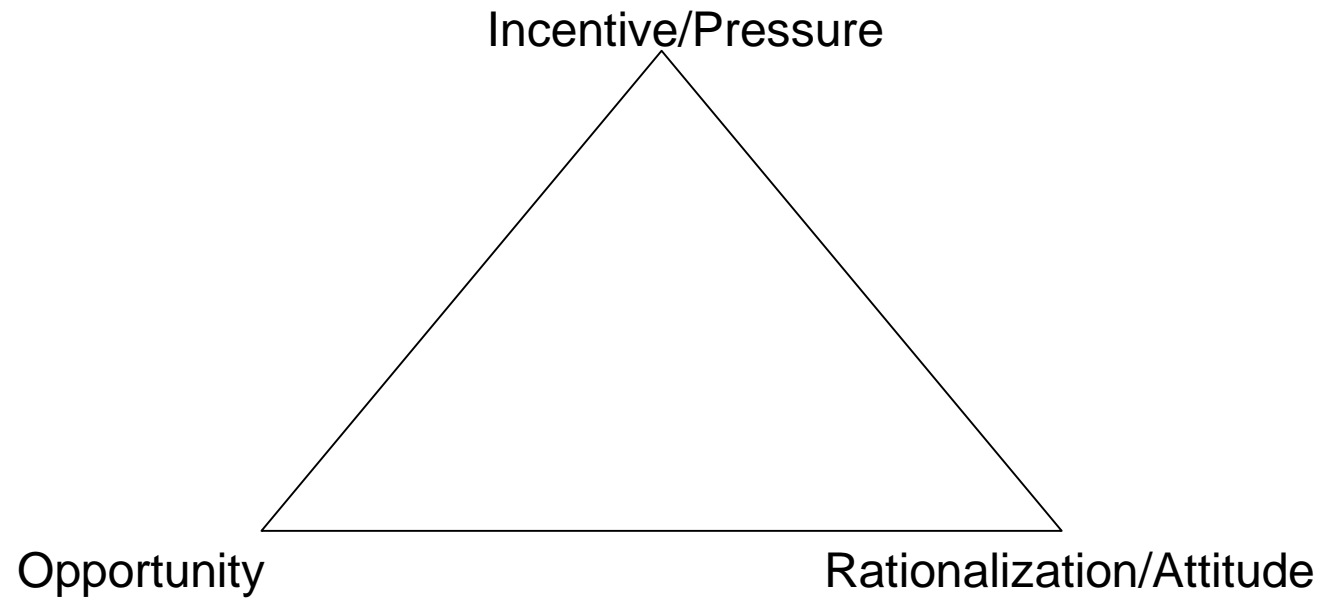


Fraud Fire - Prevention and Detection

Thomas E. Newell, Jr., CPA

Fraud Triangle



Fraud Triangle

- Incentive/pressure
 - Direct need
 - Indirect need
- Opportunity
 - Low probability of getting caught
- Rationalization/Attitude
 - Action fits inside code of conduct
 - Tone at the top

Situational Fraud

- 80- 90% of fraud is situational fraud or embezzlement
- 5-10% always commit fraud
- 5-10% never commit fraud

- Most frauds start small and grow
- Most frauds are accidentally discovered

Fraud Characteristics

- Misappropriation of assets
 - Usually employees but may involve management
 - Driven by opportunity
 - Major concern of owner-managed businesses

Fraud Characteristics

- Fraudulent Financial Reporting
 - Usually committed by management
 - Incentive/pressure driven
 - Should be a concern for all entities

Fraud Characteristics

- Three step process
 - Commission of act
 - Conversion/benefit
 - Concealment of act

Fraud Prevention

- Focus on the three points of the fraud triangle
- Eliminate or reduce opportunity
- Recognize potential incentive/pressure
- Watch for rationalization/attitude

Fraud Prevention

- Employment related
 - Background/credit checks
 - Personal Stress
 - Divorce
 - Medical bills
 - Aging parents
 - Spouse/children trouble
 - Addictions
 - Set the standard for employee behavior

Fraud prevention

- Directly involve employees in development of fraud prevention detection
- Conduct fraud awareness training
- Compensate fairly
- Assist troubled employees
- Segregate duties

Fraud detection

- Consistently staying late and coming in early
- Too much interest in controlling paperwork
- Overly defensive of job duties
- Changing computer passwords unusually often

Common Frauds

- Accounts Receivable
 - Lapping
 - Bogus credits
 - Altering invoices
 - Diversion of bad debt collections

Common Frauds

- Look for
 - Delays in recording
 - Significant credit entries
 - Unexplained differences

Common Frauds

- Inventory
 - Theft for personal use
 - Theft for resale
 - Theft of scrap

Common Frauds

- Look for
 - Large book to physical adjustments
 - Key ratio anomalies
 - Unexplained entries to inventory
 - Shipping documents no corresponding invoices

Common Frauds

- Purchasing and payroll frauds
 - Fictitious vendors
 - Kickbacks
 - Billing schemes
 - Excess purchases
 - Bid rigging
 - Ghost employees

Common Frauds

- Look for
 - Fictitious vendors
 - Vendors with only PO Box address and/or no phone numbers
 - Vendor address same as an employee
 - Knock-off vendor names
 - Multiple companies same address

Common Frauds

- Look for
 - Kickbacks
 - Over-involved purchasing agent
 - Vendors inordinate volume no apparent reason
 - Vendor salesperson frequent unexplained visits

Common Frauds

- Look for
 - Ghost employees
 - Duplicate addresses, checking accounts, SS#
 - No withholding taxes, insurance, 401K or other normal deductions

Fraud Schemes

- Fred Shapiro – attorney, tax and accounting expert
- Incentive – was conned by financial planner on real estate investments in client pension plans
- Investment promised high returns but was a ponzi scheme
- He sued financial planner but process was too long and clients were asking for their money back

Fraud Schemes

- Under extreme financial pressure
- Applied for unsecured personal loans with local banks submitting fraudulent loan applications
- Loans were with local banks, had previous relationship and few questions
- Stop gap measure but lead to additional fraud scheme

Fraud Schemes

- Set up phony real estate title company
- Sales contract on local shopping center and a well respected appraiser to value
- Purchase of shopping center for \$1.2 million to three banks \$400,000 of "own" money and borrow remaining with property as collateral
- "Employee" of bogus title company falsely stated the seller had closed a day before and all documents were in held in escrow

Fraud Schemes

- Trusting banks now have everything needed to had over the \$800,000 to the title company
- Collects \$2.4 million and invests in residential and commercial properties totaling \$8 million
- Plans to wait a year or so until market up and sell at profit pay back banks and go back to practicing law
- House of cards fell when market went south turned himself in with no way out

Fraudsters

From World's Dumbest Fraudsters by Joseph T. Wells

- Opening new checking account with \$1 million dollar bill
- Created check for \$22 million using computer but used apartment address for address of bank on the check

SAS 99

- The SAS did not change our overall responsibility to plan and perform the audit
- Does require auditor to assess the risk of material misstatement due fraud

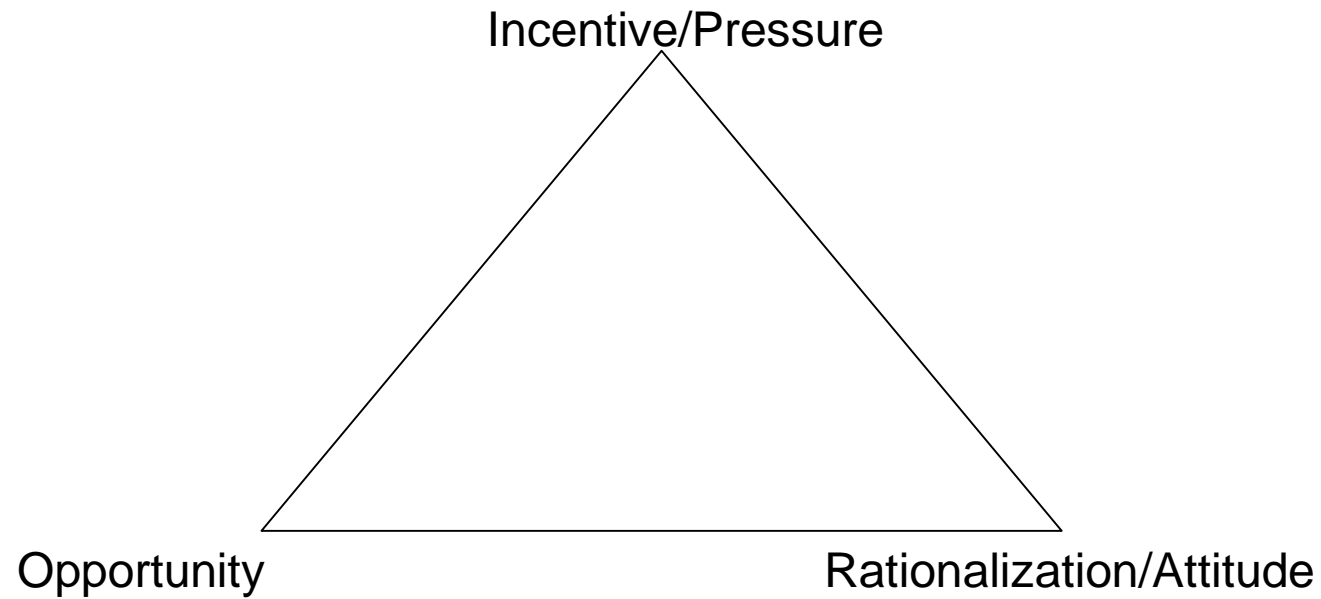
SAS 99

- Risk assessment process includes
 - Identification of risk factors
 - Audit team communications
 - Inquiries of Management
 - Analytical procedures
 - other

SAS 99

- From the risk assessment procedures the auditor
 - Identifies risks
 - Considers controls and assess risk
- Responds to these risks in performance of audit

Fraud Triangle





2006 ACFE

REPORT TO THE NATION

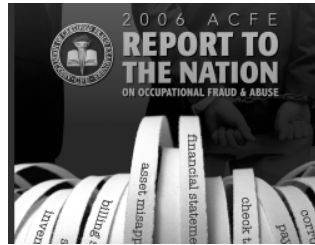
ON OCCUPATIONAL FRAUD & ABUSE



ACFE Findings

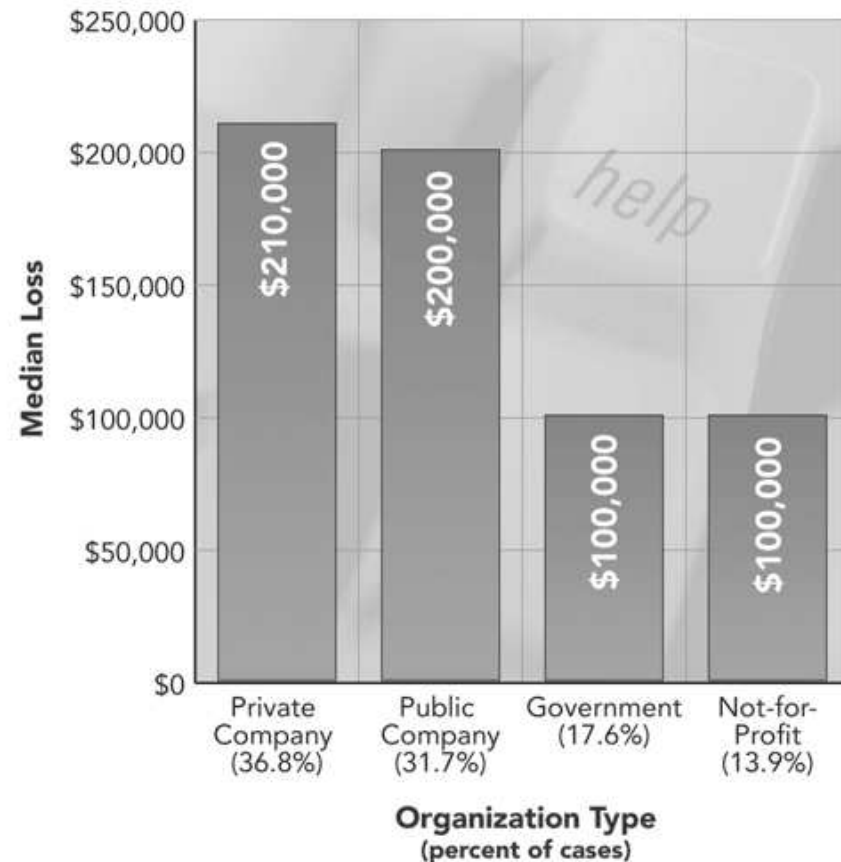


- \$652 Billion total
- External audits were next to lowest in detecting fraud
- Small organizations suffered disproportionately the largest frauds
- Private companies suffered largest losses
- Owners and executives less likely to be prosecuted

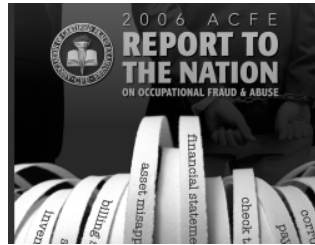


- The following chart shows the distribution of cases among the four organization types, and also illustrates the median loss for cases in each group. As we can see, privately held and publicly traded companies were not only the most heavily represented organization types, they also suffered the largest losses, at \$210,000 and \$200,000 respectively.

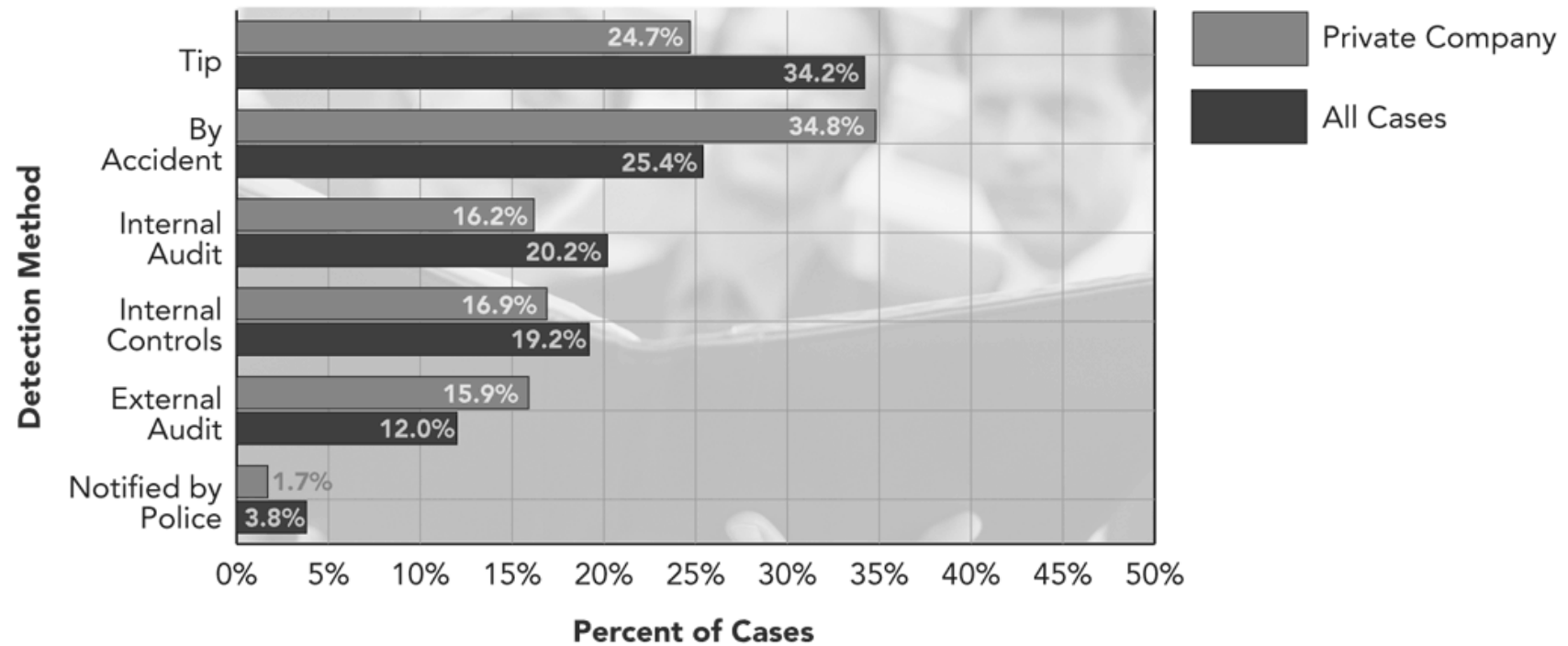
Frequency and Median Loss Based on Organization Type of Victims



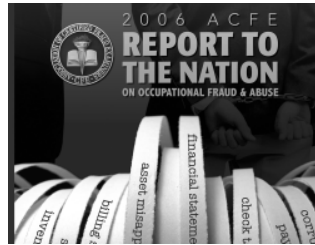
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Detection of Frauds in Privately Held Companies

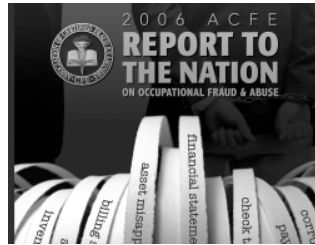


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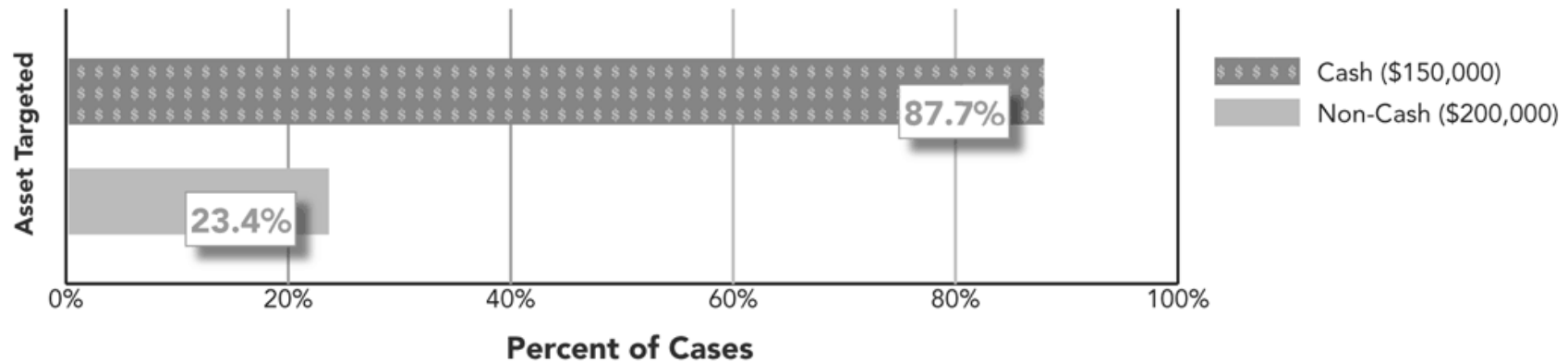


Types of Occupational Fraud & Abuse					
Category	Description	Examples	Cases Reported	% of all Cases ³	Median Loss
Asset Misappropriations	Any scheme that involves the theft or misuse of an organization's assets.	<ul style="list-style-type: none"> • Fraudulent invoicing. • Payroll fraud. • Skimming revenues. 	1,038	91.5%	\$150,000
Corruption	Any scheme in which a person uses his or her influence in a business transaction to obtain an unauthorized benefit contrary to that person's duty to his or her employer.	<ul style="list-style-type: none"> • Accepting or paying a bribe. • Engaging in a business transaction where there is an undisclosed conflict of interest. 	349	30.8%	\$538,000
Fraudulent Statements	Falsification of an organization's financial statements to make it appear more or less profitable.	<ul style="list-style-type: none"> • Booking fictitious sales. • Recording expenses in the wrong period. 	120	10.6%	\$2,000,000

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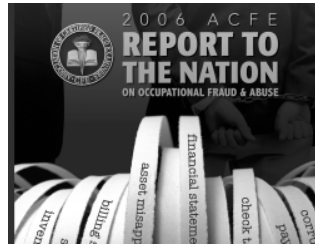


Breakdown of Asset Misappropriations – Cash vs. Non-Cash⁴



- 4 The sum of percentages in this chart exceeds 100% because a number of cases involved the misappropriation of both cash and non-cash assets. In those cases, we were unable to subdivide the losses to determine exactly how much was attributable to cash vs. non-cash schemes.

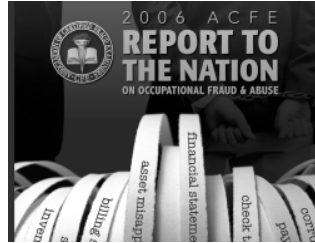
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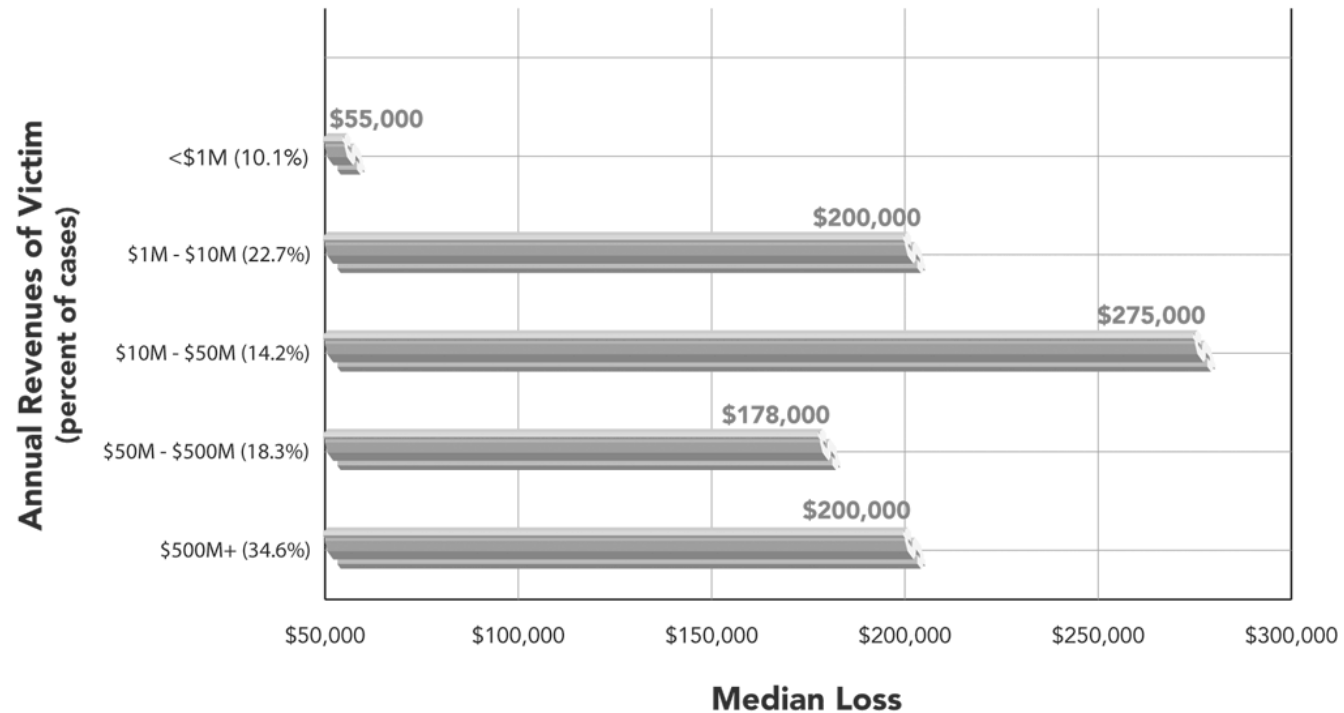
Size of Victim Organization Based on Number of Employees



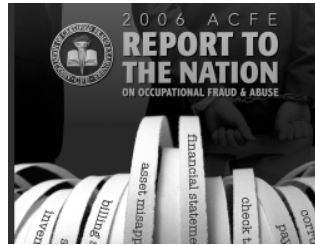
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Size of Victim Organization Based on Annual Revenues/Budget Median Loss and Frequency



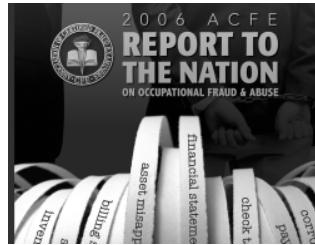
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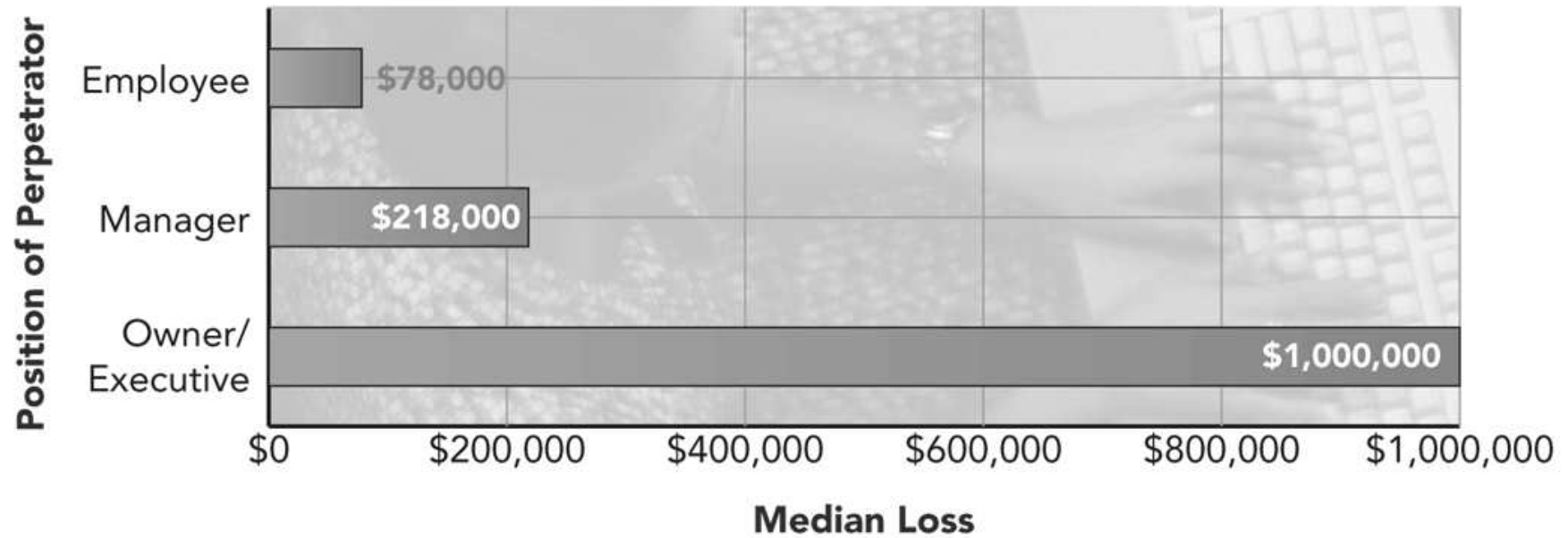
- A small business owner concerned with check tampering might take certain basic steps such as insisting on signing all checks personally or having an unopened copy of the company's bank statement sent to the owner's residence so that it can be reviewed independently and compared to the company's books and records.

Small Business (<100 employees) — 381 Cases		
Scheme	Cases	% ⁹
Check Tampering	111	29.1%
Skimming	105	27.6%
Billing	94	24.7%
Expense Reimbursements	88	23.1%
Corruption	87	22.8%
Cash Larceny	75	19.7%
Payroll	68	17.8%
Non-Cash	67	17.6%
Financial Statement Fraud	46	12.1
Wire Transfers	29	7.6%
Register Disbursements	6	1.6%

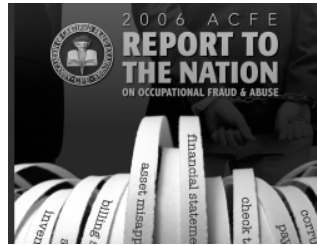
⁹The sum of percentages in this table exceeds 100% because several cases involved multiple methods of fraud.



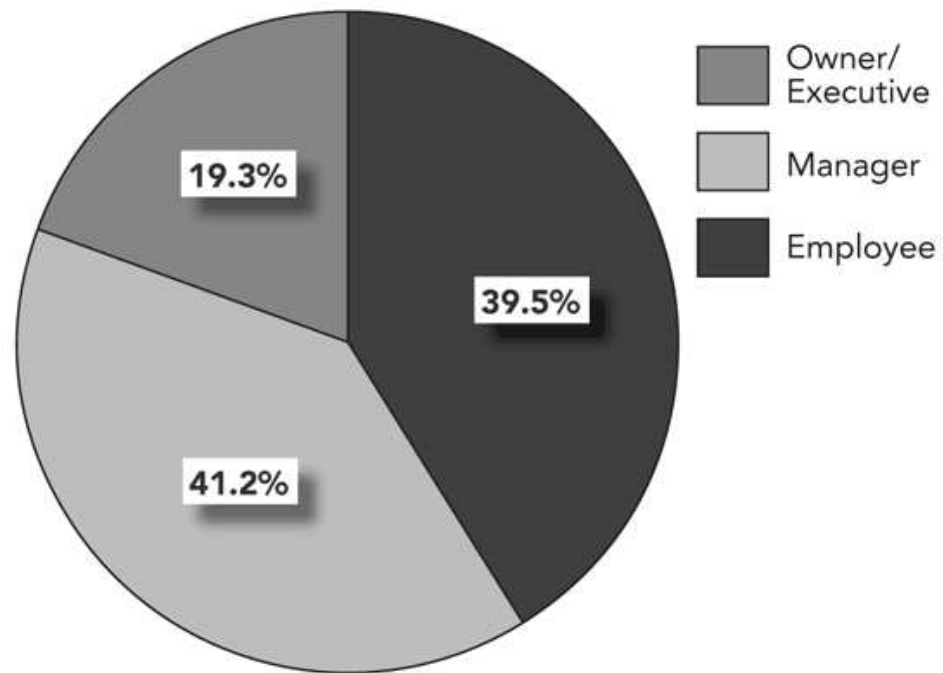
Position of Perpetrator — Median Loss



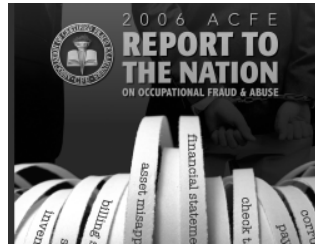
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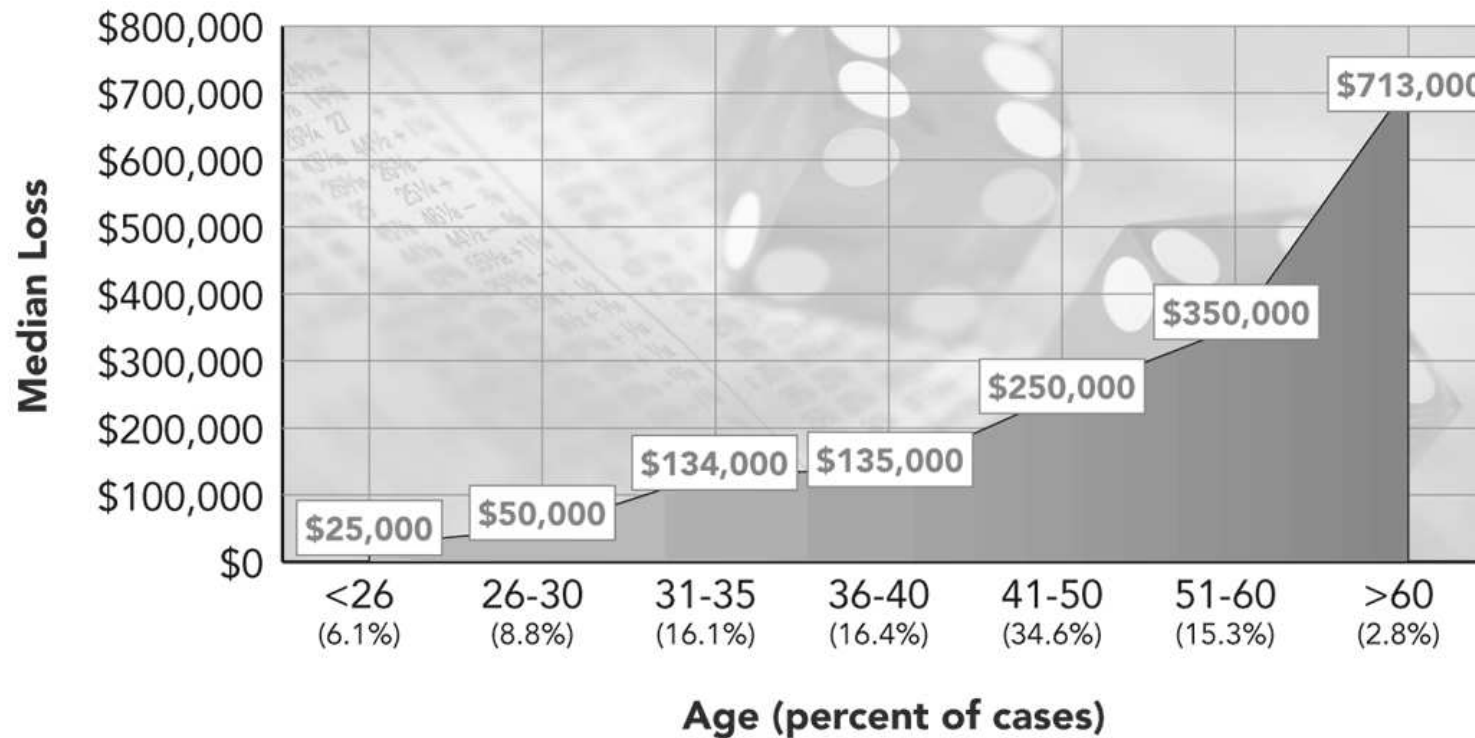
Position of Perpetrator Frequency

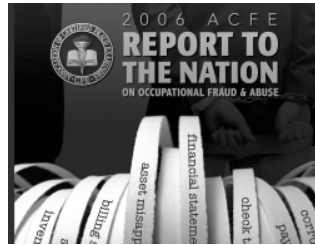


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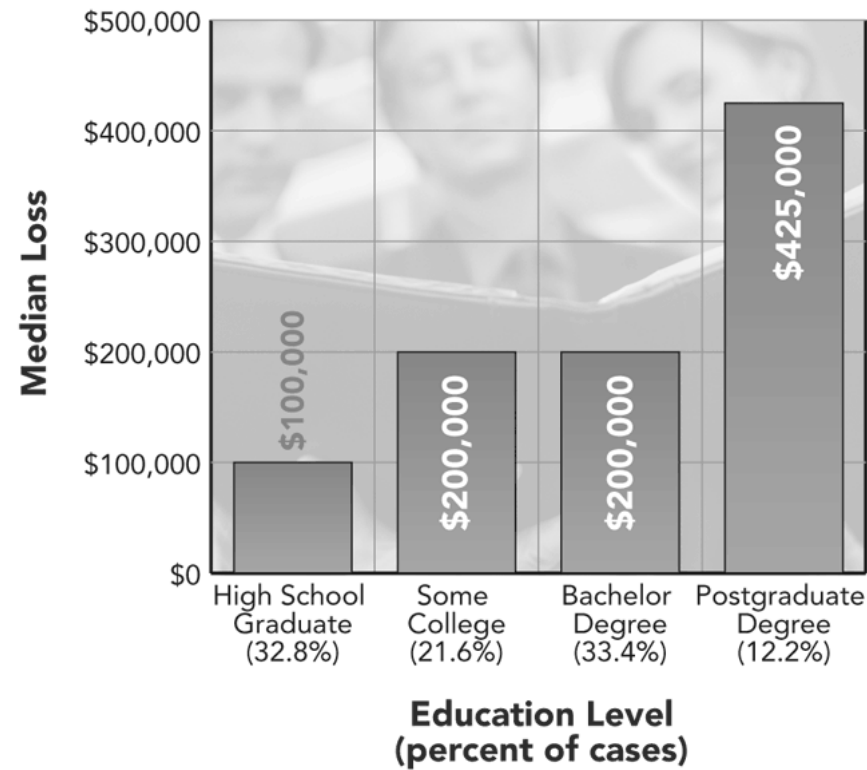


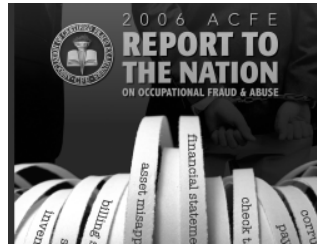
Age of the Perpetrator



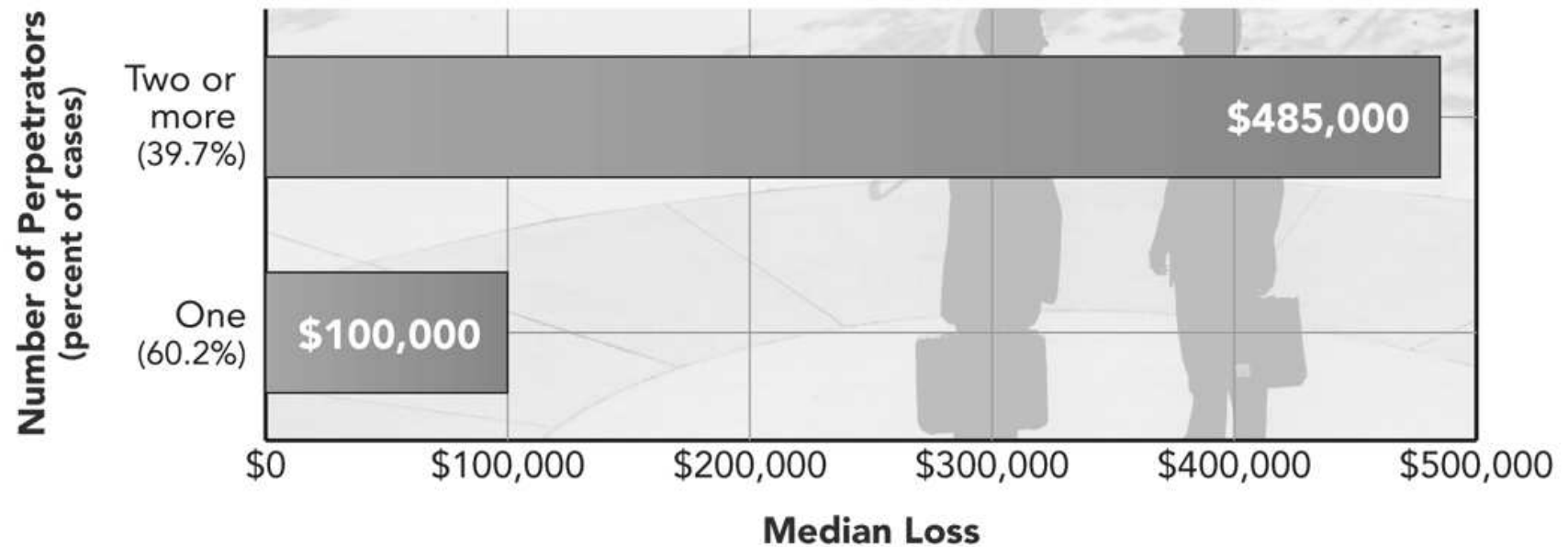


Education of Perpetrator Frequency and Median Loss

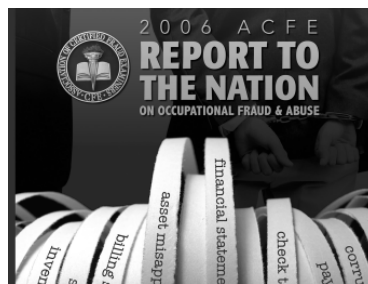




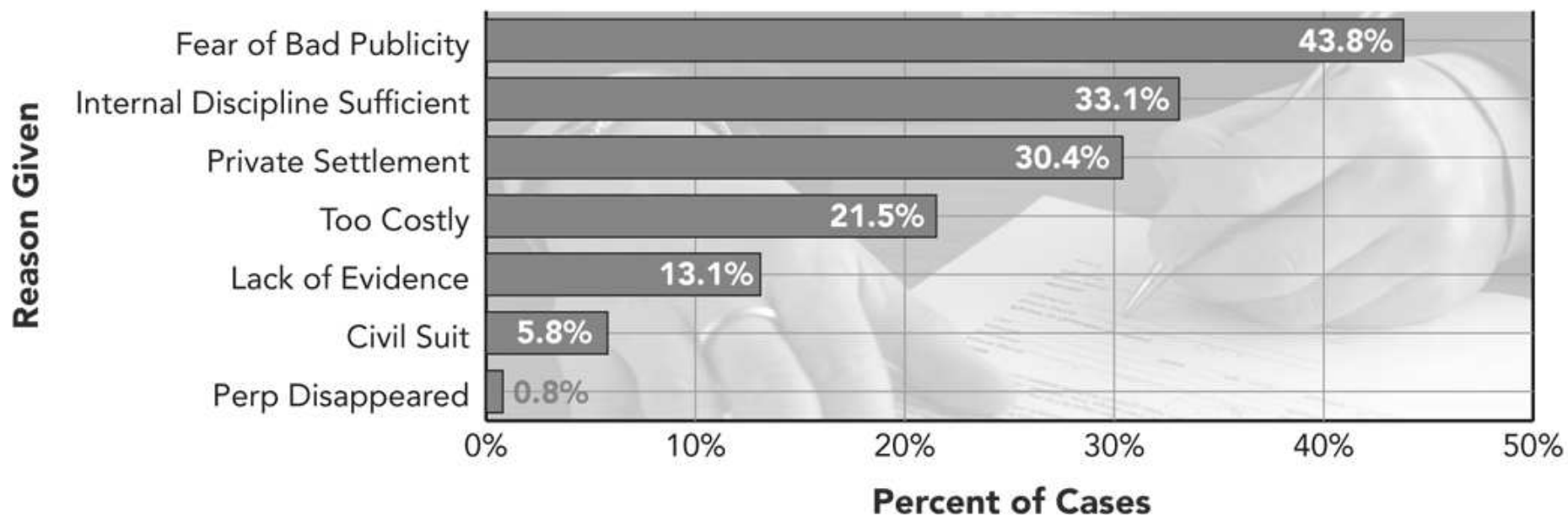
Number of Perpetrators



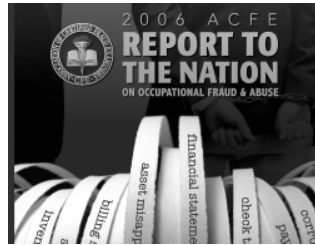
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Reasons for Declining to Prosecute¹⁴



14 The sum of percentages in this chart exceeds 100% because some respondents cited more than one reason why victim organizations declined to prosecute.



Financial Statement Fraud Schemes				
Category	Description	Examples	Cases Reported	% of FSF Cases ⁶
Concealed Liabilities	Schemes in which financial statements are misstated by improperly recording liabilities and/or expenses.	<ul style="list-style-type: none"> Organization omits significant expenses or liabilities on its financial statements. Organization records revenue-based expenses as capital expenditures, falsely increasing both net income and total assets in the current accounting period. 	54	45.0%
Fictitious Revenues	Schemes in which financial statements are inflated by recording sales of goods or services that never occurred, or by inflating actual sales.	<ul style="list-style-type: none"> Organization records the sale of inventory to a phantom customer. Organization creates invoices showing sale of goods to existing customer, but goods are never delivered. Sales are reversed at beginning of next accounting period. 	52	43.3%
Improper Asset Valuations	Schemes in which the value of an organization's assets is fraudulently misstated in the organization's financial statements.	<ul style="list-style-type: none"> Organization fails to write off obsolete inventory. Organization inflates its receivables by booking fictitious sales on account to nonexistent customers. 	48	40.0%
Improper Disclosures	Schemes in which management fails to disclose material information in its financial statements in an attempt to mislead users of the financial statements.	<ul style="list-style-type: none"> Organization's financial statements fail to note potentially material contingent liability arising from a corporate guarantee of personal loans taken out by an officer. Organization's financial statements fail to note that one of its largest suppliers is owned by the corporation's president. 	45	37.5%
Timing Differences	Schemes in which financial statements are intentionally misstated by recording revenues in a different accounting period than their corresponding expenses.	<ul style="list-style-type: none"> Organization manipulates net income by recording sales that occur in December of Year 1, but not recording the corresponding expenses until January of Year 2. 	34	28.3%

⁶The sum of percentages in this table exceeds 100% because a number of cases involved the more than one method of falsifying financial statements.