Occupational Fraud:

Detection & Prevention

Certified Public Accountants & Business Consultants

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STRENGTH IN NUMBERS

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Introduction

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- Licensed by the AICPA and the Association of Certified Fraud Examiners
- 70,000 ACFE members worldwide

What is occupational fraud?

- Defined by the ACFE as “the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.” *2014 ACFE Report to the Nations* , page 6.

Where & why does fraud occur?

- Highlights from RTN (1,483 cases studied)
  - All types & sizes of organizations
  - Small organizations suffer disproportionately
  - Median losses suffered by organizations with fewer than 100 employees was $154,000 per scheme.
  - Most common frauds in small organizations involve employees engaged in billing schemes, skimming revenue, and tampering with checks.
  - Anonymous reporting (tip hotlines) account for the detection of 51% of occupational frauds (audit 1.3%).

Where & why does fraud occur?

- Typical organization loses 5% of annual revenue to fraud
- Frauds lasted a median length of 18 months before detection
- Asset misappropriation schemes were 85% of frauds with a median loss of $130,000
- Financial statement frauds were 9% of frauds with a median loss of $1,000,000
- Anti-fraud internal controls appear to help reduce the cost and duration of frauds

Where & why does fraud occur?

- High-level perpetrators cause the greatest damage to their organizations
- More that 70% of frauds committed by employees in accounting, operations, sales, upper mgt., customer service or purchasing
- More that 86% of perpetrators had no previous charges or convictions for fraud related offenses
- Perpetrators often display warning signs – living beyond means (44% of cases); experiencing financial difficulty (33% of cases)

Findings Specific to Small Businesses (fewer than 100 employees)

- In 427 (28.8%) of cases reported in the study the victim was a small business
- Median loss of SB victims was $154,000
- Types of Fraud committed against SB organizations:
  - Corruption – 33.0%
  - Billing – 28.7%
  - Check tampering – 22.1%
  - Skimming – 17.0%
  - Expense reimbursement – 16.5%

Findings Specific to Small Business

- Types of Fraud committed against SB organizations:
  - Non-cash – 18.1%
  - Cash Larceny – 14.4%
  - Cash on hand – 12.0%
  - Payroll – 16.5%
  - Cash on hand – 13%
  - Financial statement fraud – 12.2%
  - Register disbursements – 3.2%

Report conclusions

- Fraud reporting mechanisms are a critical component of fraud prevention and detection (tip hotlines – by far the most effective)
- Financial audits are over-relied on by organizations (most common control)
- Employee education is the foundation of prevention and detection
- Surprise audits are effective, but underutilized

Report conclusions

- Small organizations are particularly vulnerable and need to target efforts to hotlines, setting an ethical tone, and risk based approach
- Implementation of the fraud prevention checklist is a good first step

ACFE's Occupational Fraud and Abuse Classification System

- Occupational Fraud
  - Corruption
  - Asset Misappropriation
  - Fraudulent Statements

ACFE's Occupational Fraud and Abuse Classification System

- Corruption
  - Conflicts of Interest
    - Purchase Schemes
    - Sales Schemes
  - Bribery
    - Invoice Kickbacks
    - Bid Rigging
  - Illegal Gratuities
  - Economic Extortion

ACFE's Occupational Fraud and Abuse Classification System

- Asset Misappropriation
  - Cash
    - Larceny
    - Fraudulent Disbursements
    - Skimming
  - Non-Cash
    - Misuse
    - Larceny

ACFE's Occupational Fraud and Abuse Classification System

- Fraudulent Statements
  - Financial
    - Asset/Revenue overstatement
    - Asset/Revenue understatement
  - Non-Financial

Conditions Necessary for Fraud

Perry Mason	SAS 99	ACFE (based on Criminological Theory)
Means	Rationalization	Rationalization
Opportunity	Opportunity	Perceived opportunity
Motive	Incentive or pressure	Pressure

Fraud Prevention (Deterrence) Checklist

- Is ongoing anti-fraud training provided to all employees? (Rationalization)
- Is an effective fraud reporting mechanism in place? (Perceived opportunity)
- To increase employees' perception of detection, are following steps taken:
  - Fraudulent conduct aggressively sought out?
  - Surprise fraud audits.
  - Continuously auditing software.

  (Perceived opportunity)

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Fraud Prevention (Deterrence) Checklist

- Is “tone at the top” one of honesty/integrity? (Rationalization)
- Are fraud risk assessments performed? (Perceived opportunity)
- Are strong anti-fraud controls in place? (Perceived opportunity)
- Internal audit department? (Perceived opportunity)

Fraud Prevention (Deterrence) Checklist

- Hiring policies include proper background checks? (Pressure)
- Employee support programs? (Pressure)
- Open-door policy in place? (Pressure)
- Anonymous surveys to assess employee moral? (Pressure)

Likely Outcomes of Fraud Investigation

- Realistic expectations
  - Report on examination will not express an opinion on guilt or innocence
  - Odds of loss recovery
  - Odds of indictment
  - Odds of conviction
  - Cost
  - Possibility of legal action against employer by subject

Recent SB fraud we've investigated

A. Lifelong best friend hired as CFO for absentee owner - $382,000 (cash larceny)

B. Outsourced controller subject to limited oversight, made refunds to his own debit card, transfers from PayPal - $292,000 (cash larceny, check tampering)

C. New controller took advantage of historically sloppy accounting records, lack of regular reconciliations, and lax oversight - $500,000 (cash larceny, check tampering)

D. Payroll clerk with limited oversight - $5,000,000 (cash larceny, check tampering)

Common fraud tests we perform

- Duplicate payments intentionally made through the AP system.
- Duplicate invoicing by a vendor with the intent of defrauding.

✓ For both A & B we obtain check registers electronically and analyze invoice numbers and amounts for commonality. The invoice numbers are stripped of spacing and punctuation, and compared for prefixes and suffixes.

Common fraud tests we perform

- Fictitious vendors established in the AP system

  ✓ We summarize the check registers obtained electronically by vendor number and discuss the high dollar vendors with management in and out of accounting, investigating any that raise suspicion.

Common fraud tests we perform

- Department head requests split invoices with the intent of circumventing approval limits.

  ✓ We use the check registers obtained electronically and perform stratification testing and/or a Benford's Law analysis.

Common fraud tests we perform

- Lapping receipts.
  - ✓ Tested using surprise inspections of remittance slips, checks, deposit ticket and AR posting report from the GL.
- Manipulation of legitimately processed and signed AP checks.
  - ✓ Tested by obtaining a block of canceled checks and comparing the payee and endorsement to the check register.

Common fraud tests we perform

- Ghost employees in the payroll system.
  - ✓ Tested using the company's payroll report as compared to the latest published list of SSN group codes

Common thread: lack of internal control, segregation of duties

- The most common control weakness we encounter involves employee access to both accounting records and live assets.

- The AR clerk that receives the customer remittances posts the payments and prepares the deposit slip. May also be authorized to post entries to the GL.

Common thread: lack of internal control

- The AP clerk receives the signed checks back from the CFO to mail. The clerk also receives directly and reconciles the checking account bank statement.

- The payroll clerk receives the payroll checks from the third party processor and also receives directly and reconciles the payroll checking account.

Common thread: lack of internal control

- Invoices and supporting documentation are not thoroughly inspected before signing, and variances within departmental budgets are not thoroughly analyzed.

The company's responsibility:

- Communicate through words and actions the Company's policy with respect to business ethics. Code of Conduct.

- Design and maintain internal controls to protect both Company personnel and Company assets.