

Detecting and Preventing Fraud

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What We Are Going to Cover

- Forensic Accounting vs. Auditing
- Types of Fraud
 - Examples and How to Approach
- Risk Mitigation Factors to Consider

Forensic Accounting

The Forensic approach involves:

- Identifying Issues
- Investigating Facts
- Analyzing Data
- Communicating
- Presenting Findings



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Comparison

Auditing

Opinion on Management's
financial statements

Professional
skepticism

Concept of **materiality**

Forensic Accounting

Investigate **specific**
issues

Environment
of suspicion

No materiality



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Comparison

Auditing

Work from **summarized** data

Financial Statement focus

GAAP/GAAS

Forensic Accounting

Review **large quantity** of data

Tell a story, uncover facts

An intuitive process is applied



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Comparison

Auditing

Verification of the Past

Focus on financial statements
taken as a whole

Active basis (annual/relationship)

Forensic Accounting

Recreate historical
transaction/activities

Focus on events
and transactions

Reactive



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Why Do Auditors Fail to Detect Fraud?



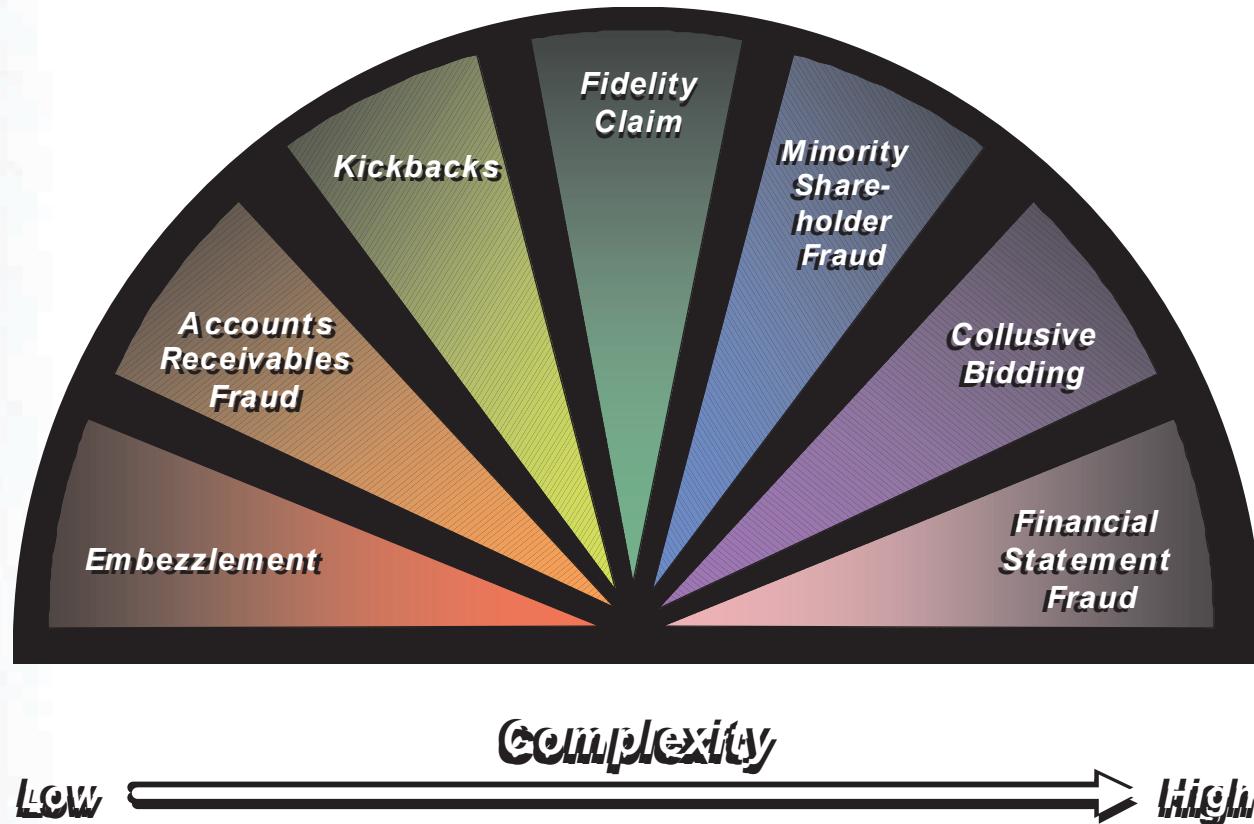
- Ignore Danger Signals/Red Flags
- Not Aware of Human Element
- Lack Knowledge of Client's Business
- Have not yet developed fraud awareness mind-set



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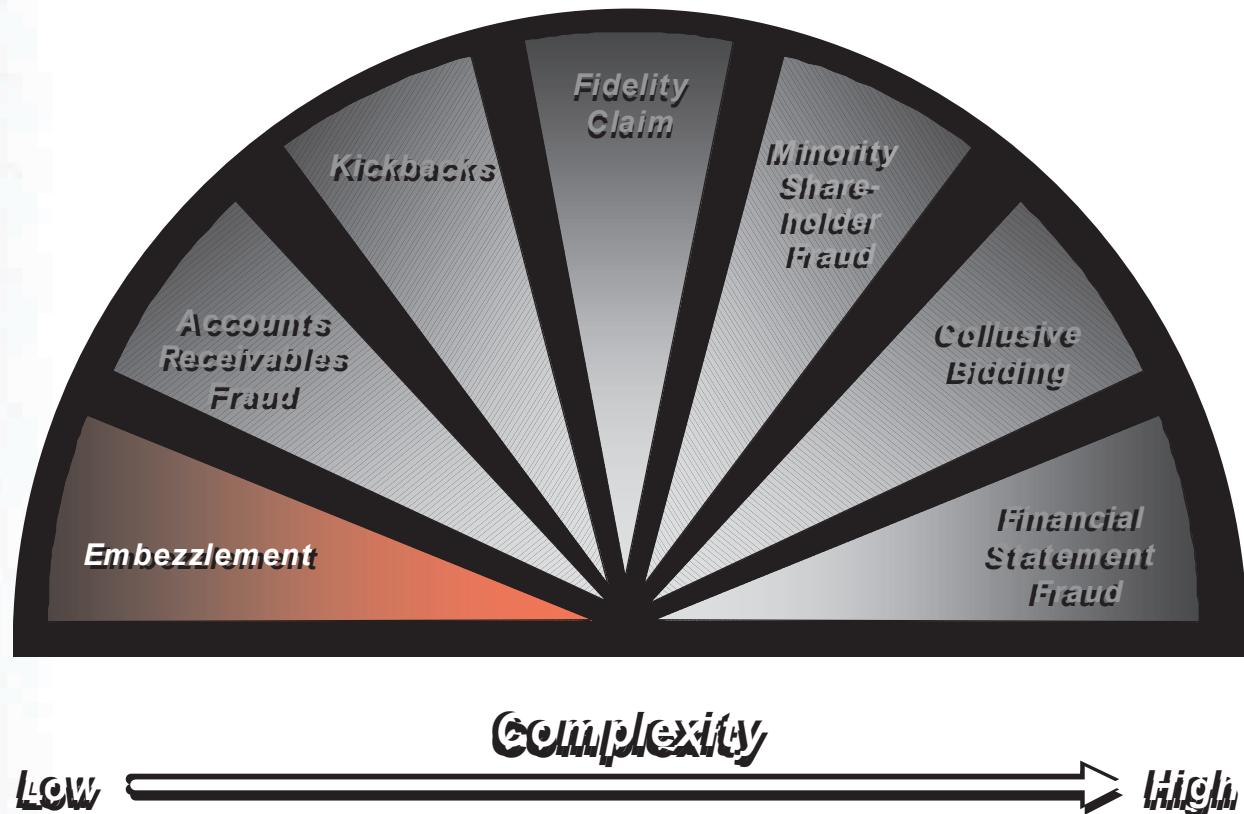
Types of Fraud



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Embezzlement



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Embezzlement – Types



- Theft of cash/assets
- Unauthorized use of property
- Dead horse on payroll
- Fictitious vendors
- Checks to self
- Expense report fraud



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Embezzlement – How to Approach It

- Lifestyle reviews
- Variance analysis
- Periodic Audits
- Logging control exceptions
- Superior's intuition



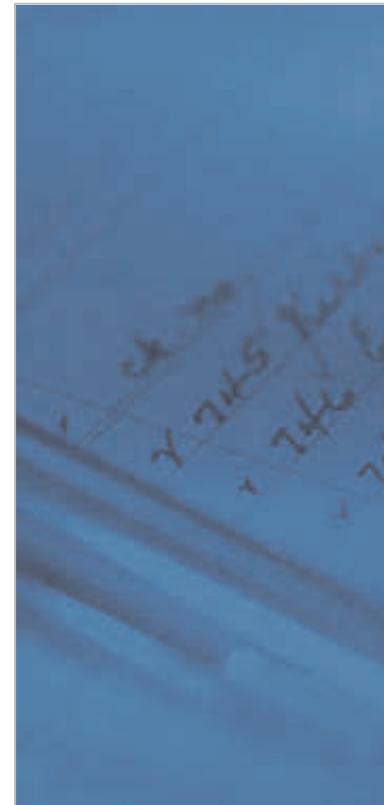
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Embezzlement – How to Approach It

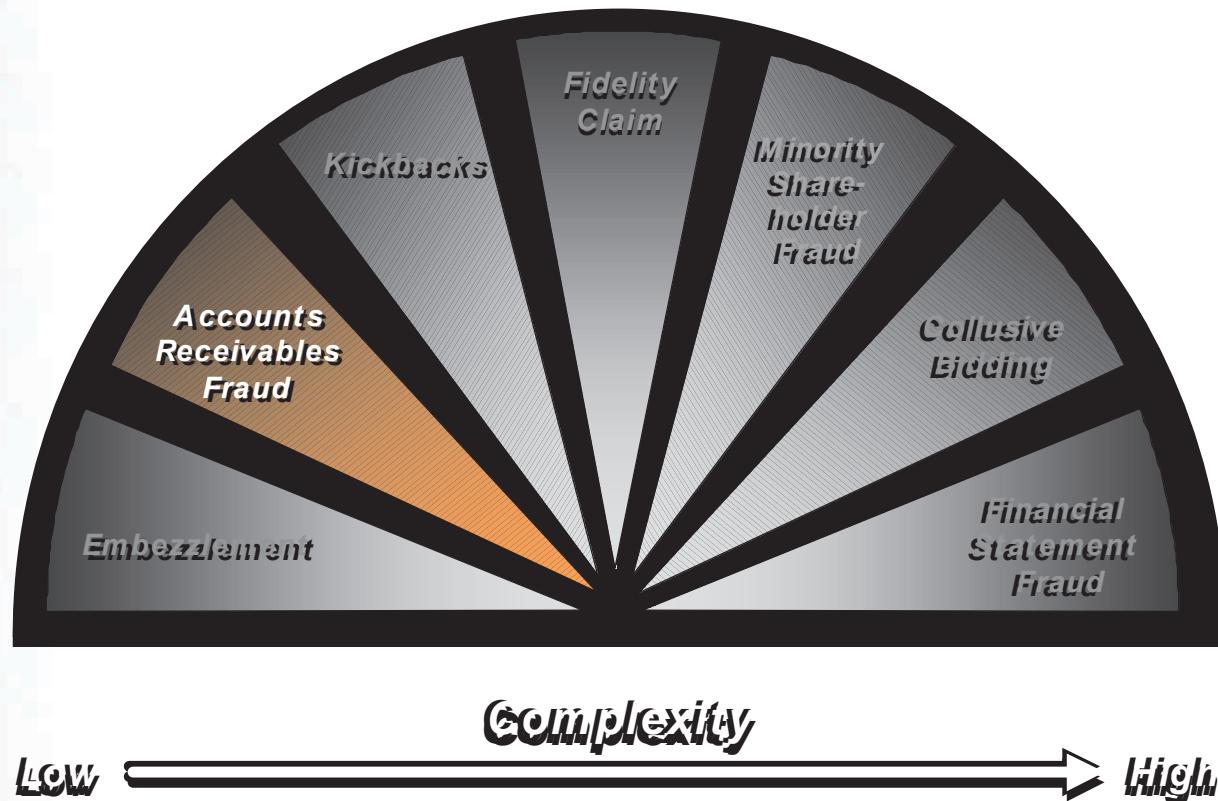
- Detailed database compiling
- Information front/back
- Nature
- Invoice
- Allowable
- Course of conduct
- Polygraph



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A/R Fraud



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A/R Fraud – Types



- Writing off receivables as un-collectible in exchange for a kickback
- Lapping
- Under billing for merchandise and splitting the difference
- Front-end fraud (not recording sales or misdirecting sales)



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A/R Fraud – How to approach it

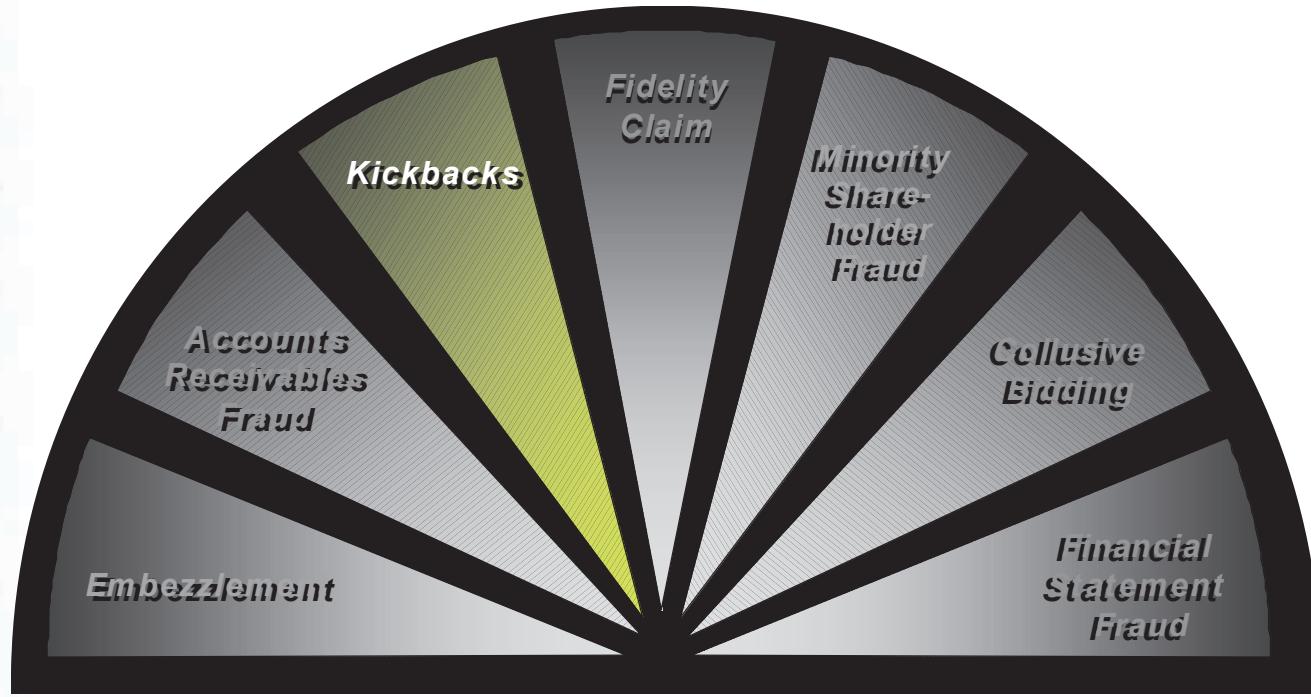
- Investigate customer credit memos
- Confirmations
- Interview A/R clerks about special arrangements between sales personnel and customers
- Investigate inventory variances (under-billing for goods or unrecorded sales)



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Kickbacks



Complexity

Low → High



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Kickbacks – Types



- Under billing for goods
- Writing off receivables and services
- False appraisals in loan transactions
- Increased quantities delivered v. invoices



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Kickbacks – How to Approach It

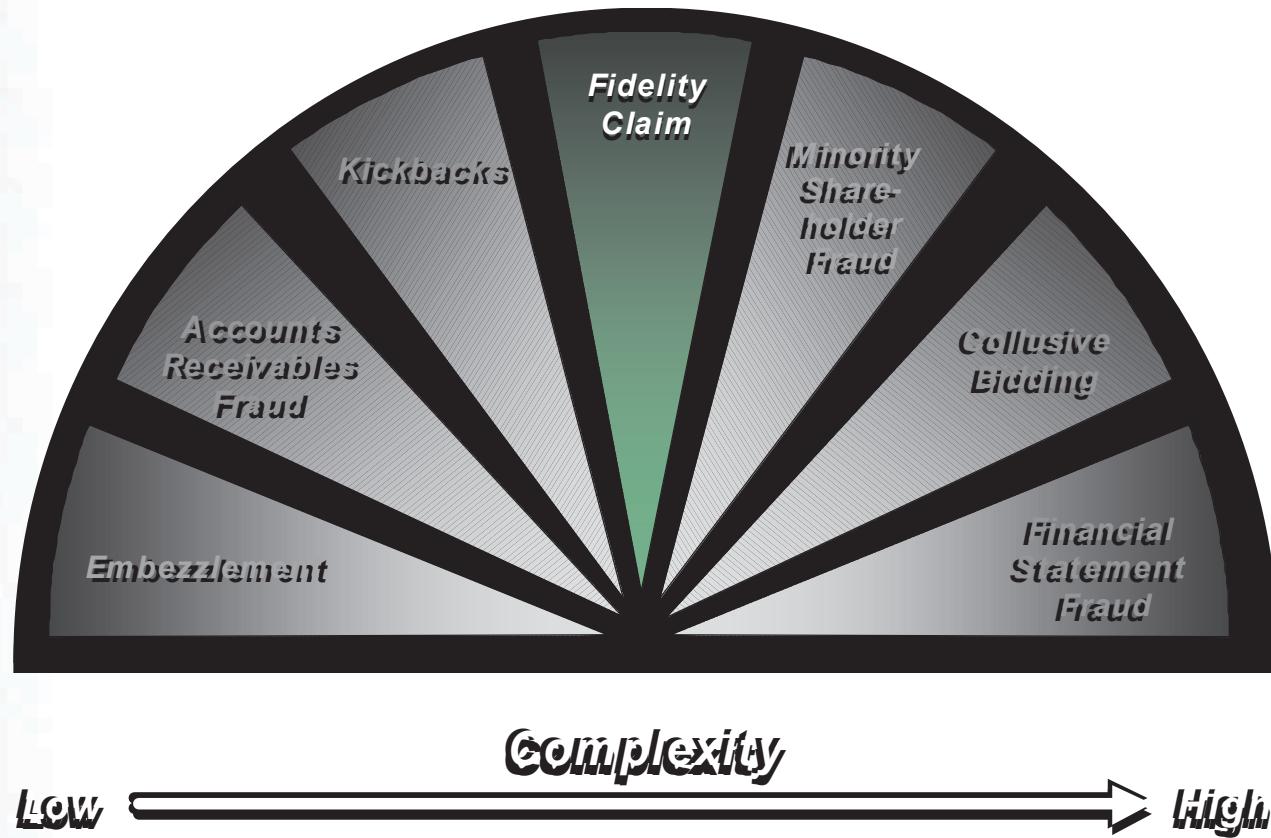
- Background checks/
lifestyle credit check
- Statistical Sampling
- Computer Analysis
- Follow-up Customer
Disputes
- Bid Process Analysis



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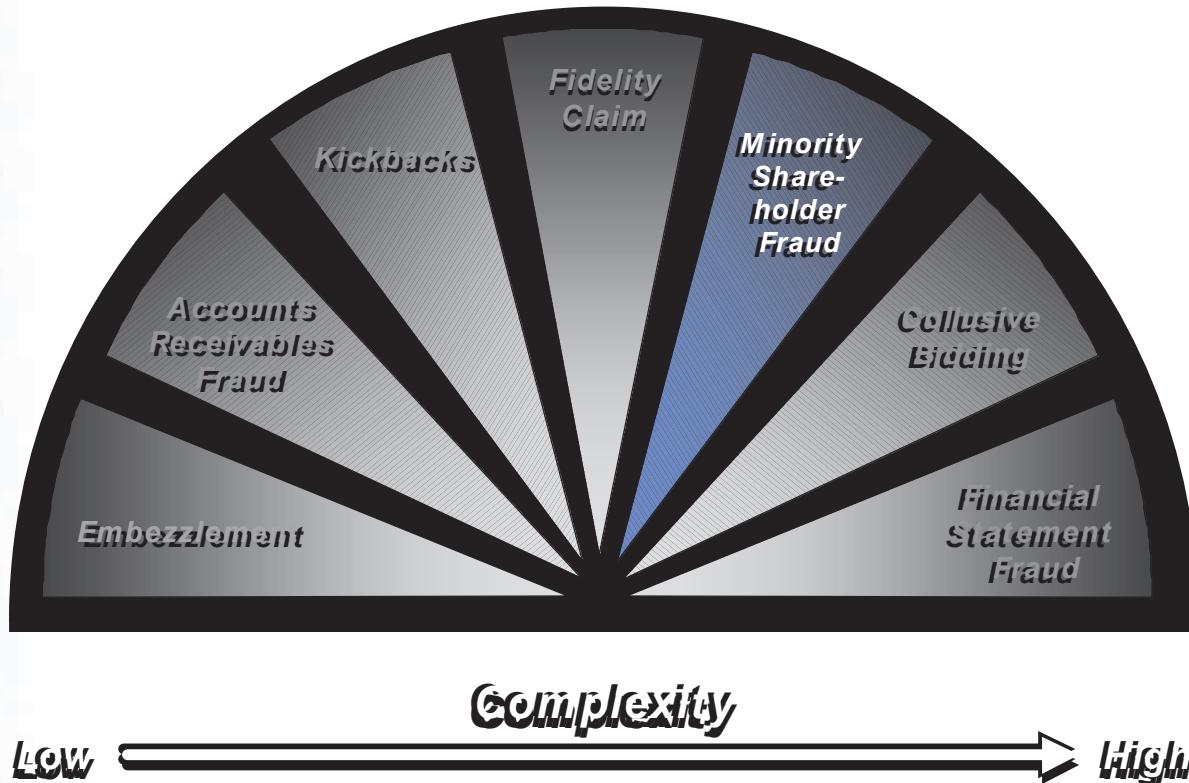
Fidelity Claim



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Minority Shareholder Fraud



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Minority Shareholder Fraud



- Controlling shareholder enters into related party transactions harming minority shareholders



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Cashco Case Study – The Facts

Mr. Big's accountant bases his valuation on an average of Cashco's historic pre-tax cash flow

Summary of Valuation below

	Year 1	Year 2	Year 3	Year 4	Average
Pre-tax Cash Flow Based on Reported Results	\$144,000.00	\$172,000.00	\$118,000.00	\$123,000.00	\$139,250.00
Discount Rate					25%
Multiple					4
					<hr/>
Value of Cashco (100%)					\$557,000.00
					<hr/>
Value of Mr. Junior's Interest (20%)					\$ 111,400.00

Cashco Case Study – Findings

	Year 1	Year 2	Year 3	Year 4
Excess rent paid for warehouse space owned by Mr. Big	\$25,000.00	\$25,000.00	\$25,000.00	\$25,000.00
Mr. Big personal expenses paid by Cashco	\$18,000.00	\$26,000.00	\$14,000.00	\$22,000.00
Salary paid to Mr. Big's son who is in college	\$15,000.00	\$15,000.00	\$15,000.00	\$15,000.00
Excess salary paid to daughter, salesperson	\$10,000.00	\$8,000.00	\$12,000.00	\$18,000.00
Expenses relating to the purchase of a new company to be owned 100% by Mr. Big				\$42,000.00
Gross Profit diverted to a company owned 100% by Mr. Big			\$50,000.00	\$50,000.00
	\$68,000.00	\$74,000.00	\$114,000.00	\$172,000.00

Cashco Case Study –

Impact of Findings on Valuation

	Year 1	Year 2	Year 3	Year 4	Average
Pre-Tax Cash Flow Based on Reported Results	\$144,000.00	\$172,000.00	\$118,000.00	\$123,000.00	
Total Excesses Identified in the Valuation Investigation	\$68,000.00	\$74,000.00	\$116,000.00	\$172,000.00	
Restated Pre-Tax cash Flow	\$212,000.00	\$246,000.00	\$234,000.00	\$295,000.00	\$246,750.00
Discount Rate					25%
Multiple					4
Value of Cashco (100%)					\$987,000.00
Value of Mr. Junior's Interest (20%)					\$197,400.00

Cashco Case Study – Summary

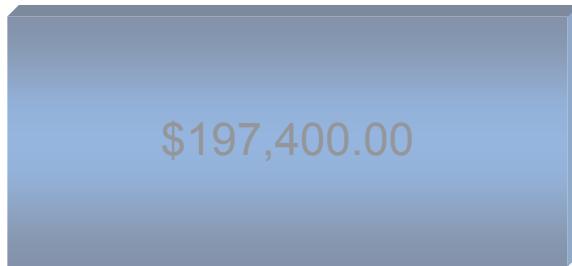
Per Initial
Valuation

Value of Mr.
Juniors
20%
Interest



Per Valuation After
Investigation

\$197,400.00



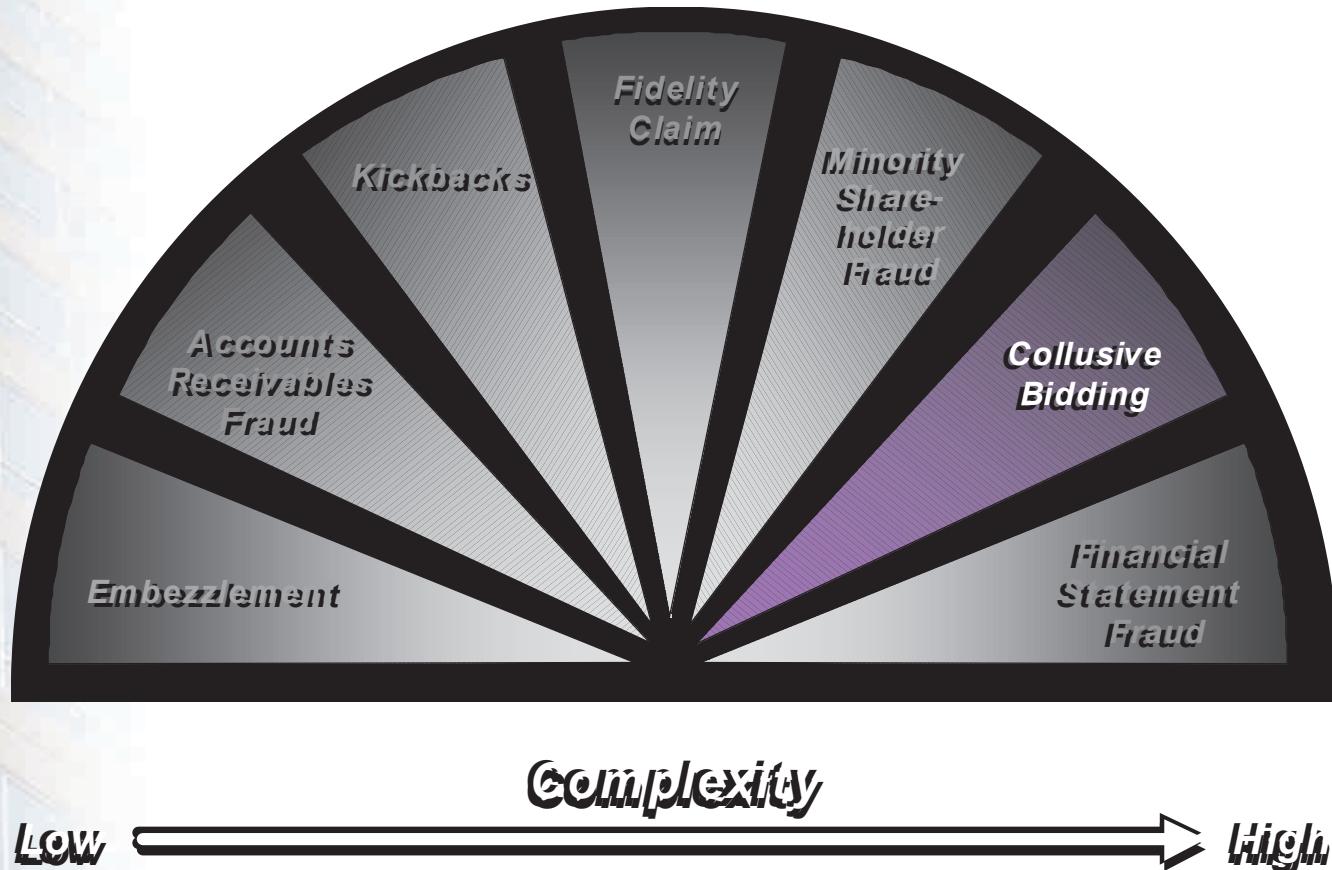
What about 20% of the past excesses?



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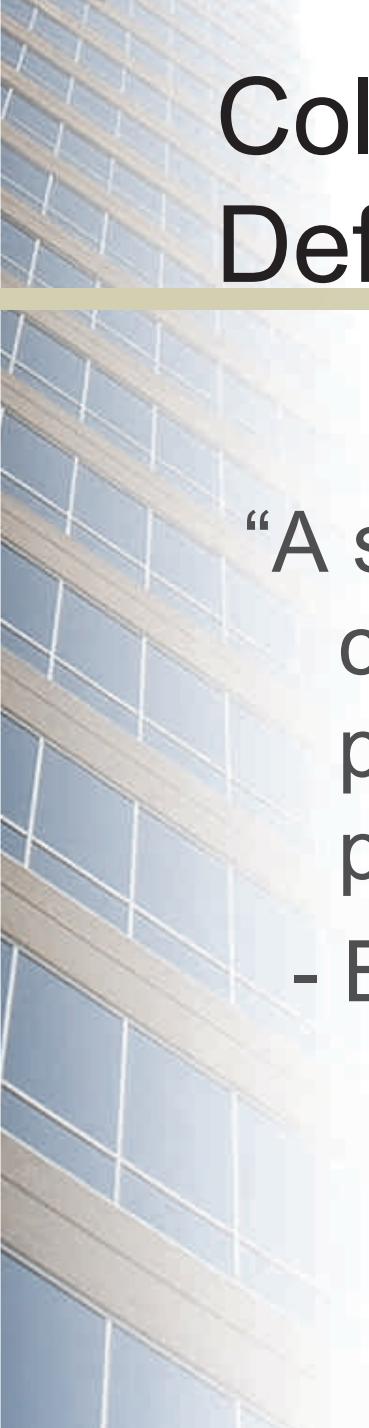
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Collusive Bidding



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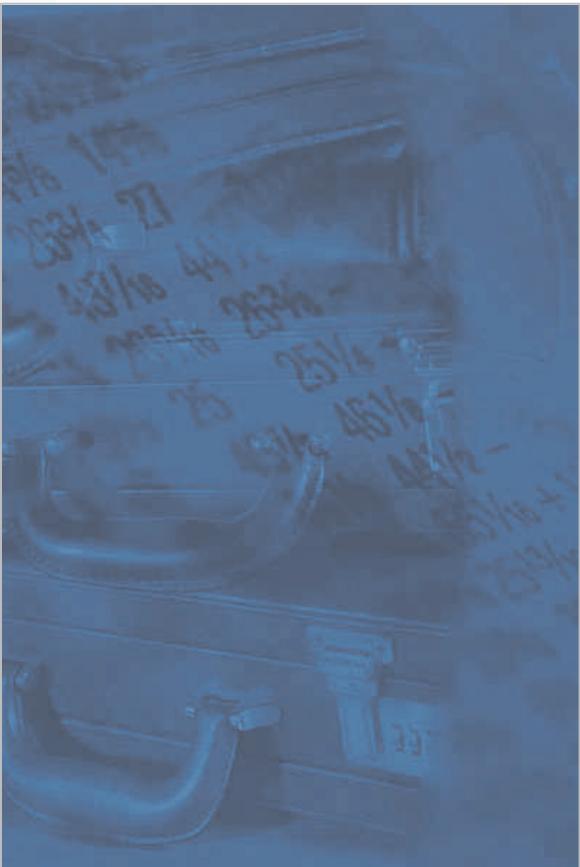


Collusion – Definition

“A secret combination, conspiracy, or concert of action between two or more persons for fraudulent or deceitful purpose.”

- Black’s Law Dictionary

Bidding Fraud – Common Frauds



- Specs Unrelated to requirements
- Restricted competition
- Repeated awards
- Rushed timing
- Change orders



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Bidding Fraud – Example



- No public notices
- Numerous small \$ P.O.'s
- Invoice prices > Bid prices
- Bids repeatedly sent to “Non-responders”



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Bidding Fraud – How to Approach It?

How do you find
it and what is the
impact?



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Bidding Fraud – Approach



Computer analysis of:

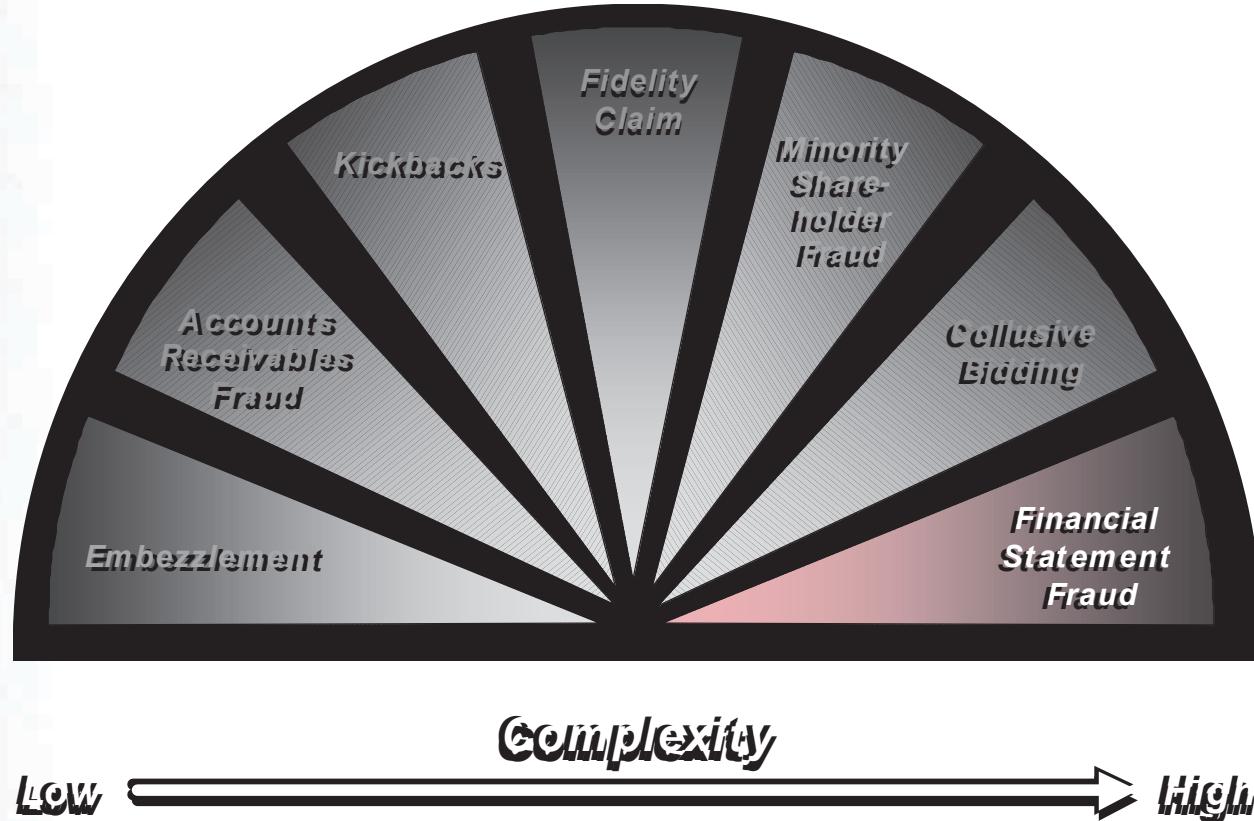
- Timing of bids
- Award patterns
- P.O. boxes
- Amount of work
- Pricing



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Financial Statement Fraud



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Managing Earnings – 10 Ways to Manage

Inventories

Revenue Recognition

Rising Receivables

Capital Spending

Extraordinary Expenses

Pension Shenanigans

Asset Sales

Foreign Currency

Research & Development

Acquisitions



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Financial Statement Fraud – Recent Examples

1. Enron Corporation
2. WorldCom Corporation
3. Adelphia
4. AOL/Time Warner



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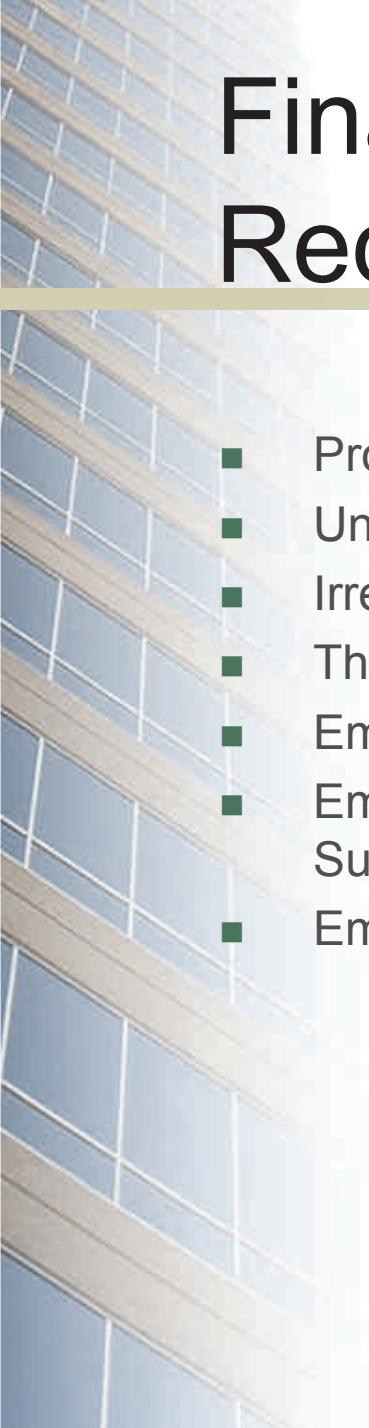
Financial Statement Fraud – Mitigate your risk

- Proper supervision and review
 - Common to find fraud indicators in auditor working papers
 - Staff for engagement/audit risk
- Recognize the warning signs –
(lack of data, push-back, flippant responses, etc.)
- Independence
 - How close is too close?
- Sufficient relevant evidence
 - Match the evidence to the assertions tested



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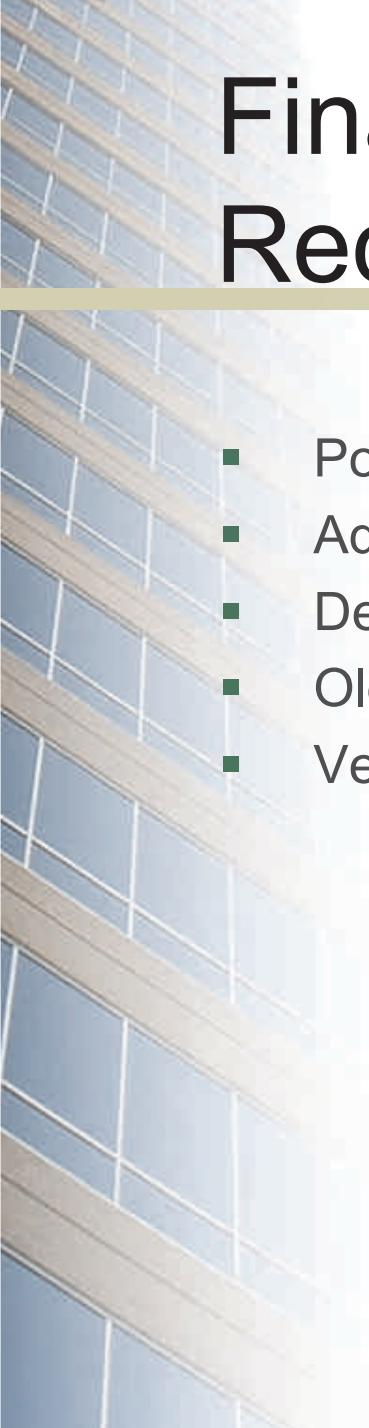
Financial Statement Fraud – Red Flags

- Problems getting information
- Unauthorized corporate transactions
- Irregular and poorly explained management activities
- Thin File Syndrome
- Employee Dissatisfied with Job
- Employee has Unusually Close Association with Suppliers/Creditors
- Employee has Addiction Problem or is Extremely Eccentric



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Financial Statement Fraud – Red Flags

- Poor Collection of Aged Receivables
- Adjusting Entries Lack Authorized Approval
- Deposits in Transit Delayed or Increasing
- Old Items Outstanding on Bank Reconciliation
- Vendor's Address Same as Employee's Address



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Thank You

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Questions and Answers



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