Understanding Fraud Risks and Fraud Prevention Strategies

Cornell Municipal Clerks School
July 16, 2014
Overview

I. Types of Fraud
II. The Fraud Triangle
III. Which Employees Steal
IV. Fraud Theories and Definitions
V. Most Common Types of Fraud
VI. Fraud in Local Government
VII. Red Flags of Fraud
VIII. Fraud Prevention Strategies
Types of Fraud

• Financial statement fraud
  *(Wall Street Journal cases)*

• Misappropriation
  *(Our Focus for today)*

• Identity Theft
  *(Personal and Corporate)*
Cost of Fraud

According to a 2012 Fraud Survey:

• Organizations lose 5% of annual revenue to fraud (*down 2% from 2008*).

• Nearly one-quarter of the cases caused at least $1 million in loses.

• Fraud costs U.S. companies $994 billion annually (*up $342 billion from 2006*).
Cost of Fraud

Average Armed Robbery
Yields $250

Average White Collar Crime
Yields $500,000
Cressey Fraud Triangle

Motive

Opportunity

Rationalization
Gender of Perpetrator

<table>
<thead>
<tr>
<th>Gender</th>
<th>Percent of Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Male</td>
<td>66.7%</td>
</tr>
<tr>
<td>Female</td>
<td>33.3%</td>
</tr>
</tbody>
</table>

Median Loss

- Male: $232,000
- Female: $100,000
Age of Perpetrator

<table>
<thead>
<tr>
<th>Age (Percent of cases)</th>
<th>Median Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;60 (2.2%)</td>
<td>$974,000</td>
</tr>
<tr>
<td>56-60 (5.2%)</td>
<td>$428,000</td>
</tr>
<tr>
<td>51-55 (9.4%)</td>
<td>$321,000</td>
</tr>
<tr>
<td>46-50 (13.7%)</td>
<td>$270,000</td>
</tr>
<tr>
<td>41-45 (19.3%)</td>
<td>$265,000</td>
</tr>
<tr>
<td>36-40 (19.3%)</td>
<td>$127,000</td>
</tr>
<tr>
<td>31-35 (16.1%)</td>
<td>$120,000</td>
</tr>
<tr>
<td>26-30 (9.6%)</td>
<td>$60,000</td>
</tr>
<tr>
<td>&gt;26 (5.2%)</td>
<td>$15,000</td>
</tr>
</tbody>
</table>
Loss By Education

<table>
<thead>
<tr>
<th>Level of Education / % of Cases</th>
<th>Median Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>High School Graduate (28.8%)</td>
<td>$100,000</td>
</tr>
<tr>
<td>Some College (17.1%)</td>
<td>$136,000</td>
</tr>
<tr>
<td>College Degree (38%)</td>
<td>$234,000</td>
</tr>
<tr>
<td>Post Graduate Degree (14%)</td>
<td>$300,000</td>
</tr>
</tbody>
</table>
Criminal History of Perpetrator

- Never Charged or Convicted: 85.7%
- Charged But Not Convicted: 7.7%
- Had Prior Convictions: 6.7%
Fraud Theories and Definitions

Watch Out!

Fraud is common, pervasive, and probably exists at your organization.
Fraud is any method employed by one person to deceive another. The elements are:

- Intentional false representation of a material fact
- That induces someone to part with his property
- To his financial detriment
Initial Detection of Frauds

*Total exceeds 100% because some participants cited more than one method of initial discovery of fraud.
Victims

Organizations with 100 or fewer employees were the most vulnerable to fraud.

- Less than 10% of small organizations have anonymous fraud reporting systems.
- Less than 20% have internal audit departments, or train employees on fraud.
Size of Victim Organizations

<table>
<thead>
<tr>
<th>Number of Employees</th>
<th>% of Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;100</td>
<td>30.8%</td>
</tr>
<tr>
<td>100 - 999</td>
<td>22.8%</td>
</tr>
<tr>
<td>1,000 - 9,999</td>
<td>25.9%</td>
</tr>
<tr>
<td>10,000+</td>
<td>20.6%</td>
</tr>
</tbody>
</table>
Types of Organizations

- Private Company (42.1%)
- Public Company (32.1%)
- Government (16.3%)
- Not-for-profit (9.6%)

Median Loss:
- Private Company: $231,000
- Public Company: $200,000
- Government: $100,000
- Not-for-profit: $90,000
Summary

• Fraud is a very serious problem.
• Fraud is vastly underreported.
• There is a direct correlation between the perpetrator's age, gender, position, and the median loss due to fraud.
• The expansion of computers and e-commerce will increase losses due to fraud.
• The rate of fraud will likely rise.
Most Common Types of Fraud

- Cash disbursements
- Cash receipts/billing
- Payroll
- Inventory/Physical assets
Breakdown of Asset Misappropriations

<table>
<thead>
<tr>
<th>Scheme Type</th>
<th>Percent of Cases</th>
<th>Median Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Misappropriations</td>
<td>87.7%</td>
<td>$150,000</td>
</tr>
<tr>
<td>Non-Cash Misappropriations</td>
<td>23.4%</td>
<td>$150,000</td>
</tr>
</tbody>
</table>

*Total exceeds 100% because some participants cited more than one method of initial discovery of fraud.
Breakdown of Fraudulent Disbursements

- Billing (28.3%)
- Expense Reimbursements (19.5%)
- Check Tampering (17.1%)
- Payroll (13.2%)
- Wire Transfers (6.5%)
- Register Disbursements (1.7%)
Which Measures Are Most Effective in Preventing Fraud?

<table>
<thead>
<tr>
<th>Measure</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strong Internal Controls</td>
<td>6.07</td>
</tr>
<tr>
<td>Background Checks on New Employees</td>
<td>5.02</td>
</tr>
<tr>
<td>Regular Fraud Audits</td>
<td>4.86</td>
</tr>
<tr>
<td>Established Fraud Policies</td>
<td>4.47</td>
</tr>
<tr>
<td>Willingness of Companies to Prosecute</td>
<td>4.08</td>
</tr>
<tr>
<td>Ethics Training for Employees</td>
<td>3.97</td>
</tr>
<tr>
<td>Anonymous Fraud Reporting Mechanisms</td>
<td>3.70</td>
</tr>
<tr>
<td>Workplace Surveillance</td>
<td>1.62</td>
</tr>
</tbody>
</table>
Primary Internal Control Weaknesses Observed by CFE’s

- Lack of Internal Controls: 38%
- Override of Existing Internal Controls: 19%
- Lack of Management Review: 18%
- Poor Tone at the Top: 8%
- Lack of Competent Personnel in Oversight Roles: 7%
- Lack of Independent Checks / Audits: 6%
- Other: 4%

The Bonadio Group
CPAs, Consultants & More

Page 22
July 18, 2014
2010 Fraud Reports

- County of Monroe, Airport Director $20,000
- Town of Fairfield, Supervisor’s wife $377,976
- Aurora Colden Fire District Treasurer $331,813
- Bolivar Joint FD, Treasurer $119,976
- Town of Ticonderoga, Highway Supt. $92,000
- Town of W Seneca, Youth Bur Director $74,108
- Town of Sodus, Town Clerk $53,148
- Town of Turin, Justice $37,199
- Town if Islip Town Clerk $12,250
- Village of Port Henry, Clerk-Treasurer $150,000
- Village of Andover, Clerk Treasurer $14,418

http://www.osc.state.ny.us/localgov/audits/typeindex.htm
2013/2014 Fraud Reports

- City of Corning, Clerk $5,000
- Fund Town of Fishkill, Rec Director $50,000
- Town of Altona, Bookkeeper $23,500
- Village of Altmar, Clerk/Treasurer $100,000
- City of Kingston, Fire Chief $23,000
- Town of Argyle, Clerk $8,000
- Village of Old Field, Treasurer $60,000
- Town of Erin, Highway Superintendent $50,000
- MET Council of Jewish Poverty, Finance Officer $9,000,000
- West Seneca Fire District, Treasurer $55,000
- Crystal Beach Fire Department, Treasurer $50,000
Personal Experiences—Nick Mazza
“It will never happen to me.”

- City of Syracuse - Payroll Fraud
- City of Cortland – Misappropriation
- Livingston County – Time/Attendance
Red Flags of Fraud

Conditions and symptoms that exist creating an increase in the risk of fraud.
Categories of Red Flags

- Environmental
- Internal Control
- Financial Statement
- Personal
Environmental Red Flags

- Type of Management
- Financial Conditions at Organization
- Communications
- Opportunities for Advancement
- Political Environment
Internal Control Red Flags

- Poor Segregation of Duties
- Weak Management Oversight
- No Job Descriptions
- Management Override
- Lack of Enforcement of Policies
Financial Statement Red Flags

- Unexplained Changes in Revenue
- Changes in Fund Balance
- Changes in Expenses
- Inventory Shortages
Personal Red Flags

- Financial
- Habits
- Feelings
- Others
Financial Red Flags

Need for Money

• Health
• Life Event
• Support of Ex-Spouse and Children
• Maintenance of Life Style
Habit Red Flags

- Drugs
- Alcohol
- Gambling
- Investing (Day Trader)
- Life Style
Feeling Red Flags

Pressure to Succeed or Keep

• Internal
• Family
• Peer
Feeling Red Flags

Perception of Unfair Treatment By Employer

- Raise
- Promotion
- Perks
- Responsibility
- Discrimination

Resentment of Supervisors

- Inappropriate Treatment
- Greater Competence Than Supervisor
- “Member of Family”

Job Frustration

Depression
Other Red Flags

Abruptly Changed Behavior

• Work Hours
• Eating Habits
• Displays of Wealth
• Attitude Toward Work/Coworkers
• Secrecy
• Possessiveness
Purchasing Red Flags

• No telephone number on invoice
• No street address on invoice
• Dollar range of invoices is narrow and limited
• Only one person is the contact with vendor
• No independent review of bank statements (unopened)
Purchasing Red Flags

- One person prepares or approves budget
- Same person selects vendor
- Same person approves invoices
- Same person signs receiving reports for materials
- Same person signs checks
Purchasing Red Flags

- Payments sent to a P.O. Box
- Name of company has initials in it
- Similarity in initials to employee
- Invoices are for services and not materials
- No company conflict of interest policy
Payroll Red Flags

• One person hires employees
• Same person prepares/approves budget
• Same person schedules work
• Employees do not sign time sheets
• Same person reviews/approves total labor hours
• Multiple locations with no direct supervision
• Same person reviews/approves job performance reports
• Certain employees only work for one supervisor
Kickbacks Red Flags

- One person selects vendors
- Same person approves prices for equipment/materials/supplies
- No competitive bidding
- No independent review of prices/costs
- No company policy re: conflict of interest
- No company policy re: accepting of gifts
Billing/Cash Receipts Red Flags

- One person prepares invoices and handles cash receipts
- Same person opens the mail
- Same person can write off a bad debt
- Same person handles customer complaints
- No review or supervision over invoicing
- Poor control over inventory
Behavioral Red Flags During Fraud Scheme Asset Misappropriation

- Living beyond means: 44.8%
- Financial difficulties: 39.3%
- Control issues, unwillingness to share duties: 22.2%
- Unusually close association with…: 19.3%
- Wheeler-dealer attitude: 19.0%
- Divorce/family problems: 18.5%
- Irritability, suspiciousness or defensiveness: 14.3%
- Addiction problems: 12.9%
- Refusal to take vacations: 10.7%
- Past employment-related problems: 9.1%
- Complained about inadequate pay: 8.6%
- Excessive pressure from within organization: 6.4%
- Past legal problems: 6.4%
- Instability in life circumstances: 5.9%
- Excessive family/peer pressure for success: 5.4%
- Complained about lack of authority: 4.7%
Should You Focus on Prevention or Detection?

**Answer:** Both

- Take proactive steps to prevent
- Be skeptical, informed, and alert in order to detect as quickly as possible
# Median Loss Based on Presence of Anti-Fraud Controls

<table>
<thead>
<tr>
<th>Control</th>
<th>Percent of Cases Implemented</th>
<th>Control in Place</th>
<th>Control NOT in Place</th>
<th>Percent Reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hotline</td>
<td>48.6%</td>
<td>$100,000</td>
<td>$245,000</td>
<td>59.2%</td>
</tr>
<tr>
<td>Employee Support Programs</td>
<td>44.8%</td>
<td>100,000</td>
<td>244,000</td>
<td>59.0%</td>
</tr>
<tr>
<td>Surprise Audits</td>
<td>28.9%</td>
<td>97,000</td>
<td>200,000</td>
<td>51.5%</td>
</tr>
<tr>
<td>Fraud Training for Employees</td>
<td>39.6%</td>
<td>100,000</td>
<td>200,000</td>
<td>50.0%</td>
</tr>
<tr>
<td>Fraud Training for Managers/Execs</td>
<td>41.5%</td>
<td>100,000</td>
<td>200,000</td>
<td>50.0%</td>
</tr>
<tr>
<td>Job Rotation/Mandatory Vacation</td>
<td>14.6%</td>
<td>100,000</td>
<td>188,000</td>
<td>46.8%</td>
</tr>
<tr>
<td>Code of Conduct</td>
<td>69.9%</td>
<td>140,000</td>
<td>262,000</td>
<td>46.6%</td>
</tr>
<tr>
<td>Anti-Fraud Policy</td>
<td>39.0%</td>
<td>120,000</td>
<td>200,000</td>
<td>40.0%</td>
</tr>
<tr>
<td>Management Review</td>
<td>53.3%</td>
<td>120,000</td>
<td>200,000</td>
<td>40.0%</td>
</tr>
<tr>
<td>External Audit of ICOFR</td>
<td>59.3%</td>
<td>140,000</td>
<td>215,000</td>
<td>34.9%</td>
</tr>
<tr>
<td>Internal Audit/FE Department</td>
<td>66.4%</td>
<td>145,000</td>
<td>209,000</td>
<td>30.6%</td>
</tr>
<tr>
<td>Independent Audit Committee</td>
<td>53.2%</td>
<td>140,000</td>
<td>200,000</td>
<td>30.0%</td>
</tr>
<tr>
<td>Management Certification of F/S</td>
<td>58.9%</td>
<td>150,000</td>
<td>200,000</td>
<td>25.0%</td>
</tr>
<tr>
<td>External Audit of F/S</td>
<td>76.1%</td>
<td>150,000</td>
<td>200,000</td>
<td>25.0%</td>
</tr>
<tr>
<td>Rewards for Whistleblowers</td>
<td>7.4%</td>
<td>119,000</td>
<td>155,000</td>
<td>23.2%</td>
</tr>
</tbody>
</table>
How Do You Minimize The Risk of Fraud?

- Set the tone at the top
- Have a written code of ethics
- Check employee references
- Examine the bank statements
- Strong internal controls
- Create a positive work environment
- Have a hotline
- Consult a certified fraud examiner
Any Questions?