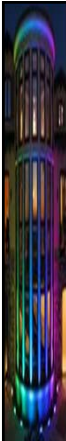


Fraud Schemes and Red Flags

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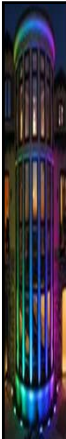
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Agenda


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- First 2 Hour Session: Basic Legal Understanding of Fraud. Fraud Scheme Intro
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2



ATTENDANCE CODE


3



Learning Objectives^α

- Understand what fraud is.
- Increase awareness, assessment and responses to current risks by learning to recognize schemes.
- Provide tools to both early detect and potentially deter fraud.


4



Learning Objectives^α


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5



LEGAL ENVIRONMENT OF FRAUD


6



Legal Elements of Fraud ^α

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


7



Black's Law Dictionary ^α

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


8



Materiality

- Fraudulent financial statements must contain "Material" misstatements.
- Materiality 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."


9



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.


10



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


11



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.


12



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.


13



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.


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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.


15



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.


16



Burden of Proof

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

17



WHO COMMITS FRAUD & WHY

18

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.

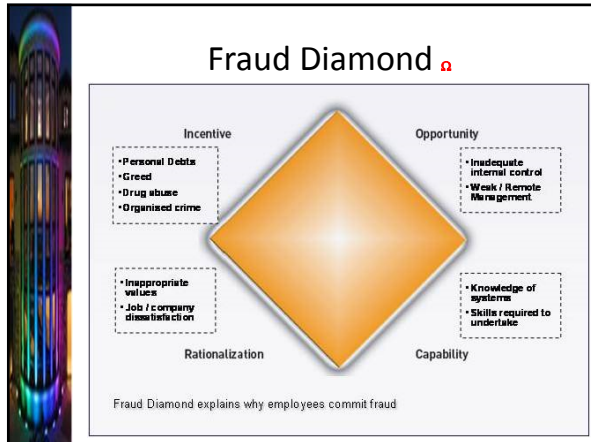
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The Cycle of Learning Ω

20

The Cycle of Learning Ω

21




22

- ### Incentives to Commit Fraud
- 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.

23

- ### 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


24



Opportunity ^Ω

- 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


25



Rationalization ^Ω

- 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

26



Capability

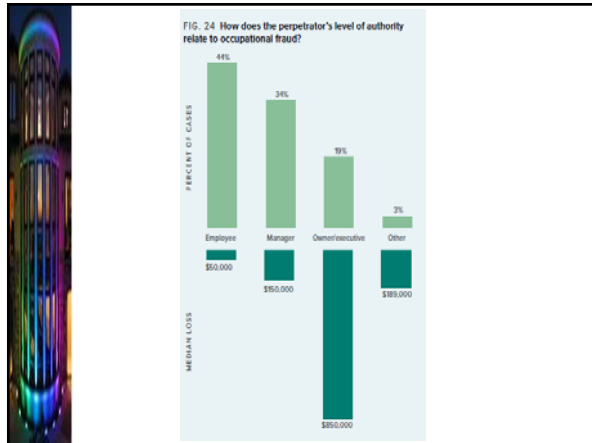
- Has a knowledge of the systems, processes or the lack thereof
- Cooperates in the 'need' to override or perpetrates the override
- Has the position or skill set to accomplish the task. In the world of corporate espionage, this could be the janitor!

27

The Typical Embezzler ^α

- 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

28




29

Biblical Pressures Discussion

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


30



Does Character Get Noticed?


- Daniel 6:3³ 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]

31



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


32



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


33



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


34



One Last Item of Note ⚠

- If it is too good to be true ...
- You don't get something for nothing ...
- There are no 'free lunches' ...


35



Part II

- Introduction to Schemes


36



Scheme Categories

- Asset Misappropriation
- Bribery and Corruption
- Fraudulent Statements

37



Scheme Subcategories

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


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Asset Misappropriation

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


39



Bribery and Corruption α

- 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]


40



Fraudulent Financial Reporting α

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

41




Medicare – Medicaid and other Federal Programs α

- Pulitzer Prize winning website: <http://www.politifact.com>
- “Pants on Fire” ratings on political statements


- Articles on “fraud” versus “error” rates
- Fraud versus abuse

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Asset Misapp. 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

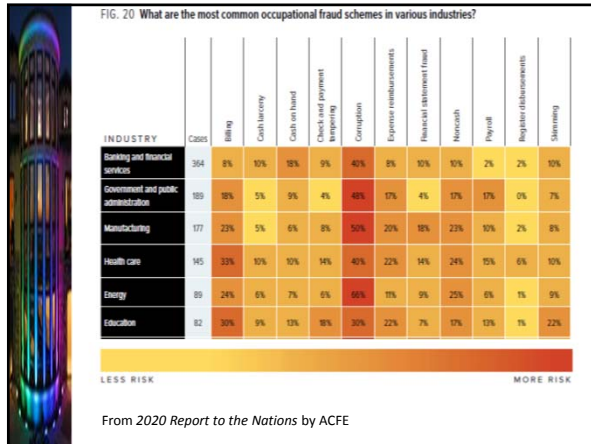
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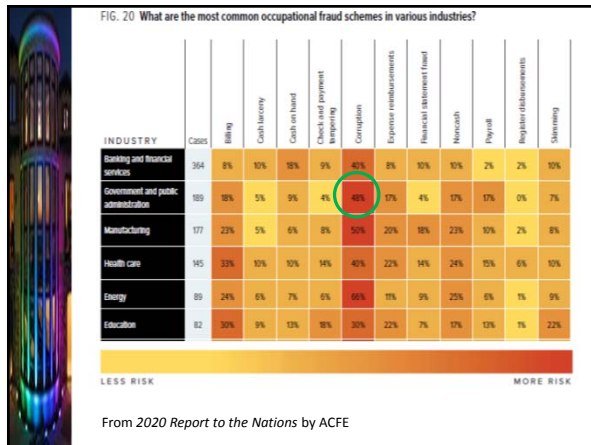
Employee Frauds ^α

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

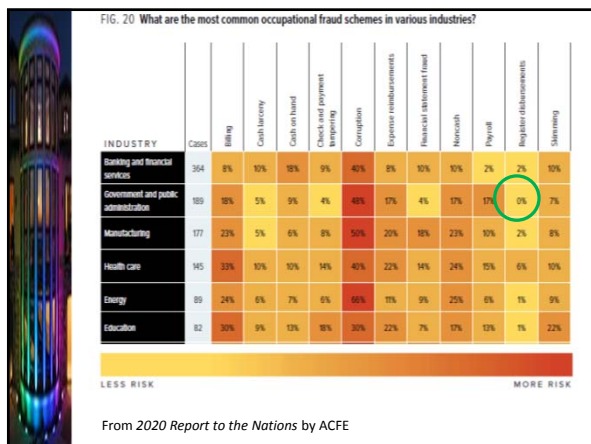
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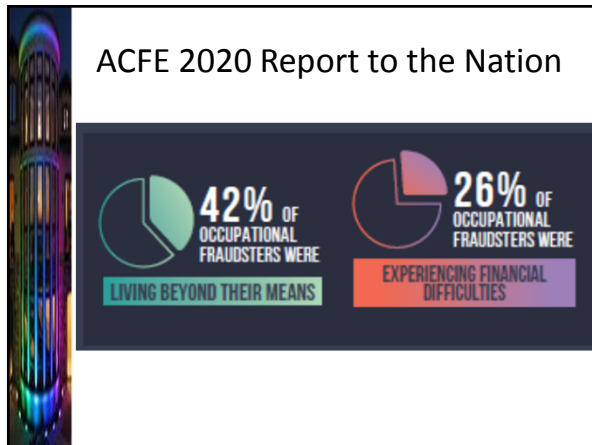
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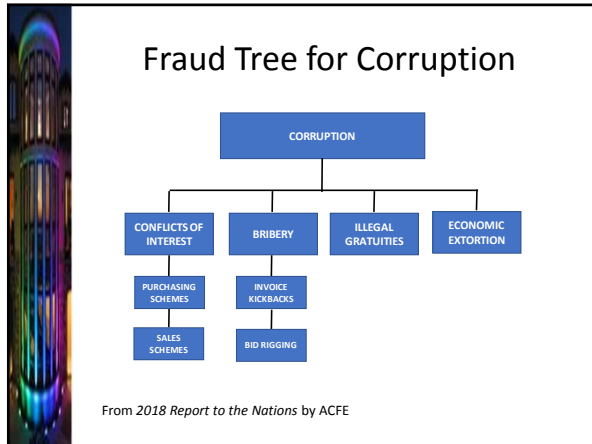
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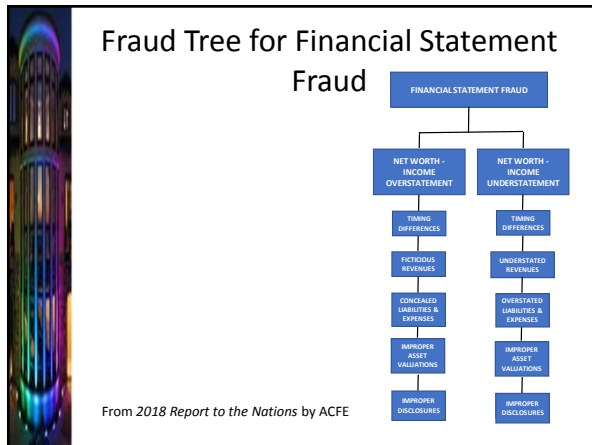
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- ### ACFE Fraud Tree
- At the top are the major Fraud Categories
 - Then come the Major Schemes
 - And then the Sub-schemes/Methodologies

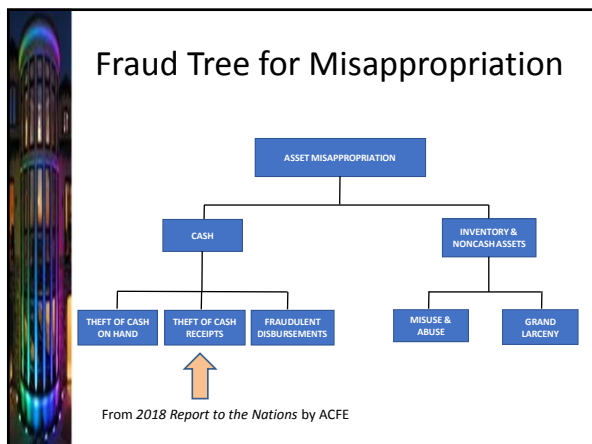
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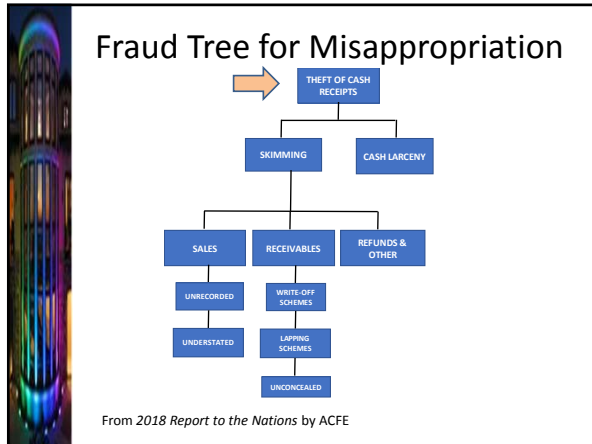
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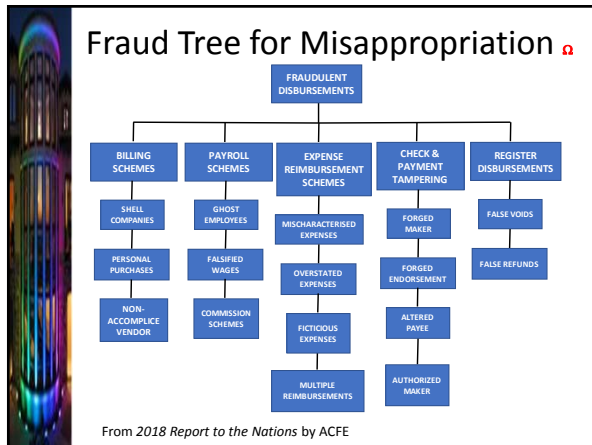
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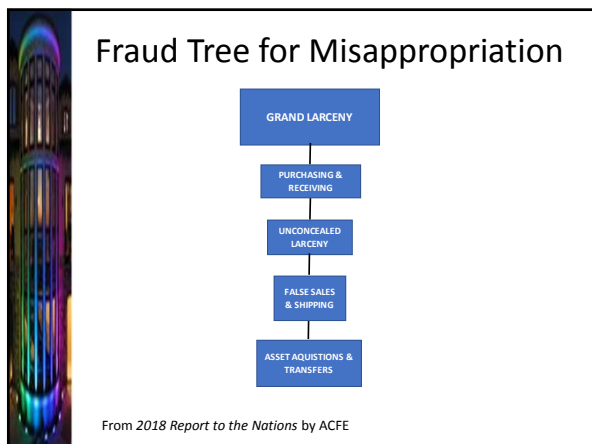
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• THE END SECTION 1


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Fraud Schemes and Red Flags

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Part II

- Specific Schemes

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ACFE Fraud Tree

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

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Fraud Tree for Corruption

```
graph TD; CORRUPTION --> COI[CONFLICTS OF INTEREST]; CORRUPTION --> BRIBERY; CORRUPTION --> IGT[ILLEGAL GRATUITIES]; CORRUPTION --> EE[ECONOMIC EXTORTION]; COI --> PS[PURCHASING SCHEMES]; COI --> SS[SALES SCHEMES]; BRIBERY --> IK[INVOICE KICKBACKS]; BRIBERY --> BR[BID RIGGING];
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From 2018 Report to the Nations by ACFE

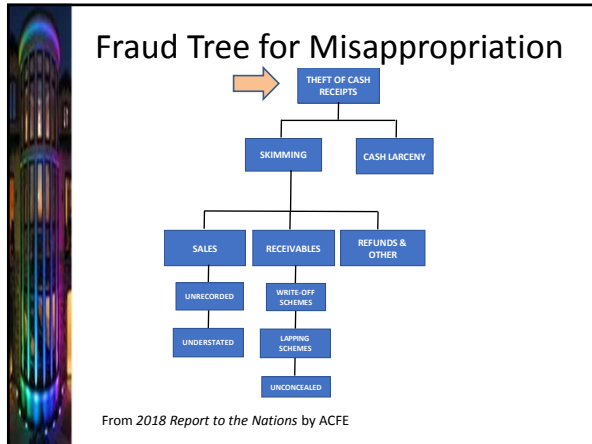
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Fraud Tree for Misappropriation

```
graph TD; AM[ASSET MISAPPROPRIATION] --> CASH; AM --> INA[INVENTORY & NONCASHASSETS]; CASH --> TCOH[THEFT OF CASH ON HAND]; CASH --> TCR[THEFT OF CASH RECEIPTS]; CASH --> FD[FRAUDULENT DISBURSEMENTS]; INA --> MA[MISUSE & ABUSE]; INA --> GL[GRAND LARCENY];
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From 2018 Report to the Nations by ACFE

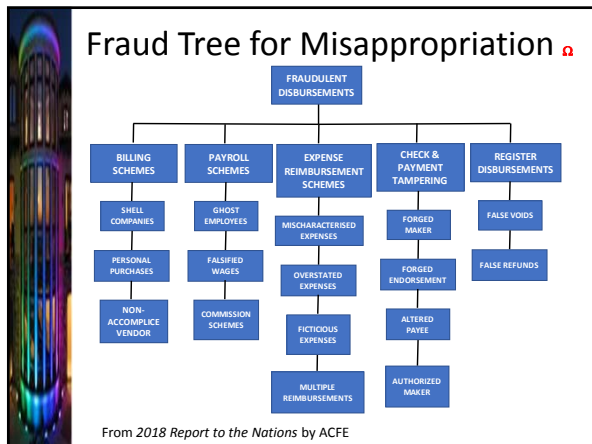
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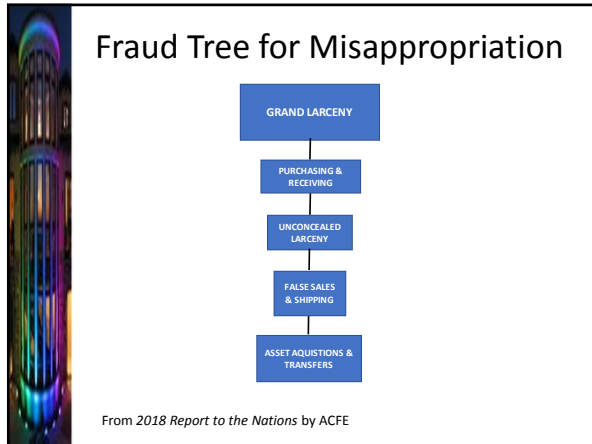
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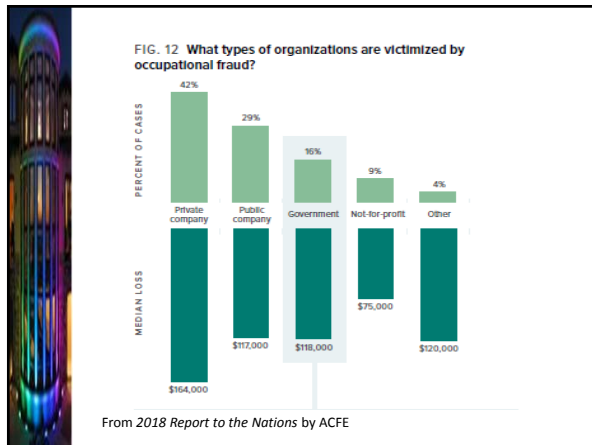
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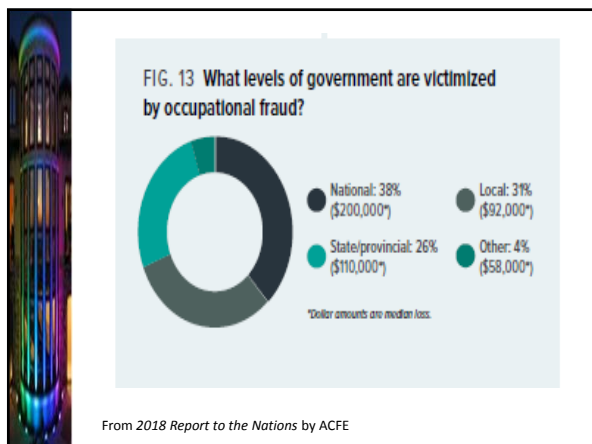
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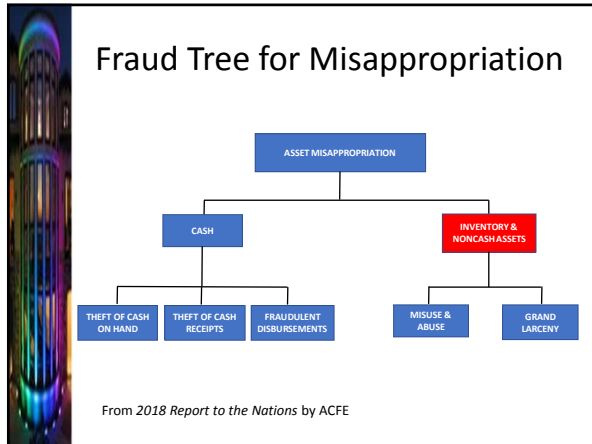
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Part III

- DETECTION AND DETERRENCE

74

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.

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76

-
- Initial Detection Methods**
1. Tips [40%]
 2. Internal Audit Only [15%]
 3. Management Review [13%]
 - Source: 2018 ACFE Report to the Nations.

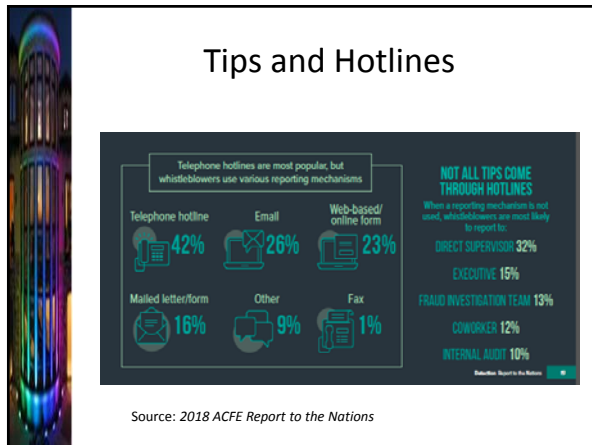
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-
- Initial Detection Methods**
- Who provides the tips?
 - Employees [53%]
 - Customers [21%]
 - Anonymous [14%]
 - Vendors [8%]
 - Other [5%]
 - Competition [3%]
 - Shareholder/Owner [2%]
 - Source: 2018 ACFE Report to the Nations.

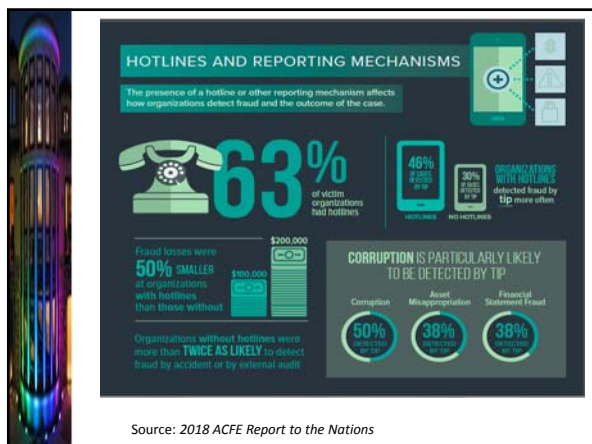
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Detection Method vs Duration & Loss

- 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

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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		

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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	\$ 189,000	44%
Formal fraud risk assessments	4%	\$100,000	\$ 187,000	38%
Employee support programs	54%	\$100,000	\$ 180,000	38%
Fraud training for managers/executives	52%	\$100,000	\$ 153,000	35%
Dedicated fraud department, function, or team	4%	\$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	6%	\$120,000	\$ 150,000	20%
Rewards for whistleblowers	12%	\$ 110,000	\$ 125,000	12%


84



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


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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


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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.


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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


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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

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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

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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

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ATTENDANCE CODE


92

Fraud Tree for Corruption

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```

From 2018 Report to the Nations by ACFE


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Data Analytics

1. Where would the 'effect' of Invoice Kickbacks, Bid Rigging and other Purchasing Schemes show up?
2. Who would be aware of these 'effects'?
3. How would one go about uncovering the 'effects'?


94



Bid Rigging – Kickbacks Investigation

1. Dual victims: Purchaser and vendors losing the contract
2. Verification of contract pricing/quality:
 1. Does the price seem reasonable? [Google for similar items/quality]
 2. Is the contract quality delivered?
3. Nonmonetary data
 1. Quantities ordered versus used over time
 2. Variety of vendors used who carry the product

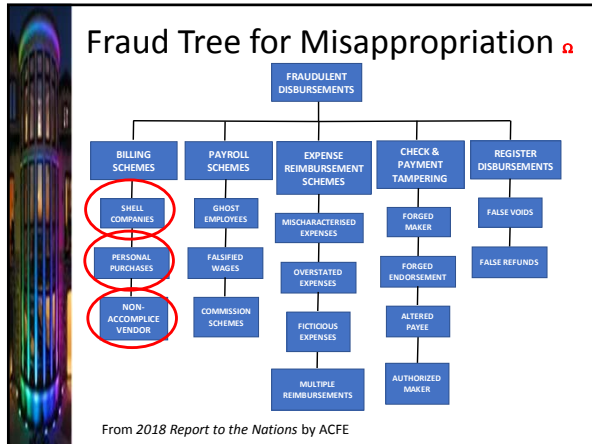
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Illegal Gratuities

1. Purchasing agent(s) relationships:
 1. Overly 'chummy' with any specific vendor or vendor representative?
 2. Takes elaborate vacations to resorts or popular vacation spots that appear out of the price range
 3. Always handles certain vendor relationships with the entity

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Shell Companies

1. Purchasing agent(s) relationships:
 1. Vendor address database
 2. Employee address database
 3. Cross reference the two for 'hits'
2. Google Earth suspicious vendor addresses to 'see' if there is an actual business at that address
3. Analytical review of purchased items
4. Vendor setup controls


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Shell Companies

Analytical Review of Invoice – Trigger Flags

1. Do the quantities purchased appear reasonable base on our known usage? Inquire of end user, not purchasing agent
2. Are vendor invoice numbers reasonable? i.e. not sequentially numbered.
3. Are item descriptions correct? i.e. detailed, item numbers match known industry codes [electrical parts 8 digits]
4. Invoice dates?

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Shell Companies

Analytical Review of Invoice – Awareness Flags

1. Invoice number high enough?
2. PO number, on it? Repeated over and over?
3. Customer number?
4. Errors in spelling or math?
5. Consistent units of measure?
6. Quantities ordered reasonable?
7. Shipping, dunnage or transit numbers?
8. Payment terms consistent with our practice?

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Shell Companies

Analytical Review of Vendor – Trigger Flags

1. Is there a phone number? Appear valid?
2. Physical address, not only a PO Box. Zip Code valid?

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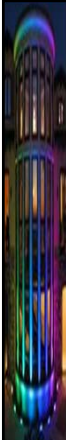


Shell Companies

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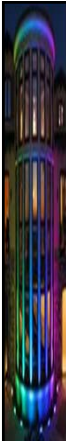
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Vendor setup controls

- Related Party Questionnaire?
- Segregation of duties in Purchasing and Vendor Setup?
- Who answers credit establishment questions? [Terms, Order Quantity etc.]
- Address, legitimacy verification? PO Box? Is this a real, bonafide company?
- Competitors?


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Principles – Review and Revision

1. Assesses Substantial Change
2. Reviews Risk and Performance
3. Pursues Improvement in Enterprise Risk Management


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Principles – Information, Communication & Reporting

- Executive Leverages Information and Technology
- Communicates Risk Information
- Reports on Risk, Culture, and Performance


105







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3% Progress 
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• THE END SECTION 2

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