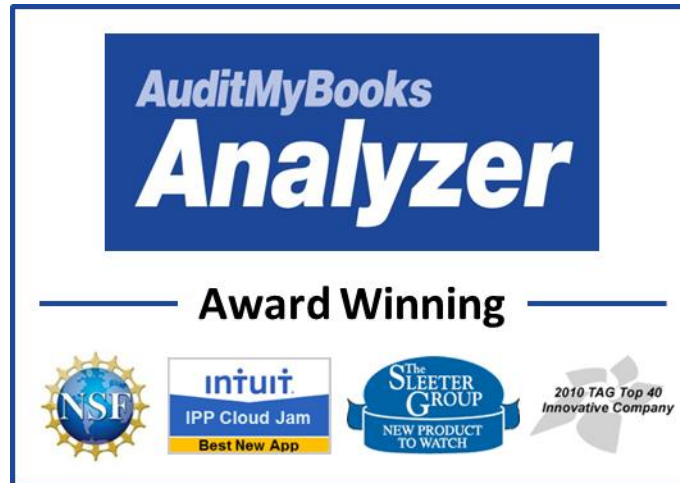


Protecting Your Business from Accounting Errors & Fraud



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Introduction

Experts say the difference between errors and fraud is a question of intent. When it's your money, does it really matter? You worked hard to earn it. Regardless of intent, you don't want to lose it because of a simple mistake or worse.



Accounting errors and fraud are serious issues for all businesses, but they are especially challenging for small companies where cash is always a top concern. Errors and fraud undermine decision making, lead to financial losses and in some cases even force companies to lay off staff or shut their doors. Unfortunately, both accounting errors and fraud are common problems for small businesses.

Fraud related research shows that small businesses suffer more than any other sized businesses. They have higher median fraud losses and a greater incidence rate relative to larger companies. Despite the severity, very little has been done to help small businesses proactively address the problem of accounting fraud. As a result, in most cases of small business fraud, the crime is discovered accidentally or via a tip from someone outside the company.

In some small businesses, the risk of fraud is low or even non-existent. Still, accounting errors can potentially be a big problem. One small mistake in recording a payment from a customer can lead to underpaid sales taxes ultimately resulting in unnecessary penalties and interest charges.

So why do errors and fraud occur so frequently in small businesses? A common reason is that small companies typically have small or even single-person accounting staffs and limited internal controls. When the bookkeeper is also the office manager and receiving clerk, problems can arise if for no other reason than the fact that no one double checks the work. Besides being more susceptible to errors and fraud, small businesses are also less likely to discover them since financial audits are seldom required.

Nearly everyone uses anti-virus software to protect their computer from attack. Similarly, analysis of financial data to detect errors and fraud should happen on a routine basis. The added diligence of a manual review or monthly automated scan of your data reduces the chances that accounting errors or fraud harms your business, ultimately helping you to stay focused on growth and financial success. The sooner potential problems are discovered, the sooner corrective action can be taken to address them.

The Facts on Accounting Errors & Fraud

Accounting systems are only as good as the data contained within them and unfortunately errors and fraud are common among small and medium businesses (SMB's). Companies of this size are frequent targets for errors and fraud as they typically have small or even single-person accounting staffs and limited internal controls. In addition to being more susceptible to financial irregularities, SMB's are also least likely to discover them since financial audits are seldom required.

Both errors and fraud undermine a small business owner's ability to make informed financial decisions, lead to penalties or losses in many cases and sometimes even force businesses to close. Accounting errors and fraud are not only common in SMB's, but are also increasing in frequency and size of loss.

The difference between errors and fraud is a question of intent. Errors are unintentional and typically result from the misapplication of accounting standards. Recent research by Indiana University and the University of Utah suggests that the majority of financial system errors result from "simple bookkeeping deficiencies or misapplication of easily understood accounting standards"¹. The research also notes that accounting errors (as measured by financial restatements) are on the rise; increasing by 220% over the last few years². While unintentional, accounting errors can lead to poor decision making as well as monetary losses resulting from the penalties and interest charges associated with misstated tax filings.



In contrast to accounting errors, fraud is intentional and results from a malicious attempt to conceal theft. Research by the Association of Certified Fraud Examiners (ACFE) suggests that fraud is also a serious problem for SMB's. In fact, a recent study estimates that more than one third of all fraud occurs in small businesses³. A startling fact considering that all businesses in the U.S. are estimated to have lost nearly \$2.9 trillion to fraud in 2009⁴. Worse yet, the median loss from fraud among small companies is higher than in any other segment studied at nearly \$150,000 per occurrence with one quarter of all cases exceeding \$1,000,000⁵.

Unfortunately, because SMB's rarely have systems or processes designed to identify errors and fraud, cases are often discovered by accident more than 18 months after the fraudulent activities begin⁶. Further, because the stolen money is often spent on gambling or substance abuse, the odds of financial recovery are typically very low. Even when the opportunity for financial recovery exists, the legal fees required to pursue the case often outweigh the expected recovery.

Considering these statistics, it's no surprise that recent research by the American Institute of Certified Public Accountants indicated that nearly 70% of CPA's

surveyed were planning to grow their forensic practices⁷. Independent of formal research, the effects of fraud can be seen in the press. The AuditMyBooks [True Stories](#) blog spotlights how small businesses are affected by this problem on a weekly basis. The blog features stories ranging from small community newspapers to major business publications including Time, Reuters and Forbes.

These recent articles from the Wall Street Journal provide an excellent overview of the problem facing millions of small businesses:

The screenshot shows the top portion of a Wall Street Journal article. The header includes the date 'Sunday, September 12, 2010' and the location 'New York'. The page is titled 'SMALL BUSINESS'. A navigation bar lists various sections like 'World', 'U.S.', 'New York', 'Business', 'Markets', 'Tech', 'Personal Finance', 'Life & Culture', 'Opinion', 'Careers', 'Real Estate', and 'Small Business'. The article title is 'When You're Most Vulnerable to Fraud' with a subtitle 'In the best of times, entrepreneurs tend to take their eye off the ball'. The date 'AUGUST 16, 2010' and the category 'RUNNING THE SHOW' are also visible.

<http://online.wsj.com/article/SB10001424052748703701004575113270809666124.html>

The screenshot shows the top portion of a Wall Street Journal article. The header includes the date 'Thursday, February 19, 2009' and the location 'New York'. The page is titled 'SMALL BUSINESS'. A navigation bar lists various sections like 'U.S. Edition', 'Today's Paper', 'Video', 'Blogs', and 'Journal Community'. The article title is 'Small Businesses Face More Fraud in Downturn' with a subtitle 'Employees Engage in Check Forgery, Petty-Cash Theft; Managers Sometimes Mistakenly Blame Lower Sales Instead of Foul Play'. The date 'FEBRUARY 19, 2009' and the category 'BUILDING YOUR BUSINESS' are also visible.

<http://online.wsj.com/article/SB123501158460619143.html>

The screenshot shows the top portion of a Wall Street Journal article. The header includes the date 'Thursday, March 11, 2010' and the location 'New York'. The page is titled 'SMALL BUSINESS'. A navigation bar lists various sections like 'U.S. Edition', 'Today's Paper', 'Video', 'Blogs', and 'Journal Community'. The article title is 'Business Owners Get Burned by Sticky Fingers'. The date 'MARCH 11, 2010, 5:41 P.M. ET' is also visible.

<http://online.wsj.com/article/SB10001424052748703862704575099661793568310.html>

Despite fraud getting more exposure in the media, accounting errors and fraud create similar problems for SMB's. When simple, honest mistakes are made the consequences include financial losses stemming from theft or budget overruns as well as faulty decision making based on inaccurate financial data. External issues resulting from accounting errors and fraud are equally, if not more, severe. For example, SMB's may over/under pay taxes or report inaccurate results to investors and creditors based on faulty data.

Accounting Errors & Fraud: Real World Examples

Accounting errors may be as simple as inadvertently paying the same bill twice. In fact, experts estimate that as much as 2% of payments are duplicated. Assuming you process \$500,000 in A/P invoices per year means you could be losing as much as \$10,000. To make matters worse, if you're running a company that makes 10 cents on the dollar, a \$20,000 expense leak requires

\$200,000 in new sales to offset it. Accounting errors are suddenly pretty interesting.

Accounting software packages sometimes have checks to limit duplicate invoices, but there are still ways to make mistakes. For example, an inexperienced bookkeeper may write a check to a vendor without linking it to the invoice, and then process the same transaction as an invoice payment a week later when reminded by a scheduled alert in the accounting system. Hopefully, the vendor will notify you of the double payment.

The techniques used to perpetrate fraud vary widely. In some cases, the fraudster may be so devious that the crime goes unnoticed for years. The AuditMyBooks [True Stories](#) blog includes cases that have spanned 10 or more years. In these examples, the emotional loss for the business owner is often as severe as the financial loss. The media coverage in these stories often reference how the fraudster was “was just like one of the family”.

Less sophisticated fraudsters often make simple mistakes that help knowledgeable practitioners spot the telltale signs. As simple as it seems, when novice fraudsters create bogus payments to a shell company, they don't add cents to the transaction (e.g. \$157.00 instead of \$157.34). Accordingly, most fraud examiners will perform a rounded payment test as one of the analytical procedures they use to investigate a potential fraud.

There are countless other techniques used to perpetrate financial fraud. Organizations like the Association of Certified Fraud Examiners and the American institute of Certified Public Accountants have created specialized programs that enable accounting practitioners to develop their skills in fraud investigation.

Solutions in the Market

While accounting systems generally include internal control mechanisms to reduce errors and fraud, applications designed for SMB's are more prone to errors and fraud because they often emphasize flexibility and ease of use over strict adherence to a process. While larger organizations typically test internal controls periodically via audits or reviews, SMB's rarely conduct these procedures due to the associated cost and complexity.

Although possible, manually reviewing transaction log files is uncommon among business owners since it is time consuming and requires an in-depth understanding of accounting standards. Even if they are employed as techniques by bookkeepers or financial service providers, manual reviews are error prone, inefficient and only as current as the date they were performed. For example, an annual review completed each January may not identify errors or fraud until 11 months later, assuming the crime was committed in February.



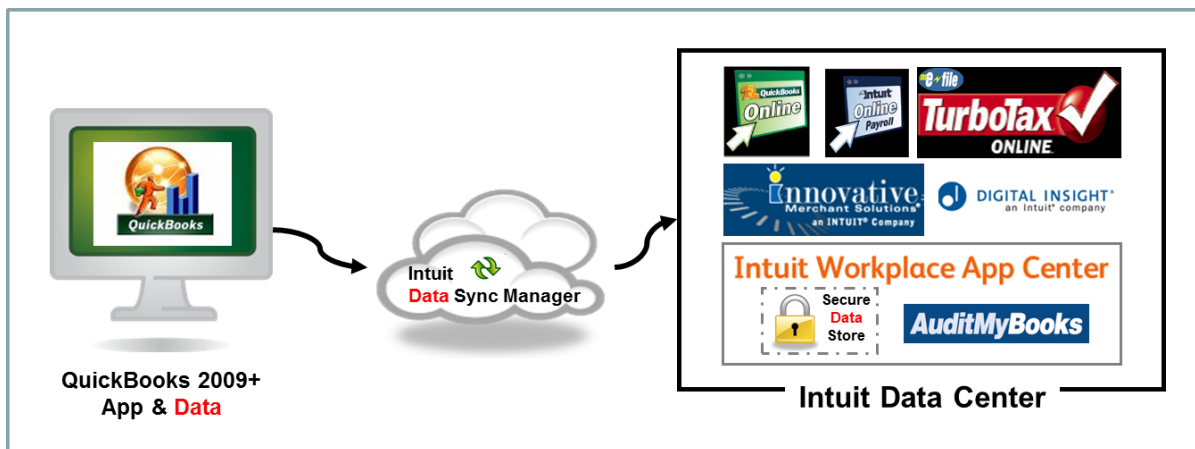
Continuous Controls Monitoring is an emerging technology that is focused on very large public companies and government entities (e.g. Department of Defense). Their primary use is to monitor systems for procedural and regulatory compliance. Solutions from companies like Oversight Systems, Approva, Lumigent and others are very effective, but far too costly and complex for small and medium businesses.

Financial audits are useful techniques to identify errors, fraud and other accounting issues. They are often required for firms, particularly those that are publicly traded. Unfortunately for SMB's, the cost and time commitments needed to conduct even an annual audit are prohibitive. Fraud and error detection is also possible with Forensic and Business Intelligence applications. However, like financial audits they are typically only used by large of organizations.

Analyzer from AuditMyBooks

AuditMyBooks Analyzer, automatically double checks accounting records in minutes to detect errors and possible fraud. Analyzer helps small businesses to ensure their data is reliable for decision making and to protect their cash.

Analyzer is secured and hosted on Intuit's App Center, a cloud-based development platform that provides a number of advantages. Security, data integration, user management and billing are provided by Intuit on a highly scalable architecture that is used by millions of small businesses and consumers.



Intuit App Center Overview

Analyzer uses advanced forensic techniques including statistical analysis, user defined thresholds and detection signatures to identify errors and fraud. The proprietary algorithms are created by AuditMyBooks with input from the Accounting Advisory Council. The algorithms leverage thousands of hours of experience with ProAdvisors, CPA's, auditors, forensic accountants, Certified Fraud Examiners, as well as insights into accounting systems design, business intelligence, financial auditing processes and information security.

Analyzer is modeled after security applications like anti-virus and anti-spyware. Users select a QuickBooks data file to scan for irregularities. After reviewing all transactions, Analyzer gives you the option of viewing everything online or creating an Excel report that can be printed for hands on analysis. The results are delivered in plain-English, so users don't need experience in finance or accounting to understand the initial results.



Detailed reports allow further investigation of high risk transactions that may relate to errors or fraud. Analyzer provides the information necessary to quickly identify suspect transactions and take corrective measures.

Analyzer can be configured to meet the needs of all small businesses regardless of company size or industry. Unlike manual reviews of transaction logs which are time consuming, costly and rarely performed, Analyzer automatically analyzes accounting records in a few minutes allowing customers to use it daily, weekly, monthly or as often as they choose.

Error & Fraud Prevention

Error and fraud detection is something no business should be without. When used regularly, applications like Analyzer can be very effective in detecting irregular accounting transactions which helps SMB's in several ways:

- 1) **Financial:** Being profitable and cash flow positive is important regardless of company size. Errors and fraud can be especially harmful for small companies where internal controls are often disregarded. Analyzer helps small businesses detect errors and fraud. The sooner problems are identified, the sooner they can be solved.
- 2) **Productivity:** Time is money, especially in resource constrained small businesses. Even if manual reviews are conducted, they are error prone, inefficient and only consider a sample of the transactions. Rather than sampling transactions, existing AuditMyBooks customers have confirmed that Analyzer can review 100% of a company's accounting transactions in only a few minutes. Manual reviews of the same data would take hours.
- 3) **Compliance:** Fraud and even simple mistakes can lead to compliance problems. A recent Wall St. Journal article chronicles the plight of a small manufacturing company, E.F. Couvrette Co. The impact from a fraud at

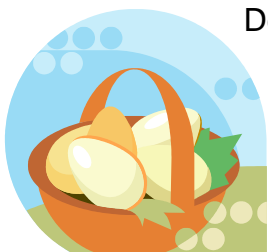
this company led to a 50%+ decrease in revenue, lost customers and unemployed workers. Because the fraud was perpetrated by diverting payroll taxes, E.F. Couvrette Co. faced fines from non-compliance and has had difficulty securing financing. AuditMyBooks Analyzer helps small businesses like the E.F. Couvrette Co. identify irregularities in the accounting data that can impact tax reporting and other compliance requirements.

Recent research also suggests that applications like Analyzer may even help to prevent fraud. The Association of Certified Fraud Examiners claims, “while surprise audits can be useful in detecting fraud, their most important benefit is in preventing fraud by creating a perception of detection. Generally speaking, occupational fraud perpetrators only commit fraud if they believe they will not be caught. The threat of surprise audits increases employees’ perception that fraud will be detected and thus has a strong deterrent effect on potential fraudsters.”

The ACFE research goes on to say that many fraudsters are first time offenders which could further support the effectiveness of preventive controls. When dealing with financial losses, prevention beats detection every time.

Defense in Depth

Although AuditMyBooks provides important capabilities to protect your business from errors and fraud, it should not be the only precaution you take.



Defense in Depth is an effective approach to dealing with accounting errors and fraud. Borrowed from the information security industry, Defense in Depth is defined as, “a strategy in which multiple layers of defense are placed throughout a system to address vulnerabilities in personnel, technology and operations for the duration of the system’s life cycle.” In plain English, it means don’t put all your eggs in one basket.

Like a strong security system, an accounting system should include multiple controls to discourage fraud and reduce errors. For example, train your employees in fraud detection, and make it clear that integrity is expected. Put checks and balances in place, like separating check writing and signing. Use closing dates to track when changes are being made to prior periods. Develop an anonymous way for employees to report suspected fraud, and make it a habit to periodically scan your QuickBooks data to identify problems. Finally, don’t overlook the simple stuff like strong passwords and role-based authorization.

Your QuickBooks Certified ProAdvisor, also plays an important role in protecting your business from accounting errors and fraud. As a trained financial professional, your ProAdvisor can help to create and monitor a system that is right for your business.

About AuditMyBooks

AuditMyBooks™ is a cloud based software company that helps small and medium businesses automatically double check their accounting records for errors and possible fraud. Designed to work with QuickBooks, the #1 small business financial software, AuditMyBooks Analyzer™ products are available in the [Intuit App Center](#). Analyzer™ requires no installation and data security is provided by Intuit.

AuditMyBooks™ is led by a team with extensive experience in financial auditing, accounting systems and information security. They saw a market need for a cost effective and easy-to-use solution that helps businesses identify suspect financial transactions to proactively reduce business risk. Drawing from techniques successfully used to detect information security threats such as viruses and spyware, AuditMyBooks™ helps businesses protect their resources and ensure their financial data is reliable for decision-making and reporting. Based in Atlanta, AuditMyBooks™ has earned awards from Intuit, the National Science Foundation, the Technology Association of Georgia and The Sleeter Group.

About the Author

C.P. Morey began his career 18 years ago as a CPA with Ernst & Young. He left public accounting after 3 busy seasons to earn an MBA and join the technology industry. Over the last 15 years, Morey has held leadership positions in product management, product marketing and business development with tech companies ranging in size from start-ups to multinational, Fortune 500 firms. Morey has worked with Software as a Service (SaaS) and cloud computing for more than a decade at companies including IBM, Internet Security Systems and AuditMyBooks.



Morey is a member of the Intuit Partner Platform Advisory Board and the Principle Investigator for a National Science Foundation research project on small business fraud. He is a frequent speaker at industry events with recent appearances at Scaling New Heights, the Association of Certified Fraud Examiners Annual Conference, the Annual Fraud & Forensic Accounting Conference and The Sleeter Group's Accounting Solution Conference.

Morey earned an MBA from Thunderbird, the #1 ranked International Business program in the world, and a BBA from UC, the #10 ranked accounting program in the U.S.

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