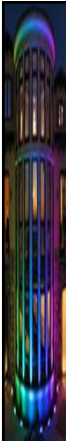



Advanced Fraud Discussion

Presented by
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Agenda

- 8:30–9:30 The ‘What’ of Fraud
- 9:30-10:00 The ‘Who’ and ‘Why’ of Fraud
- 10:00-10:10 Break
- 10:10-11:15 The ‘Who’ and ‘Why’ of Fraud
- 11:15–12:00 The ‘How’ - Specific Schemes
- Noon-12:15 Lunch 12:15-1:00 Exercise
- 1:00–3:30 Detection, Prevention and Deterrence Methods (10 Min. Break as needed)
- 3:30 – 3:45 Questions/Comments




Learning Objectives

- Increase awareness of what fraud looks like, who, what and why.
- Provide tools to both early detect and potentially deter fraud
- Discuss risk management techniques to monitor on an on-going basis




LEGAL ENVIRONMENT OF FRAUD




Legal Elements of Fraud ^α

- A material, false statement ...
- With INTENT to deceive ...
- That the victim RELIES UPON...
- And suffers DAMAGE




Black's Law Dictionary ^α

- The dictionary adds "to get advantage over another by false suggestions or suppression of the truth"




Materiality

- Fraudulent financial statements must contain “Material” misstatements.
- Material is generally defined in this environment as “had the investor known the true numbers the outcome of the decision to invest or not invest would have been different.”



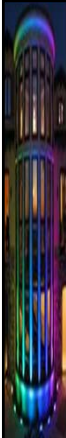
Intent

- There is no such thing as “accidental” fraud.
- An error is not fraud.
- Intent goes to ‘state of mind’.
- Because we cannot read minds, intent is usually proven by ‘circumstantial’ evidence.



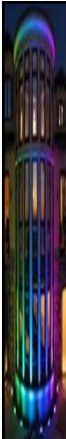
Motive

- Motive is usually the strongest element in circumstantially proving intent
- Financial statement fraud motives center around financial trouble or incentives for CEO compensation based on earnings per share or some other financial performance indicator which has been fraudulently manipulated




Other Indicators of Intent

- Positional Opportunity – Janitors rarely commit financial statement fraud.
- Repetitive “mistakes” – the “MO” repeats multiple times over lengthy periods.
- Altering documents – or other purposeful methods of concealing the fraud.




Witnesses

- While “concealment” is rarely witnessed, witness statements related to specific instructions received regarding unusual transaction processing, override of controls, exceptions to standard policies or other nonstandard business practices noted while performing their duties aid in proving fraudulent intent.




Victim Reliance on Statement Ⓜ

- One cannot overlook the fact that just because there is a material error (in financial statements) that was intentionally done – you must still have a victim
- A victim must have relied on the false statement.
- Victims sometimes are classified by type – for instance, a bank may be held to a higher standard than a typical investor.




Damages

- Usually take the form of money, restitution or actual and punitive damages.
- Must be calculated – usually done by CPA’s or other professional ‘number crunchers’ who are familiar with the various industries or transactions.



Criminal vs. Civil

- Fraud can be prosecuted both civilly and criminally
- Criminal prosecution must involve an “offense” statute such as “Shoplifting”, “Fraudulent Checks” or “Grand Larceny”.
- Civil involves duties between individuals (e.g. contracts) where restitution is sought as a remedy.



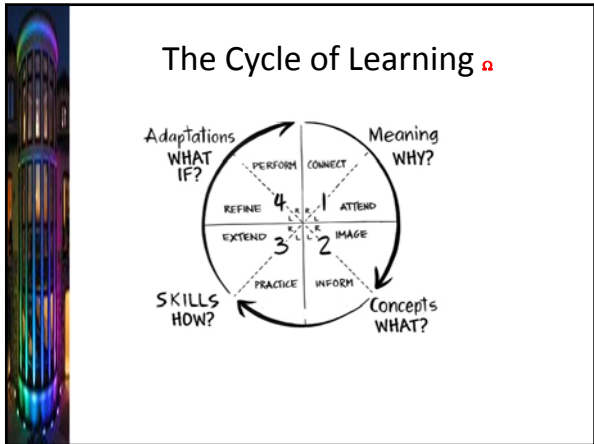
Burden of Proof

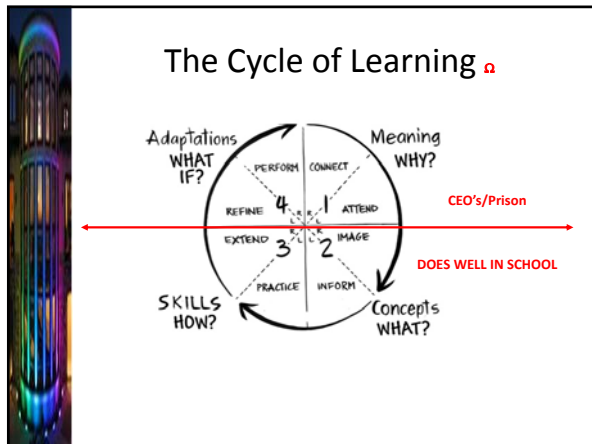
- Criminal = “beyond a reasonable doubt”
- Civil = “Preponderance of the evidence”

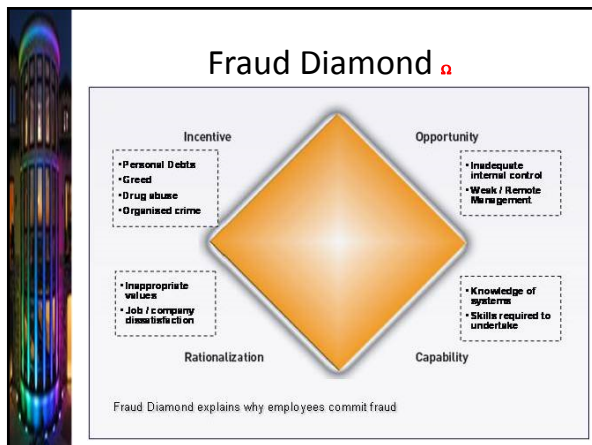
WHO COMMITS FRAUD & WHY

Who Commits Fraud?

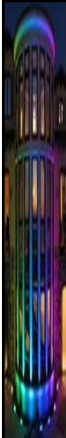
- You get more with a suit than with a gun!
- Look around the room, the description of the average fraudster looks just like us.





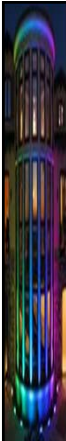


- ### Incentives to Commit Fraud Ω
- Individual Financial Pressures
 - Unexpected Financial Need e.g. Sudden Medical Bills
 - Keeping Up with the Jones'
 - Poor Credit
 - Individual Vices – Gambling, Drugs etc.
 - Work Related Pressures
 - Get Even for lack of recognition/promotion/pay.




Incentives to Commit Fraud

- Corporate Financial Pressures
 - Poor Financial Position
 - Uncollectible Receivables
 - Eroding Market Share
- Corporate Vices – Uncompetitive
 - Poor S.W.O.T. or E.R.M.
- Work Related Pressures
 - Obsolescence



Opportunity α

- Poor Internal Controls or Management Override
- Poor Information Systems – either nonintegrated or lack of audit trail
- Poor Corporate Culture
 - Lack of training/knowledge of job performance
 - Management ignorance or apathy
 - Failure to communicate integrity



Rationalization α

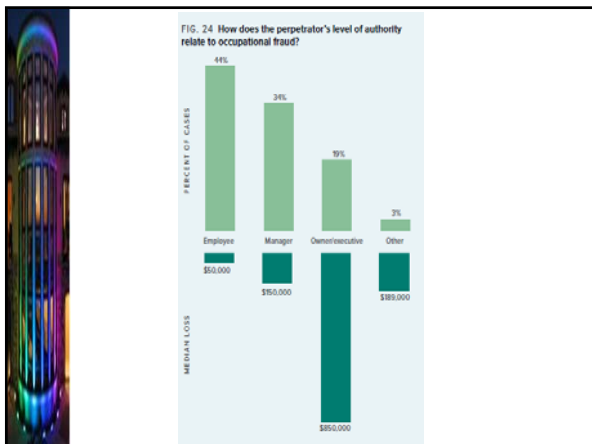
- People are moral, rational human beings, or not!
- Books by Joseph T. Wells
 - *Fraud Fighter, my Fables and Foibles*
 - *Franksteins of Fraud: the 20th Century's Top 10 White-collar Criminals*
- The amazing ability to lie to oneself.
- Integrity


Capability

- Has a knowledge of the systems, processes or the lack thereof
- Cooperates in the 'need' to override or perpetrates the override
- Has the position or skill set to accomplish the task. In the world of corporate espionage, this could be the janitor!

The Typical Embezzler ⚠


- Trusted, generally long-term employee
- Generally in a management-like role
- Dedicated, works long hours
- Rarely takes vacation, dislikes the policy of mandatory vacations. Makes excuses why they cannot go on vacation.
- Resents and will not cooperate with cross-training.
- Seen as likable and generous






Biblical Pressures Discussion

Romans 5: ³ ... we also glory in tribulations [pressures], knowing that tribulation produces ⁴perseverance; ⁴ and perseverance, ⁵character; and character, hope. ⁵ Now hope does not disappoint, [NKJV]




Does Character Get Noticed?

- Daniel 6:3 ³ Daniel proved himself to be a better supervisor than any of the others. He did this by his good character and great ability. The king was so impressed with Daniel that he planned to make him ruler over the whole kingdom. [ERV]




How do you recognize when an organization or individual is getting into trouble?




Warning Signs

- Organizational/Individual culture of arrogance and/or entitlement; failure to listen
- Accounting policies that rely too heavily on management's judgment
- Departure of key senior management
- Overly centralized control of financial reporting, especially in large organizations with a qualified finance staff




Warning Signs ⚠

- Failure to pay bills on time or as timely as in prior years
- Accounting policies seem overly aggressive, especially when given the qualifications of the accounting staff
- Periods of prolonged success even during periods when the industry is down
- Transactions lacking economic purpose




One Last Item of Note ⚠

- If it is too good to be true ...
- You don't get something for nothing ...




Part II


- Specific Schemes



Scheme Categories

- Asset Misappropriation
- Bribery and Corruption
- Fraudulent Statements




Scheme Subcategories 

- Employee Fraud
- Management Fraud
- Investment Schemes
- Vendor Fraud
- Customer Fraud
- Other - Miscellaneous




Asset Misappropriation

- Cash
- Inventory
- Office Supplies
- Expense Reports
- Company Vehicles, Cell Phones
- Accounts Receivables, Revenues
- Falsifying Hours on a Timesheet



Survey on Misappropriation

- Research indicates the potential for material fraud exists in the American workplace. According to a 2003 survey sponsored by Ernst & Young LLP, 20% of American workers are personally aware of fraud in the workplace.
- Respondents to this survey estimated employers lost 20% of every dollar to some type of workplace fraud and were personally aware of fraud due to the following:
 - Theft of office items.
 - Claiming extra hours worked.
 - Expense accounts.
 - Taking kickbacks from suppliers.



Bribery and Corruption

- By far the most common in government officials
- Common in procurement also
- Generally begins by an ethics issue related to a conflict of interest [individual interest takes precedent over organizational interest]
- Breach of Fiduciary Duty [Criminal]

Fraudulent Financial Reporting

- Manipulation, falsification or alteration of accounting records or supporting documentation;
- Misrepresentations or intentional omissions; and/or
- Intentional misapplication of accounting principles

Medicare – Medicaid and other Federal Programs

- Pulitzer Prize winning website: <http://www.politifact.com>
- “Pants on Fire” ratings on political statements
- Articles on “fraud” versus “error” rates
- Fraud versus abuse

Fraud Types

Type of Fraud	Victim	Perpetrator	Explanation
Employee fraud	Employer	Employees	Employees directly or indirectly steal from their employers.
Management fraud	Stockholders, lenders, and others who rely on the financial statements	Management	Top management “cooks the books.”
Investment scams	Investor	Individuals	Individuals trick investors into putting money into fraudulent investments.
Vendor fraud	Purchaser	Vendors	Vendors overcharge for goods or services or nonshipment of goods.
Customer fraud	Seller	Customers	Customers deceive sellers into giving customer something they should not have or charging them less than they should.

From *Advanced Fraud Techniques* by Madray & Girolami

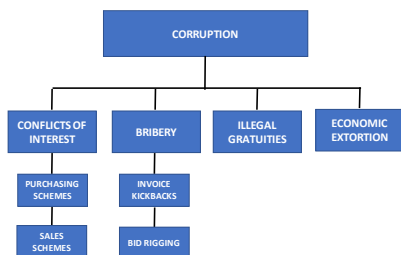
Employee Frauds ^α

- AKA "Occupational" Fraud
- ACFE *REPORT TO THE NATIONS* – a global study on occupational fraud and abuse
- Methodologies:
 - Direct – Embezzlement
 - Indirect – Bribes, Kickbacks

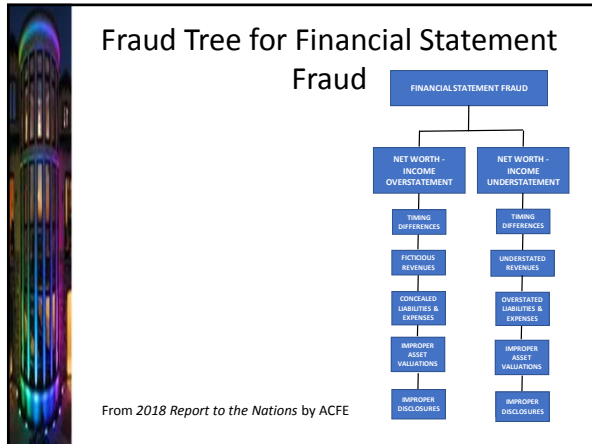
ACFE Fraud Tree

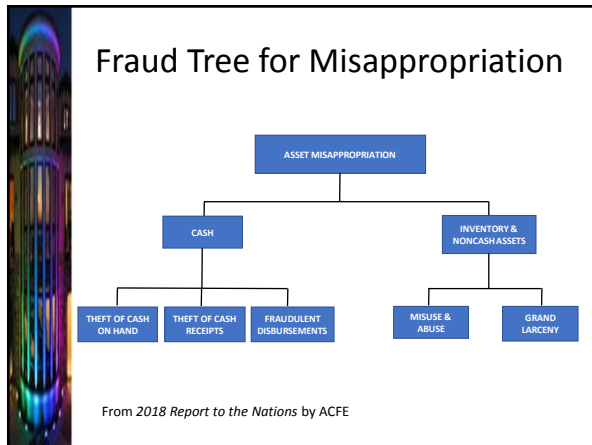
- At the top are the major Fraud Categories
- Then come the Major Schemes
- And then the Sub-schemes/Methodologies

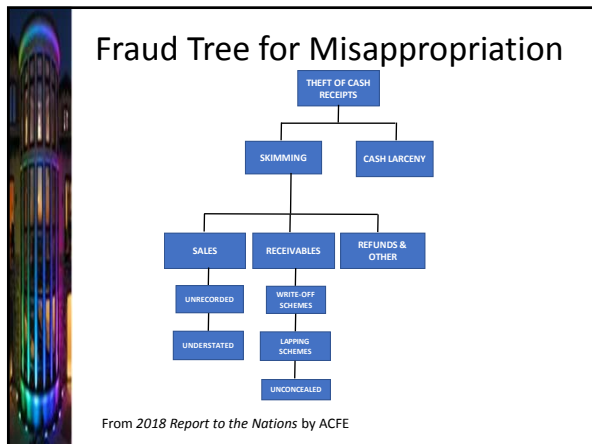
Fraud Tree for Corruption

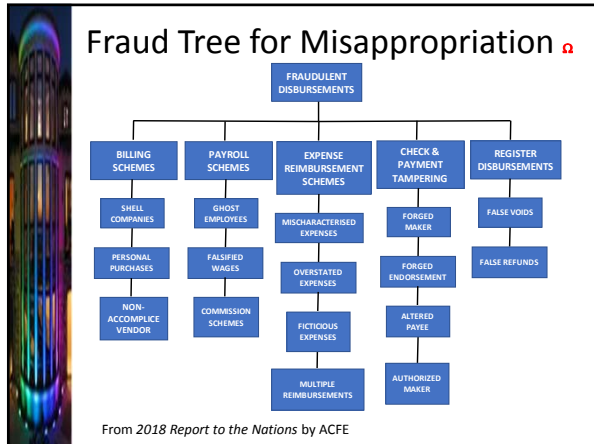


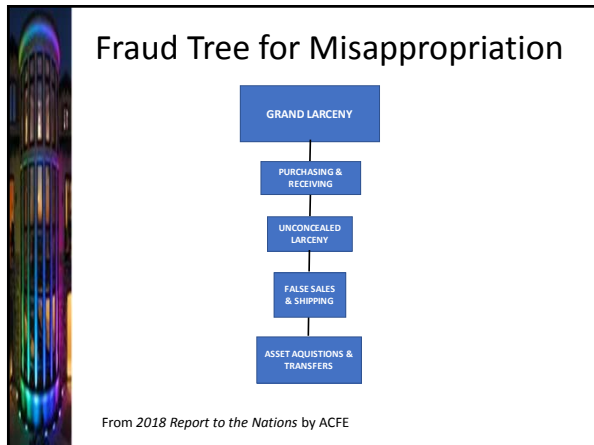
From 2018 Report to the Nations by ACFE

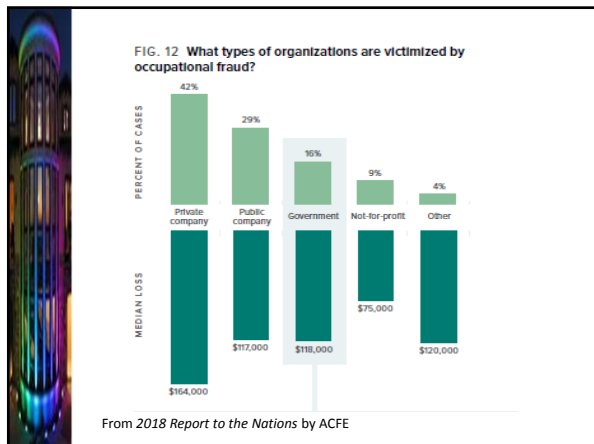












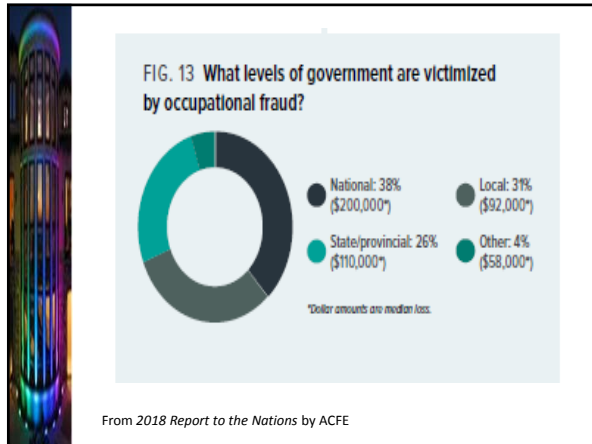
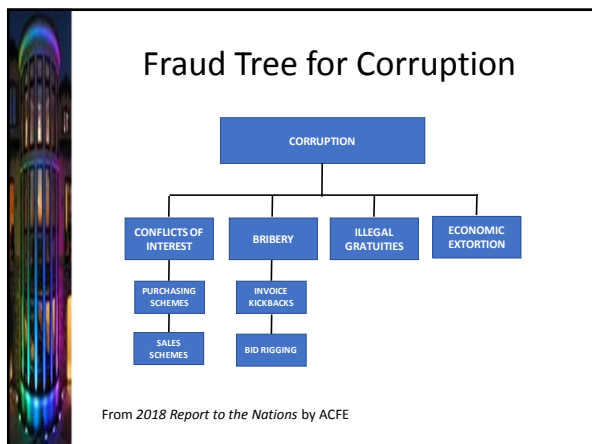
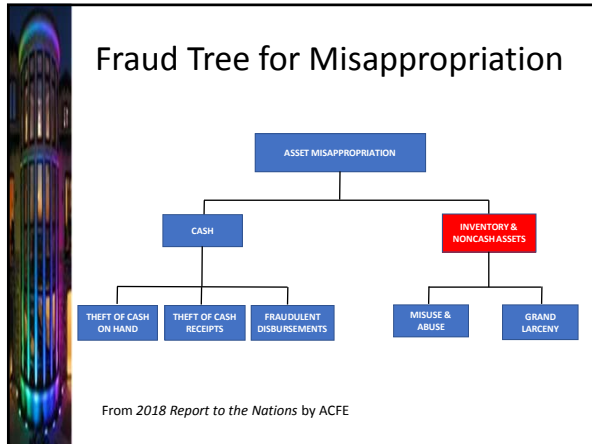


FIG. 16 What are the most common occupational fraud schemes in various industries?

INDUSTRY	Cases	Billing	Cash larceny	Cash on hand	Check and payment tampering	Corruption	Expense reimbursements	Financial statement fraud	Noncash	Payroll	Register disbursements	Skimming
Banking and financial services	338	11%	14%	23%	12%	36%	7%	8%	11%	2%	3%	9%
Manufacturing	201	27%	8%	15%	12%	51%	18%	10%	28%	5%	3%	7%
Government and public administration	184	15%	11%	11%	9%	50%	11%	5%	22%	7%	2%	11%

From 2018 Report to the Nations by ACFE

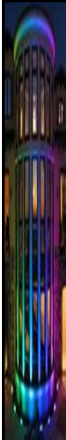




Part III

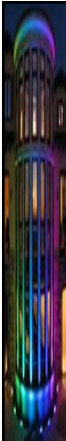
- DETECTION AND DETERRENCE

- ### Behavioral Red Flags
- In 85% of cases, Fraudsters displayed at least one of the following behaviors:
 - Living Beyond Their Means
 - Financial Difficulties
 - Unusually Close Association with Vendor/Customer
 - Control Issues; Unwilling to Vacation or Share Duties
 - Divorce, Family Problems
 - “Wheeler-Dealer” Attitude
 - Source: 2018 ACFE Report to the Nations.



Top 8 Concealment Methods


1. Created fraudulent physical documents [55%]
2. Altered existing physical documents [48%]
3. Created fraudulent transactions in the accounting system[42%]
4. Altered transactions [34%]
5. Altered electronic documents or files [31%]



Top 8 Concealment Methods

6. Destroyed physical documents [30%]
7. Created fraudulent electronic documents or files [29%]
8. Created fraudulent journal entries [27%]

— Source: 2018 ACFE Report to the Nations.



Initial Detection Methods

1. Tips [40%]
2. Internal Audit Only [15%]
3. Management Review [13%]

— Source: 2018 ACFE Report to the Nations.

Initial Detection Methods ▢

- Who provides the tips?
 - Employees [53%]
 - Customers [21%]
 - Anonymous [14%]
 - Vendors [8%]
 - Other [5%]
 - Competition [3%]
 - Shareholder/Owner [2%]

• Source: 2018 ACFE Report to the Nations.

Tips and Hotlines

Telephone hotlines are most popular, but whistleblowers use various reporting mechanisms

Telephone hotline 42%	Email 26%	Web-based/online form 23%
Mailed letter/form 16%	Other 9%	Fax 1%

NOT ALL TIPS COME THROUGH HOTLINES
When a reporting mechanism is not used, whistleblowers are most likely to report to:

DIRECT SUPERVISOR	32%
EXECUTIVE	15%
FRAUD INVESTIGATION TEAM	13%
COWORKER	12%
INTERNAL AUDIT	10%

Source: Source to Stay

Source: 2018 ACFE Report to the Nations

HOTLINES AND REPORTING MECHANISMS

The presence of a hotline or other reporting mechanism affects how organizations detect fraud and the outcome of the case.

63%
of victim organizations had hotlines

46%
of cases with hotlines

30%
of cases without hotlines

ORGANIZATIONS WITH HOTLINES detected fraud by tip more often

Fraud losses were **50% smaller** in organizations with hotlines than those without

Organizations without hotlines were more than **TWICE AS LIKELY** to detect fraud by accident or by external audit

CORRUPTION IS PARTICULARLY LIKELY TO BE DETECTED BY TIP

Corruption 50% detected by tip	Asset Misappropriation 38% detected by tip	Financial Statement Fraud 38% detected by tip
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Source: 2018 ACFE Report to the Nations

Detection Method vs Duration & Loss

- IT Controls [1% of Cases] (Capability Maturity Level 4+) – within 5 months with average loss of \$39,000
- Surveillance/monitoring [3%] – within 6 months and \$50,000
- Account Reconciliation [5%] – within 11 months and \$52,000
- Internal Audit [15%] – within 12 months and \$108,000


Capability Maturity Model Ω

Capability Maturity Model – Integrated

Level	Focus	Process Areas	Result
5 Optimizing	Continuous process improvement	Organizational Innovation & Deployment Crisis Analysis and Resolution	Productivity & Quality
4 Quantitatively Managed	Quantitative management	Organizational Process Performance Quantitative Project Management	
3 Defined	Process standardization	Requirements Development Technical Solution Product Integration Verification Validation Organizational Process Focus Organizational Process Definition Organizational Training Integrated Project Management Risk Management Decision Analysis and Resolution	
2 Managed	Basic project management	Requirements Management Project Planning Project Monitoring & Control Supplier Agreement Management Measurement and Analysis Process & Product Quality Assurance Configuration Management	
1 Initial	Competent people and heroics		


Impact of Controls Ω

Control	Percent of cases	Control in place	Control not in place	Percent reduction
Code of conduct	80%	\$ 110,000	\$250,000	56%
Proactive data monitoring/analysis	37%	\$ 80,000	\$ 165,000	52%
Surprise audits	37%	\$ 75,000	\$ 152,000	51%
External audit of internal controls over financial reporting	67%	\$100,000	\$200,000	50%
Management review	66%	\$100,000	\$200,000	50%
Hotline	63%	\$100,000	\$200,000	50%
Anti-fraud policy	54%	\$100,000	\$ 190,000	47%
Internal audit department	73%	\$108,000	\$200,000	46%
Management certification of financial statements	72%	\$109,000	\$ 192,000	43%
Fraud training for employees	53%	\$100,000	\$ 169,000	41%
Formal fraud risk assessments	49%	\$100,000	\$ 162,000	38%
Employee support programs	54%	\$100,000	\$ 160,000	38%
Fraud training for managers/executives	52%	\$100,000	\$ 153,000	35%
Dedicated fraud department, function, or team	41%	\$100,000	\$ 150,000	33%
External audit of financial statements	80%	\$120,000	\$ 170,000	29%
Job rotation/mandatory vacation	19%	\$100,000	\$ 130,000	23%
Independent audit committee	61%	\$120,000	\$ 150,000	20%
Rewards for whistleblowers	12%	\$ 110,000	\$ 125,000	12%




Control Factors

- An effective control system is the single, most important step to guard against fraud.
 - The Control Environment
 - The Accounting System [IT, Communication]
 - Control Procedures




Control Environment

- Tone at the Top
- Code of Conduct is the most effective way to implement measures to reduce wrongdoing
- Culture of honesty
- Ethical Environment
- Positive Workplace Environment




Creating a Culture of Honesty

- Create a positive work environment
- Hire honest people and train them about fraud awareness
- Disseminating a well-understood and respected Code of Conduct
- Provide an Employee Assistance Prog.




Enemies of a Positive Work Environment

- Uncaring management attitude
- Negative feedback or lack of recognition by management
- Low loyalty or feelings of ownership
- Unreasonable expectations
- Poor training and promotion opportunities
- Less-than-competitive compensation
- Lack of clear responsibilities




Discipline – Sending a Message

- Expectations about the consequences of committing fraud **MUST** be clearly communicated
- Actions taken in response to alleged fraud should be:
 - Thorough investigation conducted
 - Appropriate and consistent action against perps
 - Relevant controls assessed and improved
 - Communication and training to reinforce entity values, code of conduct and expectations




Management’s Behavior

- Buy-in to Code of Conduct based on management’s actions and examples
- Management’s consistent treatment of violators of Code of Conduct
- Management’s encouragement and openness regarding reporting violations
- Management’s actions **ARE** corporate culture
- Employee Assistance Programs




Proactive Data Monitoring/analysis

- Zero tolerance for missing documents, stale items on recons, document alterations
- Prenumbered documents used in sequence
- Unexplained, unusual or unsupported JE's
- Subsidiary ledger and other reconciliations
- Budget comparison, analytical review
- Benford's Law
- Surprise audits



Evaluating Processes & Risk Assessment



Risk Management Frameworks ^α

- COSO ERM Framework
- ACFE Fraud Risk Management
- ISO 31000 *Risk Management Principles and Guidelines*
- CoBIT5 Framework

Comparing Frameworks

Internal Control Integrated Framework

Enterprise Risk Management Framework

Strategic added to objectives

Risk Assessment in ICIF is Expanded into Three Components:
 1) Event Identification 2) Risk Assessment and 3) Risk Response

Comparing Frameworks

Linking Organization Essentials

Who is responsible for each of these important elements?


Who determines the first four elements?

Are these part of internal control?

How do I Start? α


Build Risk Awareness...

A sustainable ERM initiative must realize the importance of increasing management and employees' general awareness of business risks. As such, a key objective of an ERM initiative is to identify and develop senior management's agreed-upon view and approach to risk management – the Company's risk philosophy – and to identify any gaps between the *existing* understanding of risk and management's *desired (appetite)* risk philosophy.




Risk Awareness

- Across departments
- By Type
- Embedded into existing management systems



Risk Appetite


- Can be Subjective
- Based on Cost Benefit
- Capability Maturity Model



COSO ERM Definition α

Enterprise Risk Management (ERM) is a process affected by an entity's board of directors, management and other personnel, applied in a strategic setting and across the enterprise.


ERM is designed to identify potential events or situations that may affect the entity, manage risks to be within the company's risk appetite, and provide reasonable assurance regarding the achievement of entity objectives.



Another Definition


- Enterprise Risk Management (ERM) is a process-driven tool that enables senior management to visualize, assess and manage significant risks that may adversely impact the attainment of key organizational objectives

(source: University System of Georgia, Board of Regents ERM program)




Levers of Control Ω

- Belief System
- Boundary System
- Diagnostic System
- Interactive Control System




Belief System

- The entity's core values used to INSPIRE and DIRECT actions




Boundary System

- Ethical limits beyond which behavior is prohibited




Diagnostic System

- The entity's system(s) that ensure the effective and efficient achievement of goals; i.e. budgets




Interactive Control System

- The entity's top level development of strategy, risk assessment and monitoring of competitive conditions and technology changes




Fraud Risk

- The risk/vulnerability an entity has to the possibility that someone in their organization is capable of overcoming the elements of the fraud triangle/diamond
- This risk differs from any other risk because by nature it is intentional misconduct designed to evade detection.




Inherent and Residual Risk

- Inherent risk exists in the system before any type of system/management intervention
- Residual risk exists in the system after system or management actions are taken.




What to do with Risk or “Risk Responses”

- Risk Avoidance,
- Risk Reduction,
- Risk Sharing,
- and Risk Acceptance



Risk Assessment Measurements


- Impact
- Likelihood




ERM Sustainability

- A popular definition of sustainability is to meet present needs without compromising the ability of future generations to meet their needs.


(Source: United Nations, 1987 Conference)



Risk Procedures Integration




```
graph LR; A[Fraud Detection] --> B[Fraud Deterrence]; B --> C[Fraud Prevention];
```




Traditional Outlooks

- External audits provide assurance
- People are for the most part honest
- These are good economic times



Specific Process Interventions

- TIMELY Reconciliations
- Segregation of Duties
- Cross-training
- Mandatory vacations where others perform your duties and answer your phone calls
- Analytical procedures
- "Turn the Light on" decisions




Audit Committee

- Evaluate management's identification of fraud risks
- Active oversight to reinforce management's commitment to creating positive corporate culture
- Setting tone at the top
- Serve to deter senior management from fraudulent activity by encouraging measures like Hotlines, analytical review etc.
- Has a financial expert serving




Fraud Investigation



Predication

- Most important factor as innocent people can be harmed if someone launches an investigation prematurely
- Best left to well trained professionals – this is no area to be amateurish
- Document, document, document circumstances that led a reasonable, trained professional to suspect fraud.



Investigative Methods

- Surveillance and covert operations [video, PI's]
- Invigilation – lock down a process for a test period
- Obtain physical evidence
- Employees' duty to cooperate but be careful regarding suspended or terminated persons.
