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Owner-Manager Fraud: Getting Worse…How to Detect It

Companies not subject to the rules embodied in Sarbanes-Oxley and Dodd-Frank are often far more vulnerable to fraud schemes than public companies. In addition, auditing standards may be contributing to the failure to detect fraud in private companies.

Statistics show that these businesses— often owner-managed— typically lack the internal controls mandated by federal laws and the human and managerial resources to focus on possible employee crimes such as embezzlement, corruption and trade secret theft.

But there's a bigger problem at privately-held companies: Owners *themselves* committing fraud.

Most common offenses: Asset misappropriation and fraudulent financial reporting.

When stealing cash, owners aren't just stealing from themselves — they are often stealing from lenders or co-owners who aren't in a position to monitor it.

With financial reporting fraud, the motives are numerous. *Examples:*

- To secure financing — third-party financing normally depends on the entity's reported financial results, and poor performance could lead to restrictions on credit.
- To obtain private equity investment or conclude joint venture agreements.

RISKS, PREVENTION AND DETECTION

A key reason privately owned company management fraud goes undetected for long periods of time is that the auditing standards contain a provision allowing auditors to overlook the fraud risk related to owner-managers.

Details: SAS 99, *Consideration of Fraud in a Financial Statement Audit*, curiously points to the risk of fraud only when non-owner management is dominated by a single person or small group.

The current standard thus gives owner-managers a "pass" — by allowing auditors to ignore the risk of fraud committed by owner-managers.

Essential lesson: Privately-held company boards of directors and audit committees should insist that the entity's auditors consider the fraud risk factors and red flags contained in SAS 99 specifically with respect to owner-managers in planning and carrying out the audit. *Examples:*

- Domination of management by a single person or small group without compensating controls, whether they are an owner-manager or a nonowner-manager.
- Lack of day-to-day involvement in the business by co-owners.
- Pressure to overstate earnings or assets or to enter into transactions leading to a

- To maintain compliance with debt covenants or regulatory requirements.
- To secure contracts that require that the business is financially sound.

CONCEALMENT SCHEMES

Owner-managers cover their tracks in the same way as other bosses: They intentionally inflate revenues, overestimate asset values ... or underestimate liabilities.

Misappropriation of funds is typically concealed in fraudulently overstated assets or expenses or understated liabilities or revenues.

Key: Owner-managers have authority that isn't available to non-owner managers and, in many cases, there is an absence of effective oversight. This enables them to intimidate subordinates into cooking the books or going along with questionable accounting, frequently by the implied threat of job loss.

Added problem: Federal whistleblower protection statutes normally don't apply.

material misstatement of the financial statements, such as entering into side agreements.

- Unusual involvement by the owner-manager in the financial reporting process.
- Withholding information or restricting access to information by other members of management or the auditors.
- Making false representations to auditors.

Important: Auditors should be particularly critical in their assessment of the level of oversight exercised by boards of directors or the segregation of duties afforded by a chief financial officer or controller in an owner-managed business. In many cases, the oversight or segregation is not be as effective as it appears.

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