


Stomping Out the Fraud Fire

Stomping Out the Fraud Fire

**GSCPA
North Perimeter Chapter**


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**Fraud
Knowledge Survey**




Part 1



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1) Which *type* has the *highest occurrence*?


- A) Asset misappropriation
- B) Corruption
- C) Financial statement fraud



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2) Which *type* has the *highest average loss*?


- A) Asset misappropriation
- B) Corruption
- C) Financial statement fraud



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3) Which *tenure* range has the *highest occurrence*?


- A) <1
- B) 1-5
- C) 5-10
- D) 10+



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4) Which *level of education* has the *greatest average loss*?

- A) High school diploma
- B) Bachelor's degree
- C) Postgraduate degree




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5) Which *position* has the *highest occurrence*?

- A) Employee
- B) Manager
- C) Owner/executive


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6) Which *position* has the *greatest average loss*?

- A) Employee
- B) Manager
- C) Owner/executive


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Presentation Overview


1. Fraud Overview
2. Fraud Triangle
3. Fraud Detection
4. Fraud Prevention
5. "Crazy" Eddie Antar Dissection

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1. Fraud Overview


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2006 ACFE Report to the Nation

- Participants in the study estimated that U.S. organizations lose an *estimated 5%* of annual revenues due to *occupational fraud*.


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**Hypothetical Example:
Wal-Mart Fiscal Year 2007**

Reported Net Sales	\$345.0 Billion
Reported Net Income	\$11.3 Billion
Hypothetical 5% Occupational Fraud Loss	\$17.3 Billion

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Fraud

- Fraud has many definitions
- In the broadest sense, fraud is:
 - an *intentional deception* made for personal gain.


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Occupational Fraud

- ACFE 2006 Report to Nation definition:
 - The use of one's occupation for *personal enrichment* through the *deliberate* misuse or misapplication of the employing organization's resources or assets.


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Occupational Fraud: Broad Types

- 1) Asset misappropriation
- 2) Corruption
- 3) Financial statement fraud

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1) Asset misappropriation

- Stealing inventory
- Skimming and embezzling
- Ghost employees


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2) Corruption

- Accepting or paying a bribe or kickback
- Undisclosed conflicts of interest


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3) Financial statement fraud

- Booking fictitious revenues
- Overstated assets
- Undisclosed liabilities

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Who Does Fraud Hurt?

Fraud Hurts Everyone!

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2. Fraud Triangle

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The Fraud Fire

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Fraud Triangle: Pressure

- Pressure to commit fraud.
- Examples:
 - Sudden financial hardship
 - Profit-based compensation

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Fraud Triangle: Rationalization

- A frame of mind that allows justification for fraud.
- Examples:
 - "I will pay it back."
 - "Everyone does it."

Walt Pavlo
Former Senior Manager
WorldCom

*Clip from the ACFE's "Fraud and the Tone-at-the-Top" video

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Fraud Triangle: Opportunity

- Circumstances, actual or perceived, that allow fraud to occur.
- Examples:
 - Lack of segregation of duties
 - Failure to prosecute offenders


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Imagine:

- You lost your job 6 months ago (decided to save money by dropping your family's health insurance coverage)
- Your home was just washed away in a flood (no flood insurance)
- Your spouse just passed away
- You just found out that your 3-year old child needs critical surgery that will cost \$100K

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Imagine:


- You have access to fraudulently "borrow" the funds you need to pay for your living expenses and surgery
- You have no other access to the necessary funds
- You will be able to get a job to pay the money back in 4 months

What would you do?

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Fraud Knowledge Survey




Part 2

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Who's the Fraudster?

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The Company

- Big Time Closers, Inc.
 - Owned by several passive investors
 - Closes sales of new homes
 - Three employees


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The Predication

- Investors are concerned about decreased revenues in a thriving real estate market.
- Customers have started complaining that Big Time Closers, Inc. has become Big "Cost" Closers, Inc.

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The Employees

- Alicia Armstrong (Bookkeeper)
- Brandi Brown (Real estate closer)
- Calvin Carr (Real estate closer)


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Alicia Armstrong (Bookkeeper)

- Age: 48
- Tenure: 1 Year
- Salary: \$48K/Yr
- Vehicle: 2006 Lexus RS330
- Home: Purchased in 2007
- Only employee with access to accounting software
- Only employee authorized to write checks and make deposits
- Married, quiet, & keeps to herself
- Two children in college

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Brandi Brown (Real estate closer)

- Age: 49
- Tenure: 3 Years
- Salary: \$78K/Yr
- Vehicle: 2005 Acura TL
- Home: Purchased in 1995
- Married with two children in middle school
- Bowls four nights a week


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Calvin Carr (Real estate closer)

- Age: 46
- Tenure: 3 Years
- Salary: \$78K/Yr
- Vehicle: 2005 Corvette
- Home: Purchased in 1997
- Single & enjoys the nightlife

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Who's the Fraudster?

A.) Alicia Armstrong (Bookkeeper)

B.) Brandi Brown (Real Estate Closer)


C.) Calvin Carr (Real Estate Closer)

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3. Fraud Detection

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Finance-Related Red Flags

- Cash shortages
- Unbalanced ledgers
- Unreasonable document sequences
- Unreasonable expenses or reimbursements
- Strange financial statement relationships (e.g., increased revenues with decreased receivables)

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Other Red Flags

- Excessive turnover of executives
- Tips or complaints
- Extravagant lifestyles
- Unusual behaviors
 - Guilt leads to fear
 - Fear leads to stress
 - Stress leads to behavior changes

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Detection Method Study

Initial Detection of Occupational Frauds*


Detection Method	Percent of Cases
Tip	34.20%
By Accident	25.40%
Internal Audit	20.20%
Internal Controls	19.20%
External Audit	12.00%
Notified by Police	3.80%

* Data from the 2006 ACFE Report to the Nation on Occupational Fraud & Abuse

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Fraud Knowledge Survey




Part 3

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What's Wrong?


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What's Wrong?



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Fraud Triangle Detection Technique

- Pressure
 - Who has had a recent change in their lifestyle (e.g., from a divorce)?
- Rationalization
 - Are all employees given competitive compensation?
- Opportunity
 - Where are significant control weaknesses (e.g., lack of segregation of duties)?


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Other Fraud Detection Techniques


- Data-mining (e.g., ACL or IDEA)
- Statistical analysis of company databases (e.g., Benford's law)
- Risk-based analysis (e.g., determining common frauds within the industry, and identifying typical symptoms of those frauds)
- Analyzing financial statements (e.g., ratio analyses)

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4. Fraud Prevention


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Fraud Prevention

1. Creating a culture of honesty, openness, and assistance
2. Minimizing opportunities for fraud

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Creating a Culture of Honesty, Openness, and Assistance

- Creating a positive work environment
- Hiring honest people and providing fraud awareness training
- Implementing employee assistance programs



Dr. Stephen Salbu
Organizational Behavior Specialist

*Clip from the ACFE's "Fraud and the Tone-at-the-Top" video.


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Minimizing Opportunities for Fraud

- Effective internal control is the other key to minimizing opportunities to commit fraud.

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Internal Controls

Cash

- *Posting notices* offering customers gifts if they don't receive a receipt or it's incorrect.

Accounts Receivable

- Using a *lockbox system*.

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Internal Controls

Inventory

- *Halting production* or *controlling movement* during physical counts.

Fixed Assets

- Using a *capital budget* and following up on excess costs.

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Internal Controls

Investment Securities

- Maintaining a *record of due dates* for income (such as bond income) and follow up if it is not received promptly.

Accounts Payable

- *Locking up* unused checks and signature stamps.

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Internal Controls

Payroll

- Requiring that someone *independent* of the payroll function *mail* or *deliver* paychecks.

Borrowing


- Periodically obtain copies of the organization's *credit report*.

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Internal Controls

Equity

- Using *prenumbered* stock certificates, issuing them *sequentially*, and *reviewing* their sequence periodically.


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Can a Company Eliminate All Opportunities?

NO

Why?

- *Always* a risk of management override of controls

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Should a Company Try to Eliminate All Opportunities Possible of Being Eliminated?

NO

Why?

- Must *always* weigh costs with benefits.

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Is that a Precise Process?

NO

Why?


- Companies may be able to estimate costs, but cannot precisely estimate benefits since they are unknown until it's too late.

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5. "Crazy" Eddie Antar Dissection

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Crazy Eddies




© 1990 Crazy Eddie, Inc. Retrojunk.com

Eddie's Frauds Lasted Approximately 18 Years

*Clip from RetroJunk.com.


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Overview


- Eddie evolved a small discount electronic store into a powerhouse in the discount electronic industry.
- In the process, Eddie engineered one of the longest-lasting fraud schemes in the modern business world.
- Eddie had many perceived pressures, perceived opportunities, and rationalizations.

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Eddie's Frauds

Tax Fraud to Securities Fraud



Insurance Fraud

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Eddie's Tax Fraud

- Hiding revenues
 - Under floorboards
 - Israeli bank accounts
- Avoiding payroll taxes
 - Paying employees with skimmed cash

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Eddie's Securities Fraud

- Inflation of revenues
 - Panama Pump
- Inflation of inventories
 - Backdating shipping documents
 - Counting empty boxes
 - Building tall "dummy" columns of boxes
- Insider trading

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62




Eddie's Insurance Fraud

- Inflation of thefts
 - Based on the logic that, if the thieves were caught, who would believe them?
- Inflation of water losses
 - Watered down merchandise from previous losses was reused in new water claims.

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Crazy Eddie: Pressures

- Financial Distress
- Preoccupied with being "successful"
- Challenge to "beat the system"
- Greed

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Crazy Eddie: Rationalizations

- "I will only do this until I get back on my feet."
- "No one will get hurt."
- "There is nothing wrong with switching a customer to an item that better fits his or her needs." (relating to bait & switch schemes)
- "It's us against them."

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Crazy Eddie: Opportunities

- No "outsiders," including board of directors
- "Educated" family member
- Ineffective audit procedures
- Lack of detection and punishment

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Eddie's Detection

- Crazy Eddies was hostilely taken over in 1987.
- During the takeover, Eddie tried to counter-offer but couldn't hold it off.
- After the takeover, inventory was found to be grossly overstated (approximately \$80 million).
- This finding launched numerous investigations and lawsuits.

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Have We Learned Our Lesson?

- Increased fraud awareness
- Sarbanes-Oxley Act of 2002
 - Increased accountability & penalties
 - * Officers
 - * Board of directors & audit committees
 - * Auditors
- Statement on Auditing Standards No. 99 (SAS 99)
 - Fraud brainstorming sessions
 - Emphasis on inquiry and analytics
 - Considering antifraud programs and controls

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Eddie's frauds could still occur today but would be...

- Less likely to occur
- Less likely to last as long

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THE BOTTOM LINE

- *Occupational fraud* is a serious *threat to all* businesses.
- The *fraud triangle* (pressures, rationalizations, and opportunities) is a very *powerful tool* for both fraud detection and prevention.
- *Fraud detection* occurs *after damage* occurs to an organization.
- *Fraud prevention* efforts are *essential* for all businesses.

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70



Resources

- 2006 ACFE "Report to the Nation on Occupational Fraud & Abuse" - www.acfe.com/documents/2006-rttn.pdf
- "Fraud and the Tone-at-the-Top" video - www.acfe.com/video/tone-at-the-top.wmv
- "The World's Dumbest Fraudsters" written by Joseph T. Wells and published in May 2003 - www.aicpa.org/PUBS/jofa/may2003/wells.htm

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71



Questions?

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72

