

# Fraud—the ultimate illusion

## By Derek Malcolm, Partner, Forensic Accounting and Investigative Services, Grant Thornton

The best stage illusionists use distraction and misdirection. Their illusions are clouded by mystery and secrecy. They make you believe in something that's just not real.

Fraud too allows us to believe that something is there when in fact it is not, or shows that it was used in one way when it was, in fact, used in a completely different manner. Both have the appearance of reality and both will deceive even the brightest—for short periods of time.

Consider the examples of Bre-X, Enron, WorldCom and, more recently, the alleged Madoff Ponzi scheme and Stanford investment scam investigation by the SEC. In each of these cases things appeared too good to be true and were even accepted as such. They were, however, illusions—based on a plausible starting platform, built on perceived reputations, greed and temptation—using distraction, misdirection and secrecy to succeed in keeping attention away from the truth.

So why, when we so often suspect the truth, do these illusions succeed? Sigmund Freud provides one answer. “Illusions commend themselves to us because they save us pain and allow us to enjoy pleasure instead...” But as we all know, the pleasure is always brief and leads down the path to great pain later.

### The reality of fraud

With the good times over, many organizations are under significant

pressure to take all possible steps to control costs and stem financial losses. With human resources often reduced or redirected to other corporate survival matters, holes begin to develop in an organization's internal control system designed to reduce and detect fraud. The symptoms resulting from downsizing or rightsizing provide increased motivation to defraud—significantly changing the risk profile of an organization.

Acts of fraud that may have flourished undetected in the shadows of prosperity begin to emerge in the light created by increased operational scrutiny that occurs in times of economic decline. Organizations should be prepared for this reality and be ready to deal with feelings of betrayal such findings elicit. Despite the need to cut expenditures, organizations that are victims of fraud are now faced with the expense of having to investigate to determine what cash and other vital assets have been taken and then pursue legal action in an attempt to recover it. Measures must then be put in place to prevent fraud from happening in the future.

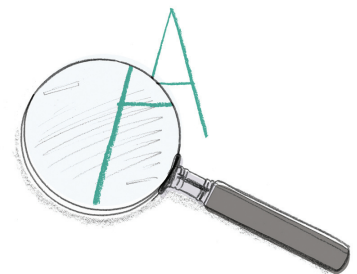
### Seeing the light

What steps can private businesses take to coax the illusion of fraud out from the shadows? Seeing it through the eyes of the illusionist is a start. A forensic accountant puts on the magic glasses necessary to see through the smoke and mirrors—bringing the act of fraud and its consequences out into the light for all to see.

Regardless of what position an organization finds itself in during times of economic downturn, there are measures that should always be in place when it comes to safeguarding from acts of fraud including:

- continuously reviewing and monitoring your internal control systems to ensure that they are in place and working as designed;
- establishing an investigation protocol/fraud policy for your organization now. Having a logical process already in place will keep emotions in check—helping to ensure you'll do the right thing at the right time;
- implementing or improving a confidential reporting process, such as the Grant Thornton C.A.R.E (Confidential, Anonymous, Reporting for Employees) program, for employees to report suspicions of fraud and other acts of wrongdoing;
- trusting your instincts and investigating the “too” good as well as the bad; and
- staying informed—ask questions, keep good notes and records, and follow-up until the issue is resolved.

Despite having anti-fraud measures in place, sometimes even the most secure of businesses may find it necessary to call in expert help in order to get to the bottom of a situation. Early involvement of legal counsel and forensic accounting and investigation specialists can save considerable time and money later on. More importantly, professionals trained in fraud investigations release your vital internal resources to continue to look after the going concern of the business.



# E-discovery—the new legal environment

Have you used your office computer today? Do you use a BlackBerry, Smartphone, MP3 player, or other personal digital assistant? To what degree do you rely on voice mail, email or instant messaging? Do you surf the Internet in the workplace? What about your employees? What about your suppliers or customers?

In the current legal environment, you should be aware of the concept of “e-discovery”—the process by which electronic data and information is searched for, located and then secured, with the intent to use it as evidence in a court proceeding.

The law in Canada is moving towards meeting the twelve Sedona Canada Principles, which address the issues

surrounding the discovery of electronic records. Why is this important to understand? Non-compliance can result in sanctions by the courts against you.

The most basic of the Sedona Canada Principles are:

- all electronically stored information (ESI) is discoverable;
- you have an obligation to take reasonable steps in good faith to preserve all potentially relevant ESI for your litigation opponent; and
- in the absence of an agreement, judicial direction will be necessary to protect privileges, privacy, trade secrets and other confidential information.

Why is this significant? The risk of legal action being brought against you in order

to search your electronic devices for evidence is a very real possibility. Organizations need to be aware of how they obtain, store and communicate electronic information—meaning that effective data retention policies are critical for compliance. All things considered, even if your organization has never been faced with an e-discovery request, it simply makes good business sense to be prepared.

**Jim Blatchford**  
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Grant Thornton

## Fraud and the individual

While businesses and other organizations need to remain vigilant when it comes to protecting against fraud, so too should the individual take precautions to reduce the risk of falling victim. Regularly checking your credit card and bank statements for anything unusual may be the best method of protecting yourself. You should quickly report discrepancies or unusual transactions to your bank or

the credit card agency for further investigation. Ordering a copy of your own personal credit report from one of Canada’s credit reporting agencies every year will allow you to monitor who is asking about your credit status. You should then follow up on any unusual and unknown inquiries into your credit history as they may indicate signs of possible identity theft.

Finally, people are often victimized because of their desperation to believe in a fraudulent scheme—if it sounds too good to be true, it probably is. Take a moment to reflect on the reality of what is being presented as it may save you a lot of money in the end.

**Jim Farrell**  
Detective Sergeant,  
Toronto Police Fraud Squad



We hope you enjoyed this edition of *Catalyst*. Your comments on the topics covered here are welcome. Contact us at [editor@GrantThornton.ca](mailto:editor@GrantThornton.ca). For more Grant Thornton publications for privately held business, visit [www.GrantThornton.ca/insights](http://www.GrantThornton.ca/insights).

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