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# **Types of Fraud and Recent Cases**

Developing an Effective Anti-fraud Program  
from the Top Down

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# Types of Fraud and Recent Cases

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# Types of Fraud and Recent Cases

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**Assessing the True Risk of Fraud - Breaking through common Myths and Misconceptions**

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2

**Setting the proper Tone at the Top and throughout the Organization**

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3

**Understanding the Limits of Internal Control**

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**Being Proactive about Fraud Risk Management**

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5

**Knowing When and how to Respond to Allegations**

**1****Assessing the True Risk of Fraud:  
Breaking through common Myths and Misconceptions**

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There is a lot of anecdotal information circulating about fraud and fraud risk management many of it based on common misconceptions including...

*“We work in a culture of trust - our people are not capable of committing fraud.”*

*“Fraud is not material in our organization otherwise it would already be detected.”*

*“We have a good internal controls system. That minimizes the risk of fraud.”*

*“Our Audit and Controls procedures would detect any material incidents of fraud.”*

*“Fraud and Corruption is just a cost of ‘doing business’ in many parts of the world.”*

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***Research, case studies, surveys, legal statutes and our own experience indicate that these statements are in most cases false.***

# 1

## Assessing the True Risk of Fraud: Breaking through common Myths and Misconceptions

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### *Here are some statistics:*

- ❖ Research has shown that **60% of any given population is capable of committing fraud** under conditions of pressure, opportunity and rationalization
- ❖ The Association of Certified Fraud Examiners estimates that on average companies **lose approximately 6% of their sales to fraud**
- ❖ **41% of fraudulent activities are detected through “whistle blowers”** whereas only 35% are detected through audits and controls
- ❖ Our Surveys show **that 25% of companies globally describe fraud as prevalent** in their business sector
- ❖ **FCPA actions** by the US Department of Justice have increase significantly over the last 5 years

# 1

## Assessing the True Risk of Fraud: Breaking through common Myths and Misconceptions

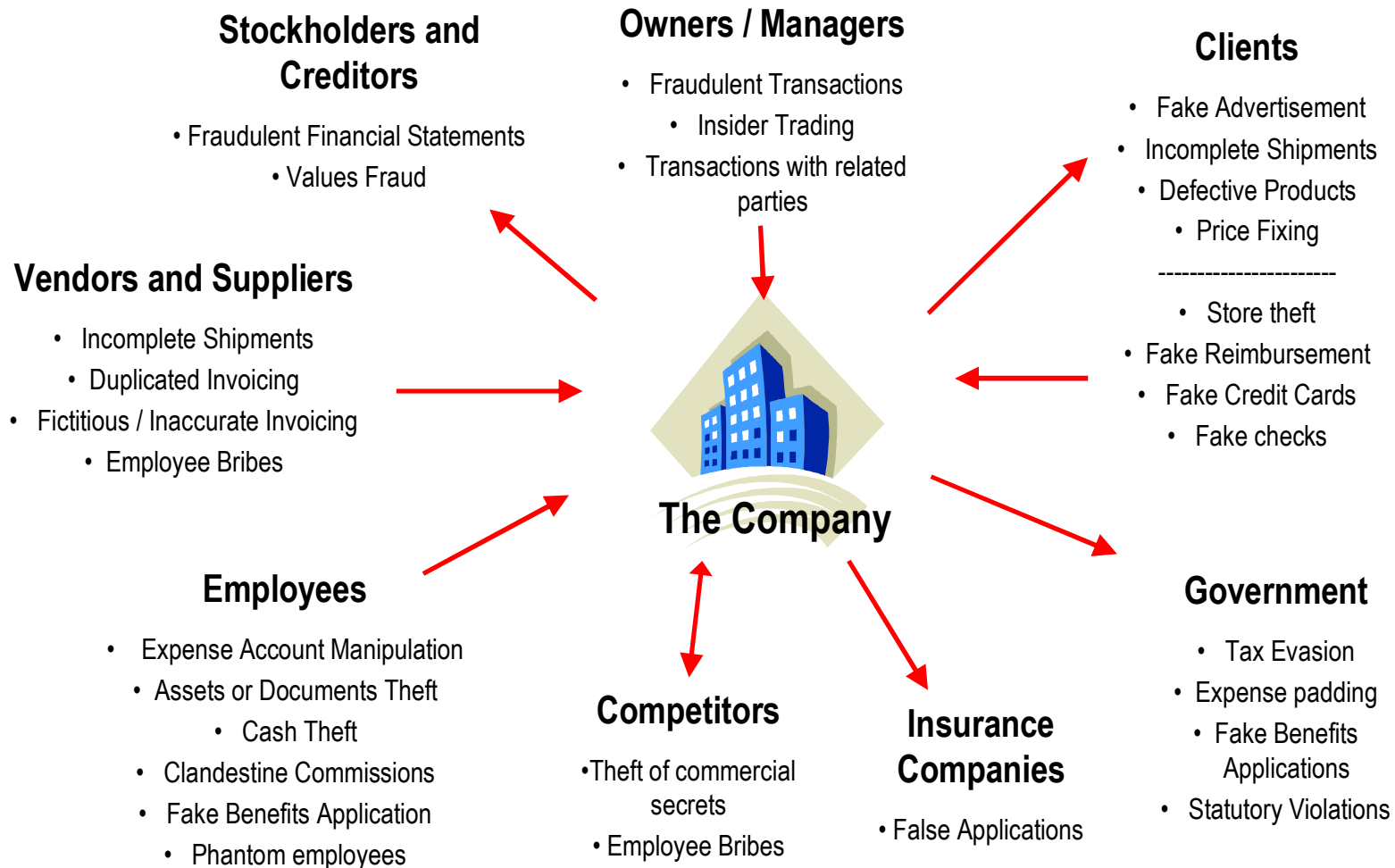
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***These statistics underlie some basic facts about fraud:***

- **Today, fraud exists at some level in every company**
- There is a great diversity of frauds which a company can fall victim to
- **Aside from the economic costs, fraud has psychological and reputation costs which can be extremely high. Fraud also affects employee moral**
- Fraudulent activity by one or a few individual can lead to corporate violations of legal and regulatory standards magnifying its impact on the organization
- **Internal Audit and/or Internal Control procedures do not detect the majority of frauds**
- Fraud is a business risk which to some extent is inevitable but is also manageable

# 1

## Assessing the True Risk of Fraud: Breaking through common Myths and Misconceptions

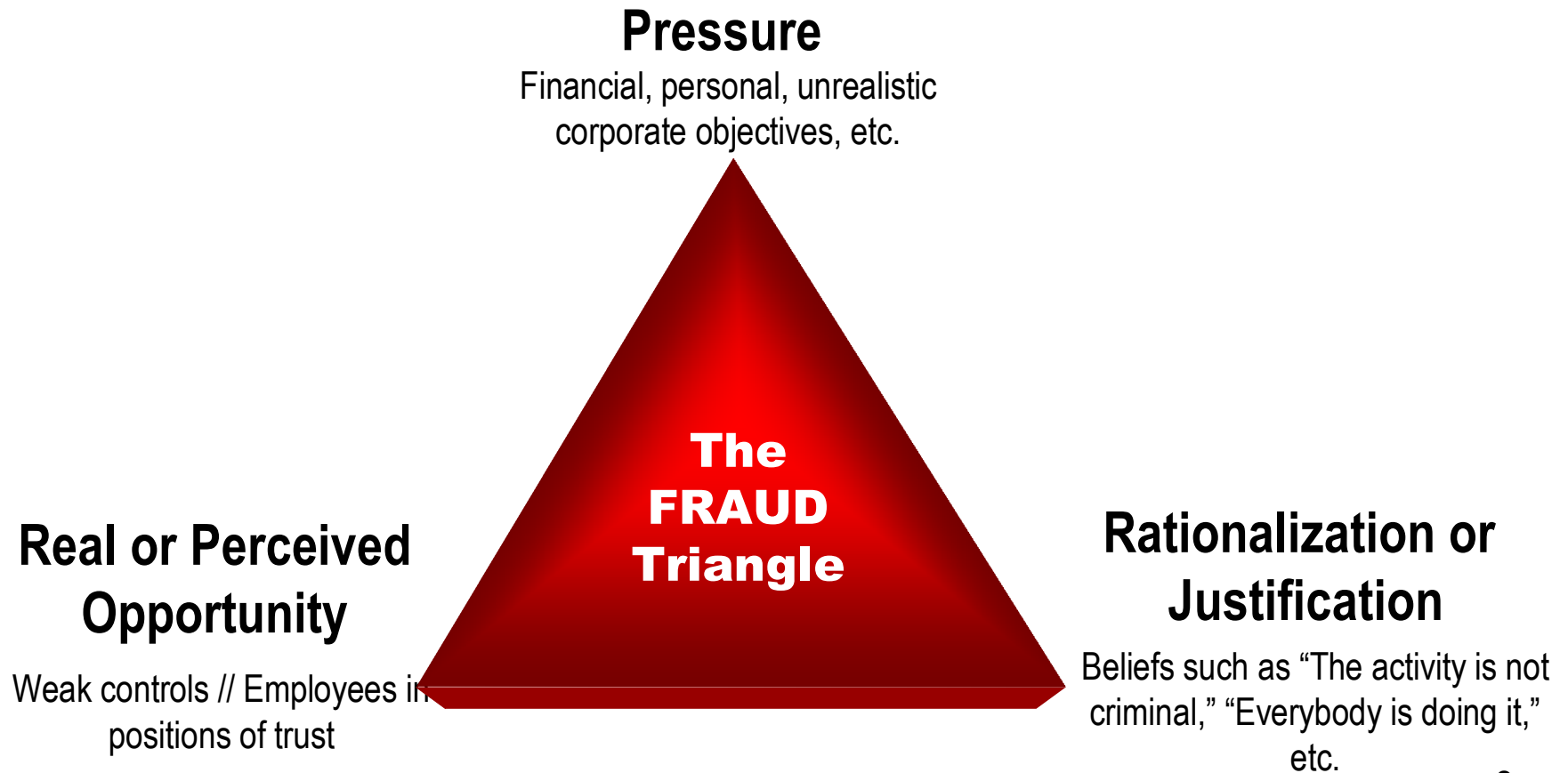


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## Assessing the True Risk of Fraud: Breaking through common Myths and Misconceptions

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So how do we develop an effective anti-fraud program that mitigates the risk of fraud in our organizations? We begin with a clear understanding of why fraud occurs...



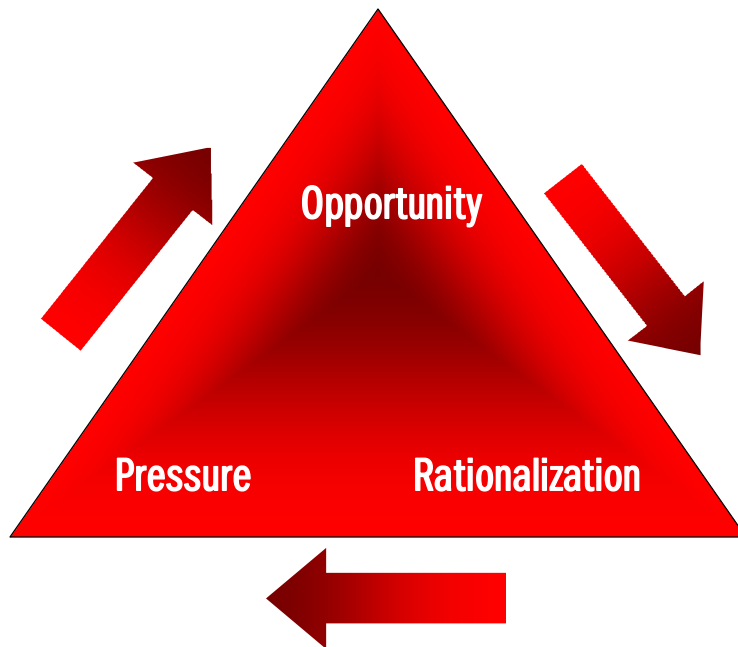
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## Assessing the True Risk of Fraud: Breaking through common Myths and Misconceptions

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### What can management do?

**\* *Be Proactive about Fraud Risk Management***



### Reduce Probability:

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- **Reduce opportunities** - real and perceived
- Provide **clear and unambiguous guidelines & policies** - Eliminate excuses
- **Monitor pressure drivers**
- Be consistent in responding to allegations of fraud

### Reduce Impact:

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- **Monitor Fraud Drivers / Indicators**
- **Respond quickly and thoroughly** to allegations of fraud
- **Learn from past experiences**
- **Swift and severe disciplinary action** once a fraud is conformed

# 1

## Assessing the True Risk of Fraud: Breaking through common Myths and Misconceptions

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How can management and the internal auditor affect the elements of the triangle?

By...

- **Setting the proper Tone at the Top and throughout the Organization**
- **Being Proactive about Fraud Risk Management**
- **Knowing When and how to Respond to Allegations**



2

## Setting the Proper “Tone at the Top” and throughout the Organization

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If effective fraud risk management begins at the top, what should be there?

### (1) A Strong Overall Control Environment

(2)

A strong and well defined  
**CODE of Ethics**

(3)

Specific  
**Anti-fraud Program Policies**

(4)

**Communication And Training Program**

# 3

## Understanding the Limitations of Internal Control

### *Limitations of Internal Control*

- Collusion
- Management override
- Inconsistency in application
- Cost / Benefit
- Falsified Documents / Signatures
- Errors / Negligence

#### How are frauds detected?

Method of Detection	All Frauds	Frauds over \$1million USD
Internal or external informants	34%	44%
Accidental detections	25%	24%
Internal audit	20%	17%
Internal controls	19%	12%
External audit	12%	15%
Other formal mechanisms	4%	8%

*Source: ACFE 2006 "Report to the Nation" – total exceeds 100% given incidents where frauds were detected by more than one mechanism.*

# 4

## Being Proactive about Fraud Risk Management

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To minimize the risk of fraud, the company must **go beyond internal controls**.

There must exist an integral and **pro-active anti-fraud program** in place which incorporates high level fraud policies, anti-fraud process controls and specific targeted fraud detection strategies.

Management and Board support for any such Program is essential.

### Benefits of an Anti-Fraud Program

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- **Provides tangible evidence of a culture of integrity**
- **Helps to prevent fraud and facilitates early detection**
- **Safeguards the assets and reputation of the company**
- **Limits unpleasant surprises that can distract management**
- **Addresses concerns of external auditor and board of directors**
- **Limits potential for class action lawsuits**

# 4

## Being Proactive about Fraud Risk Management

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### What should an effective anti-fraud program include?

- A comprehensive **Assessment of Fraud Risk** to focus anti-fraud efforts going forward
- **Company Level Anti-fraud controls** (“tone at the top” policies and controls)
- **Process and transaction level Anti-fraud Controls**
- Specific **pro-active Fraud Detection Procedures**
- **Monitoring** of anti-fraud controls and fraud detection efforts
- A comprehensive and consistent **Fraud Response Program**

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❖ *An Anti-Fraud program demonstrates that management is setting the proper “tone at the top”*

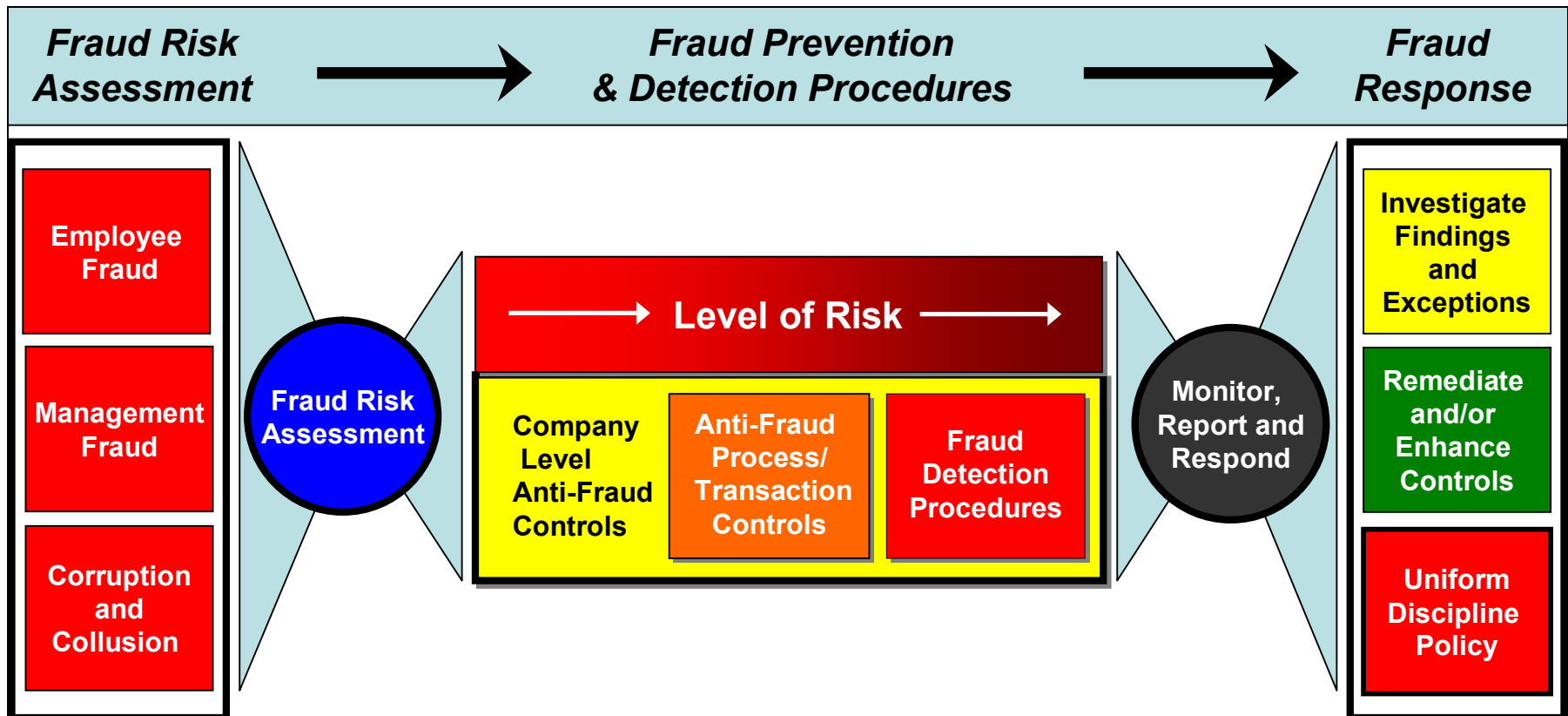
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❖ *An Anti-Fraud program will not provide absolute assurance against fraud, but it can help to mitigate the effects of fraud*

# 4

## Being Proactive about Fraud Risk Management

### Elements of a Fraud Risk Management Program



# 4

## Being Proactive about Fraud Risk Management

### Fraud Risk Assessment:



Fraud risk assessment implies identifying fraud schemes that the company may be exposed to, their probability of occurrence, location and possible impact. This enables the company to focus its efforts on the prevention and detection of such risks.

**Fraud schemes** the Company generally faces or is susceptible to:

Based on:

- Experience
- Industry
- Operational Structure



Develop specific **fraud hypotheses** detailing fraud risks further

- Who
- What
- Where
- Concealment techniques
- Potential trail



**Risk Evaluation** based on **probability** factors

- Pressure
- Opportunity
- History



**Risk Evaluation** based on **possible impact** factors

- Type of Fraud (Managerial, Employee, Collusion)
- Economic cost
- Reputational cost
- Legal / Reg. implications

# 4

## Being Proactive about Fraud Risk Management

### Fraud Risk Assessment

### Fraud Classifications (ACFE):



*The majority of frauds can be classified in one of these three categories.*

*It is important to define the type of fraud faced by the company in order to be able to evaluate the risk, its possible impact and mitigate its probability of occurrence.*



- 60% of frauds are committed by employee of low hierarchy level and they represent 5% of losses.



- 30% of frauds are committed by managers, representing 20% of losses.



- 10% of frauds are committed by high level employees and they represent 75% of losses.

Source: Association of Certified Fraud Examiners (ACFE)

# 4

## Being Proactive about Fraud Risk Management

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### Company Level Anti-Fraud Controls

The anti-fraud controls at an entity level are those that help mitigate the risk at the company level. These are not related to a process or a specific unit; they do, however, affect the risk of fraud at an institutional level.

❖ **An efficient fraud prevention program requires certain key controls and systems at a global level:**

- Code of Ethics and related policies, Conflicts of Interest and Fraud (Development, Application, and Monitoring)
- Sponsorship, accountability and supervision of anti-fraud programs
- Communication and education around anti-fraud policies and procedures
- Confidential reporting mechanisms / Whistle-blower protection program
- Other systems of fraud detection
- A system of formal investigation of possible frauds
- Consequences and disciplinary actions

# 4

## Being Proactive about Fraud Risk Management

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### Anti-Fraud Process Controls

An efficient fraud prevention system not only requires anti-fraud controls at an entity level but also requires anti-fraud controls at an operational level. These controls may be preventive or detective, but their design is primarily focused in protecting the company's assets.

Key operational controls in terms of fraud prevention and detection will vary among companies and industries, but they tend to impact certain fundamental areas of the business including:

<u>Human Resources</u>	<u>Treasury and Accounting</u>	<u>Purchasing and Procurement</u>	<u>Information Technologies</u>
<ul style="list-style-type: none"><li>• Candidate background investigations</li><li>• Mandatory vacation</li><li>• Exit interviews</li></ul>	<ul style="list-style-type: none"><li>• Segregation of duties</li><li>• Authorization limits</li><li>• Reconciliations</li><li>• Control over manual journal entries</li></ul>	<ul style="list-style-type: none"><li>• Bids / Quotations</li><li>• Authorizations</li><li>• Budget control</li><li>• Job rotations</li></ul>	<ul style="list-style-type: none"><li>• Physical access</li><li>• Logical access (internal and external)</li><li>• Control of changes</li><li>• Logs and reports</li></ul>

# 4

## Being Proactive about Fraud Risk Management

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### Fraud Detection Procedures

An efficient fraud prevention system requires not only the anti-fraud controls at an entity level and operational level, but also requires systems and procedures established and operated to detect possible fraud.

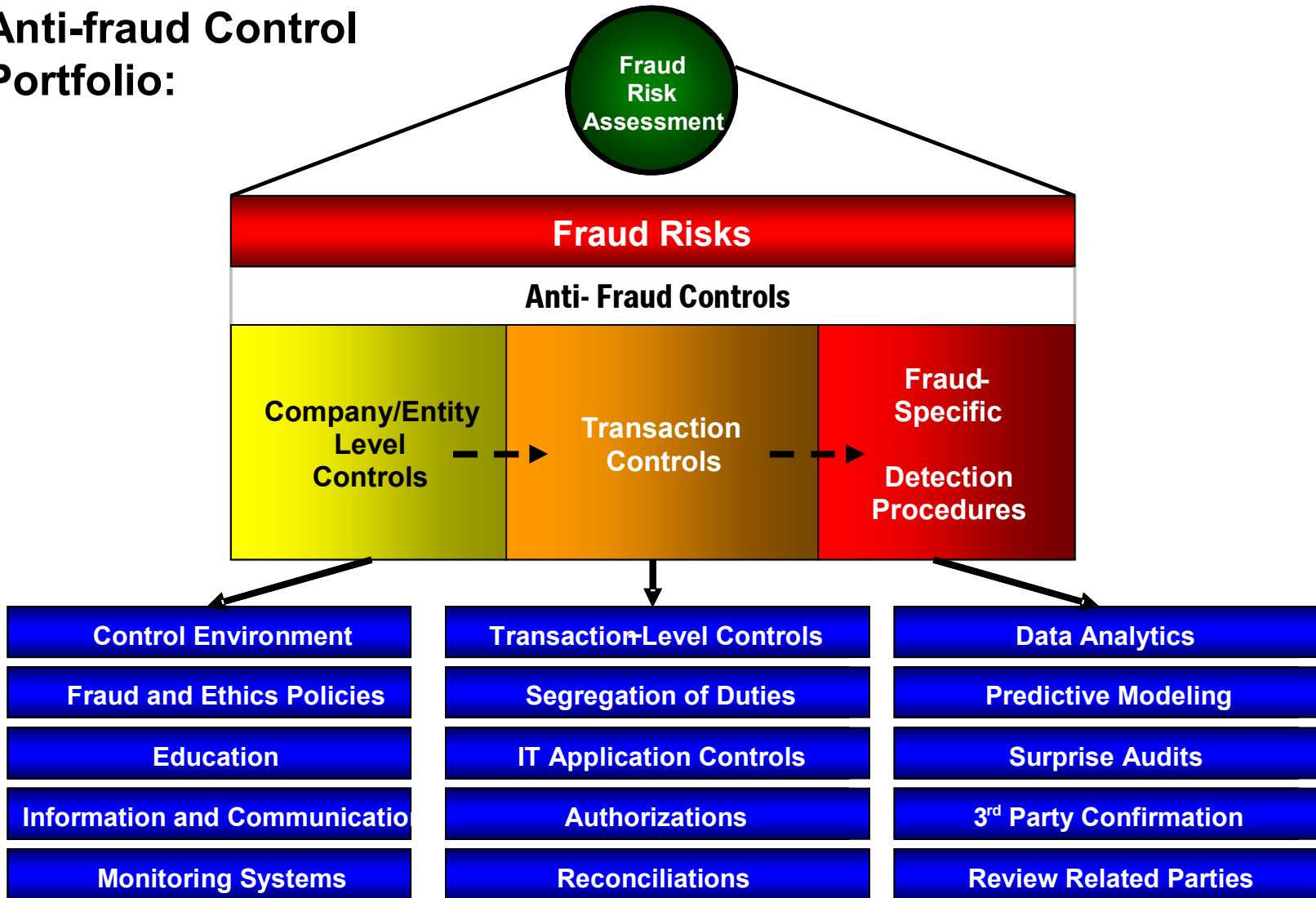
These processes go beyond internal controls and focus primarily in identifying fraud as early as possible to mitigate its effect on the company. These can include, but are not limited to the following:

- **Hot Line Calls**
  - **Data Analysis**
  - **Communications Monitoring**
  - **Access Monitoring**
  - **Confirmations**
- Confidential reporting mechanisms (application and monitoring)
  - Developing, monitoring and analysis of fraud indicators
  - Developing and monitoring of exception reports
  - Monitoring access changes and system changes
  - Audits, inventories and surprise counts
  - Spot confirmations
  - Interviews / questionnaires with employees, clients, suppliers
  - Monitoring of internal communications

# 4

## Being Proactive about Fraud Risk Management

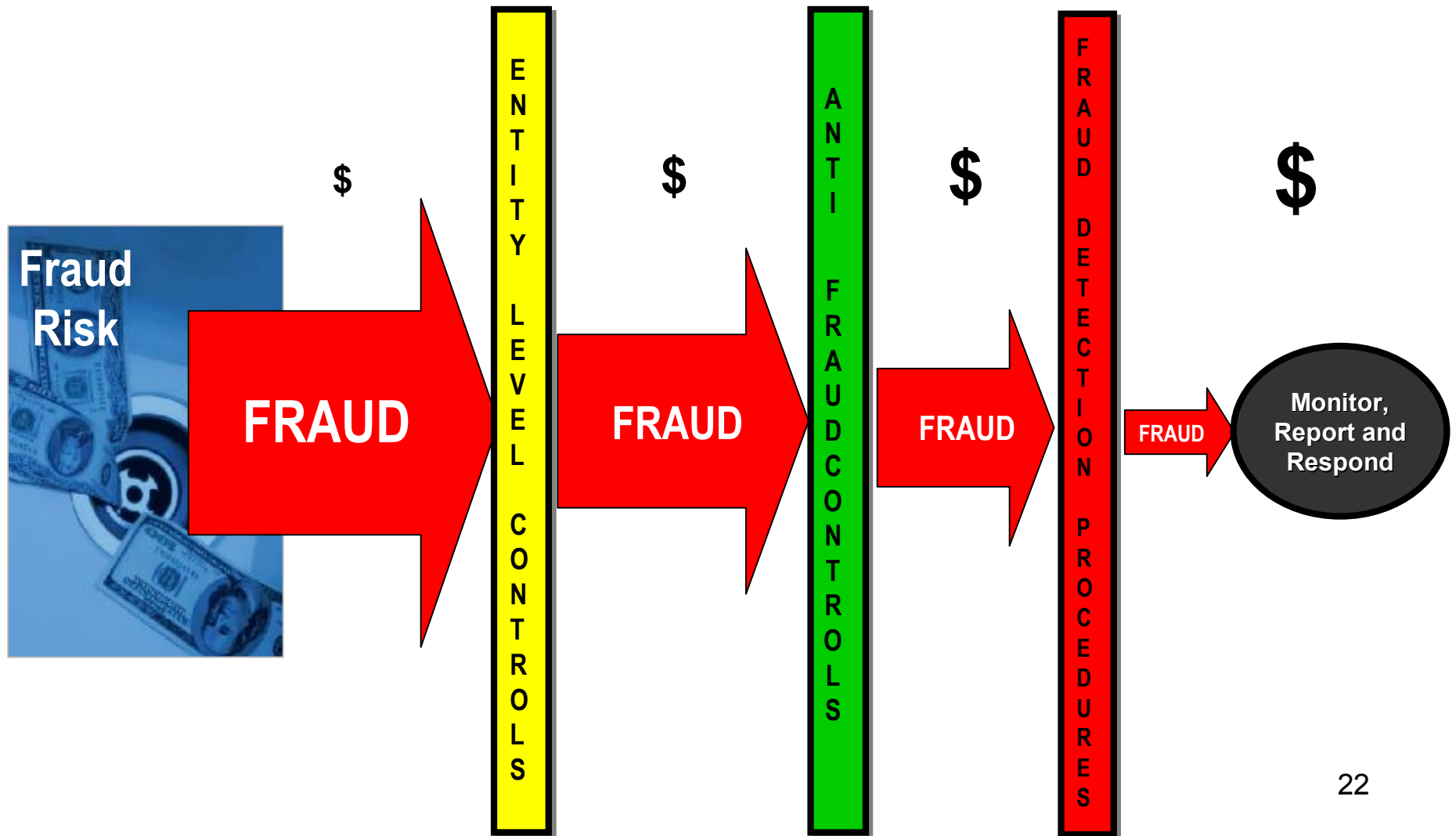
### Anti-fraud Control Portfolio:



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# Being Proactive about Fraud Risk Management

An Ounce of Prevention...



# 4

## Being Proactive about Fraud Risk Management

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Monitor,  
Report  
and  
Respond

To make the controls and systems previously mentioned effective, they have to be monitored, analyzed and the results reported. They also have to be determined, approved, and carried out to (a) resolve a possible control failure, or (b) investigate a possible fraud.

In any case, to be effective, any action taken has to meet the following characteristics:

- It has to be prompt
- Responses have to be consistent
- Investigations have to be sufficiently broad/deep
- Disciplinary action must be severe if a fraud is confirmed

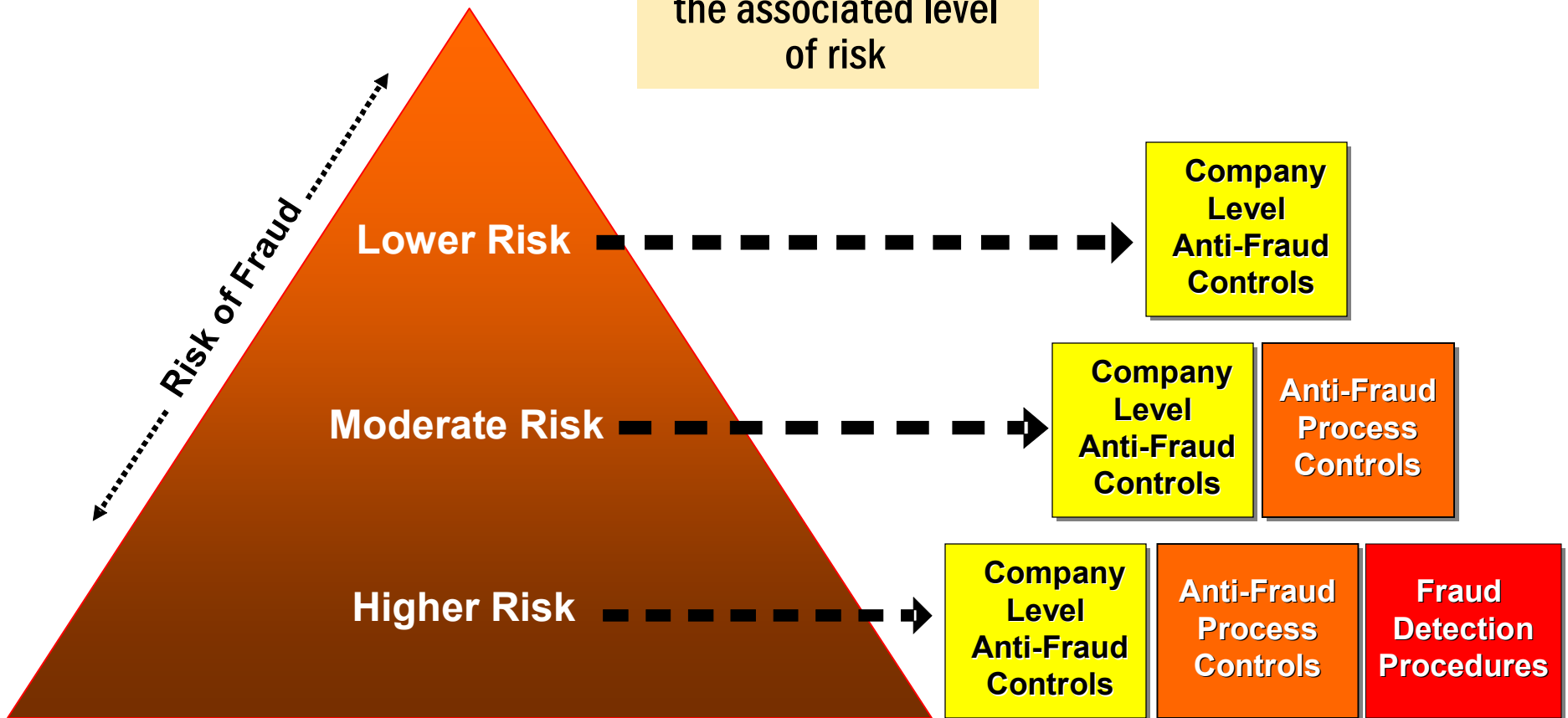
***If this element of the fraud prevention program fails, the whole system may be compromised.***

# 4

## Being Proactive about Fraud Risk Management

### Risk-Based Monitoring:

Identify the appropriate controls to monitor based on the associated level of risk



# 5

## Knowing When and How to Respond to Allegations of Fraud

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### Fraud Response Plan – Key Elements:

- **Purpose**
  - Escalate concerns appropriately
  - Assign responsibility for investigating fraud
  - Develop and initiate disciplinary actions
  - Maintain mechanism to record reported fraud
- **Detection and Action Taken**
  - Action plan upon the detection of suspected fraud
- **Prevention of Further Loss**
  - Validate that discipline is applied consistently
  - Ensure assets or information within the organization are not destroyed
- **Establish & Secure Information**
  - Establish procedures to secure information and assets during an investigation
  - Determine applicability of laws and regulations to evidence
- **Recovery of Losses**
  - Legal advice should be obtained on options to recover losses
- **Reporting Suspected Fraud**
  - Written report clearly indicating the findings and recommendation upon completion of all investigations
- **Review of Plan**
  - Review the plan at least annually

# 5

## Knowing When and How to Respond to Allegations of Fraud

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### Elements of an effective investigation:

- ❖ Clear definition of who will take a leadership role
- ❖ Definition of the investigative team, including legal, HR, data analysis and computer forensics resources, etc.
- ❖ Consistent investigation methodology
- ❖ Protocols for the establishment of hypothetical fraud and verification procedures
- ❖ Clear objectives, priorities and clear scope definitions
- ❖ Communication protocols
- ❖ Clear procedures to obtain and protect evidence
- ❖ Clear criteria and objectives to conclude an investigation

### Elements of an ineffective investigation:

In fraud cases there is a real risk in terms of a cycle of emotional reactions which appear from the moment there is suspicion of fraud:

- Denial
- Anger/Resentment
- Negotiation/Rationalization
- Acceptance

The inability to control those emotions during the investigation may cause inappropriate or inconsistent reaction from the company and in many cases can even plant the seed for future embezzlements.

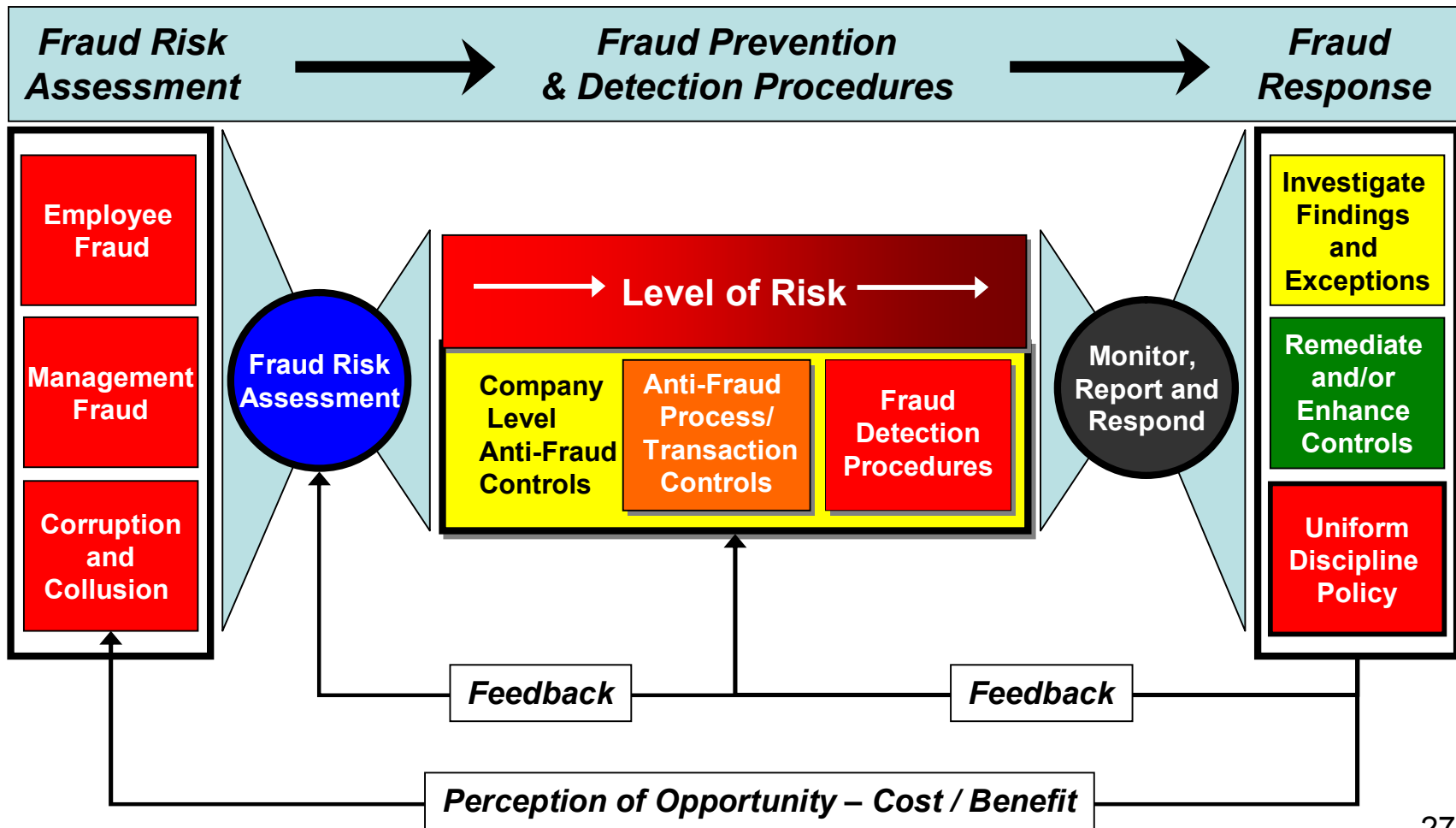
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***An inadequately managed investigation may have a negative impact on the company's fraud prevention system as a whole and its ongoing effectiveness.***

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# Knowing When and How to Respond to Allegations of Fraud

## Fraud Response Plan – Feedback:



# What Role(s) can Internal Audit Play?

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1) *Execution of a Fraud Risk Assessment*

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2) *Periodic evaluation of entity level controls*  
3) *Entity level controls - implementation support*

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4) *Increase audit coverage of areas of high fraud risk – processes and/or locations*  
5) *Increase focus and frequency of monitoring over anti-fraud controls*

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6) *Development and Application of fraud detection procedures and systems*

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7) *Monitoring the results of fraud detection procedures and systems*  
8) *Follow up / Investigation of alleged frauds*

## Final Message: An ounce of prevention...

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**Prevention**  
constitutes 80% of  
the solution in the  
fight against fraud;  
it is more effective  
than most  
investigations and it  
is much less costly.



**Prevention**



**Detection**



**Investigation**