THE CONSTRUCTION PROCESS OF FRAUD PREVENTION

Designing an Effective Anti-Fraud Program

DFG
FORENSIC ACCOUNTING SERVICES

Presented by
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Internal Fraud

Fraud committed against the organization by its own officers, directors, or employees

… an attack from within

… a betrayal of 

No One Was Watching

The accountant stole $735,000 by making 242 transfers from the bank account to his personal account; $260,000 by making 252 payments to his and his family members' personal credit card accounts.

No One Was Watching

The Leadership failed to separate incompatible financial duties and to provide increased oversight when appropriate. The former accountant recorded financial information, made online payments, and reconciled the bank statements without adequate oversight.

DFG Reports: Disclaimer to Defense

It is noted that "deficiencies in internal controls" is not justification for the committing of fraud; rather, it simply makes the perpetration of that fraud less burdensome to the perpetrator. Thus, control deficiencies do not render the illegal act of fraud as suddenly legal. The deficiencies simply make the perpetration of the illegal act easier.

What Internal Control Is NOT!!

ACFE Report to the Nations

Initial Detection of Fraud

Tips	43%
Internal Audit	15%
Management Review	12%
By Accident	5%
Account Reconciliation	4%
External Audit of FS	4%

What Internal Control Is NOT!!

ACFE Report to the Nations

What Internal Controls Did the Victim Organization Think They Had in Place?

External Audit of FS	83%
Internal Audit	74%
Management Review	65%
Hotline	64%
Fraud Policy	56%

What Internal Control Is NOT!!

This is the EXPECTATION GAP

Your external audit is a financial statement audit, not a forensic investigation (two different designs)

Your external auditors cannot legally be a part of your internal control structure…


THE
BASICS

Types of Fraud

Misappropriation – the taking of company assets

Corruption – Bribery, kickbacks, illegal gratuities, etc.

Financial Statement – misrepresentation of financial statements

THE FRAUD TRIANGLE

JOSEPH T. WELLS; *OCCUPATIONAL FRAUD AND ABUSE;* (OBSIDIAN PUBLISHING CO. – 1997); PG. 11

- **Perceived Non-shareable Financial Need (Incentive/Pressure)**
- **Rationalization**
- **Opportunity**

DFG Statistics

WHY do people commit fraud?

Need-based	**95%**
Greed-based	**4.5%**
Pathological	**.5%**

DFG Statistics

WHO is committing fraud?

Decent People	95%
Evil People	4.5%
Sick People	.5%

Flush with Cash…

Larry the CFO (age 66, 36 years with the Company) stole over $1,300,000 by…

Causing disbursements to be made to credit card companies related to his personal credit card accounts

Payments were made monthly, sometimes twice monthly, to VISA and Chase Mastercard, even though the company only had an account with American Express

Flush with Cash…

- Causing disbursements to be paid directly to himself for “travel reimbursement” “paid” personally.

Flush with Cash…

The Company's annual gross revenue was approximately $175,000,000

The disbursements were recorded to "travel expense"

The CFO caused journal entries to periodically be made to credit "travel expense" and debit various other expense accounts so as to conceal any budget versus actual comparison issues

Flush with Cash…

Supporting documentation included…

- **Credit card receipts for charges properly made to the company's American Express card**
- **Gas pump receipts that had obviously been "left hanging" by the previous customer**
- **Thick "card stock" junk mail flyers for educational conferences**

Flush with Cash…

Supporting documentation included…

- **Hotel bills for hotel stays 5 – 10 years in the past**
- **Airfare reservation confirmations for air travel never taken**
- **Receipts for items paid with cash**
- **Documentation stapled between two pages of 8 ½ by 11 inch copy paper, sometimes with up to 100 staples**

Flush with Cash

<u>His Rationalization</u>

"It just isn't that much money when you spread it out over a ten-year period. It's more of a longevity bonus. I just didn't think they would ever miss it".

I'M NOT TAKING THAT MUCH

The Victim Response

“Steve, I can’t believe this happened to us… and by him…

I trusted him; he’s been here forever; he’s the last person I would have suspected!”

Question 1

In most cases, people steal from the organization because,

A. They are evil

B. They are greedy

C. They need the money

D. It's fun

THE CONSTRUCTION PROCESS OF FRAUD PREVENTION:

Internal Control / Anti-Fraud Program Design Considerations

Principles of Self-Preservation

A properly designed anti-fraud program serves to protect an organization in two ways:

- **To reduce the probability of fraud occurring, and if nothing else,**
- **Protects the organization in the event of mishandled accusations or investigations (Self-Preservation)**

The Anti-Fraud Program

THE FRAMEWORK

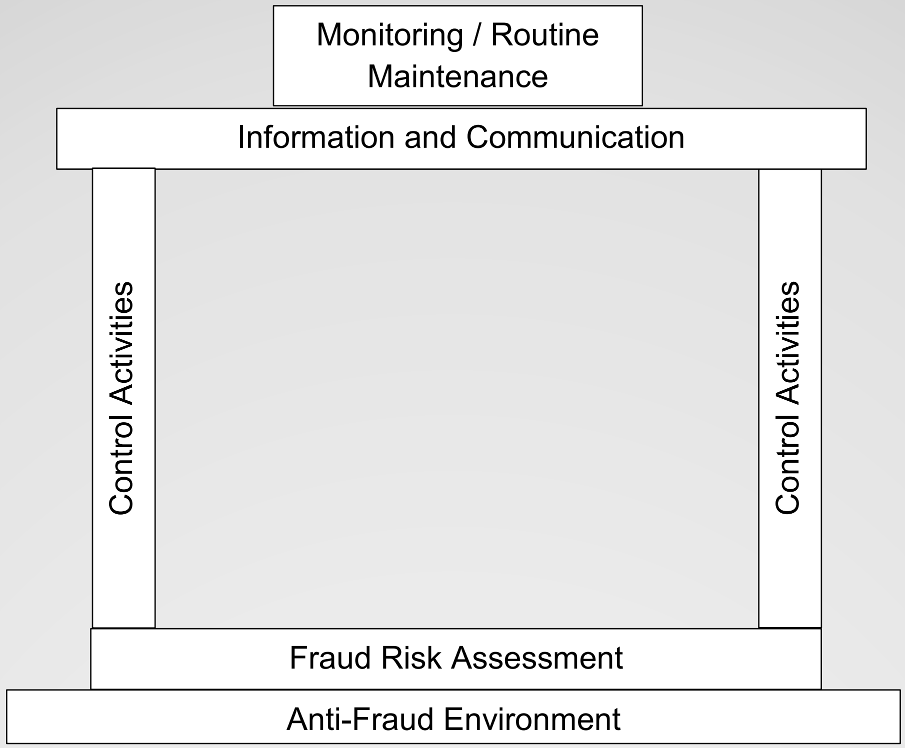
The Anti-Fraud Environment
Fraud Risk Assessment
Control Activities
Information: Program Documentation
Communication: The Company Fraud Training Program
Monitoring and Routine Maintenance

The Architect's Blueprint

Establishing the Framework

The Anti-Fraud Environment: **Laying the Foundation**
Fraud Risk Assessment: **Installing the Ground Floor**
Control Activities: **Raising the Walls**
Information: Program Documentation **Constructing the Ceiling**
Communication: **The Company Fraud Training Program** **Constructing the Ceiling**
Monitoring and Routine Maintenance **Putting on the Roof**

The Completed Anti-Fraud Program



ANTI-FRAUD ENVIRONMENT

Anti-Fraud Environment

Which Policies and Programs are in Place / Content

Foundational Policies:

- Code of Ethics
- Fraud Policy
- Fraud Reporting Policy (Anonymous Reporting Mechanism)
- Policy Provisions for Removal of Employee Presumption of Privacy

Anti-Fraud Environment
Laying the Foundation

<u>Other Environmental Provisions</u>:

- **Organizational Chart**
- **Formal Written Employee Job Descriptions**
- **Required Annual Employee Evaluations**
- **Payroll Advance / Financial Counseling Programs**
- **Employee Dishonesty Insurance / Fidelity Bond**

Anti-Fraud Environment
Laying the Foundation

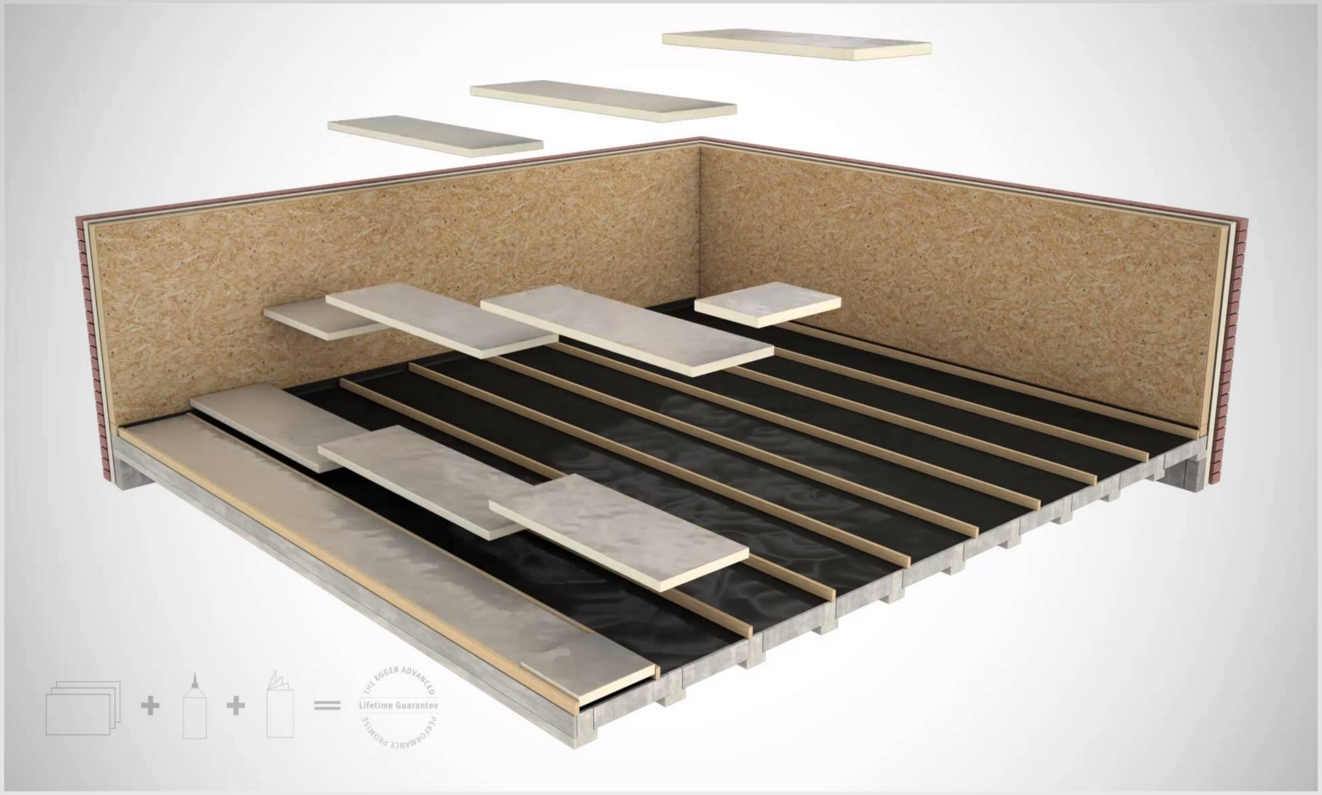
Other Environmental Provisions:

Leadership Requires Staff to Implement the Anti-Fraud Program

- ❑ **Implement and Administer Risk Assessment**
- ❑ **Design Control Activities**
- ❑ **Document the Program**
- ❑ **Train the Workforce**
- ❑ **Monitor and Maintain the Program**

- ❑ **Report Back to Leadership Regarding the Anti-Fraud Program**

FRAUD RISK ASSESSMENT
Laying the Ground Floor



FRAUD RISK ASSESSMENT

Laying the Ground Floor

“The process aimed at proactively identifying and addressing an organization’s vulnerabilities to fraud”

FRAUD RISK ASSESSMENT
Laying the Ground Floor

Goal: To Identify the Areas Vulnerable to the Risk of Fraud in Our Organization

The Objective is not to prevent fraud… the Objective is to determine what frauds need to be prevented.

Control activities have the objective of "preventing fraud".

FRAUD RISK ASSESSMENT
Laying the Ground Floor

- **More of an art than a science**
- **There is no “one size fits all”**
- **Fraud risks constantly change so the process is ongoing and continuous**
- **Improves overall fraud communication**

FRAUD RISK ASSESSMENT
Laying the Ground Floor

What makes a GOOD fraud risk assessment?

- **Fits the culture of the organization**
- **Sponsored/Supported by the right people**
- **Encourages all to be open in their participation**
- **Is embraced by all as a valuable process**

FRAUD RISK ASSESSMENT
Laying the Ground Floor

Set the Framework

- **Identify potential fraud risks**
- **Assess the likelihood of occurrence**
- **Assess the significance of the risk**
- **Evaluate the positions or departments**
- **Identify existing controls**
- **Determine controls effectiveness/efficiency**
- **Develop a risk response**

CONTROL ACTIVITIES
Raising the Walls

The Development of Control Activities

Guiding Principles of Control Activities Design…

"Design the internal control around the POSITION, never around the PERSON in that position"

"The perception of detection is the strongest internal control that can be implemented"

It Is Time For a

DIFFERENT APPROACH / RENEWED FOCUS

to Internal Fraud Prevention

It Is Time To Consider Control Processes that Speak to the MIND of the Potential Perpetrator

The #1 Internal Control that can be implemented in any company, regardless of size or complexity of operations is…

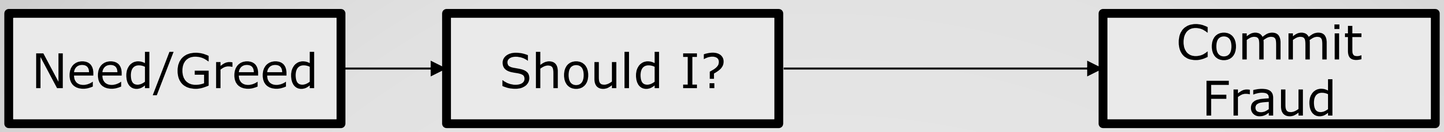
INCREASING THE PERCEPTION OF DETECTION

"Will I Get Caught?"

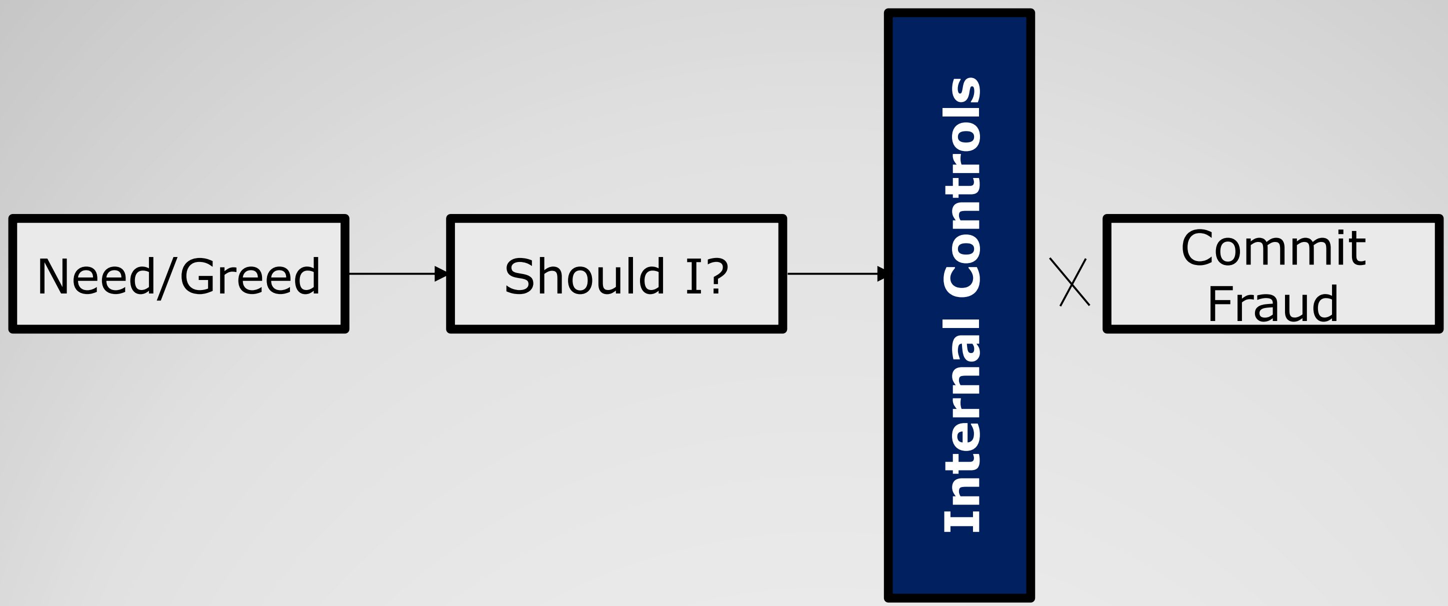
The Perception of Detection

You're driving down the highway at 15 miles per hour over the speed limit…

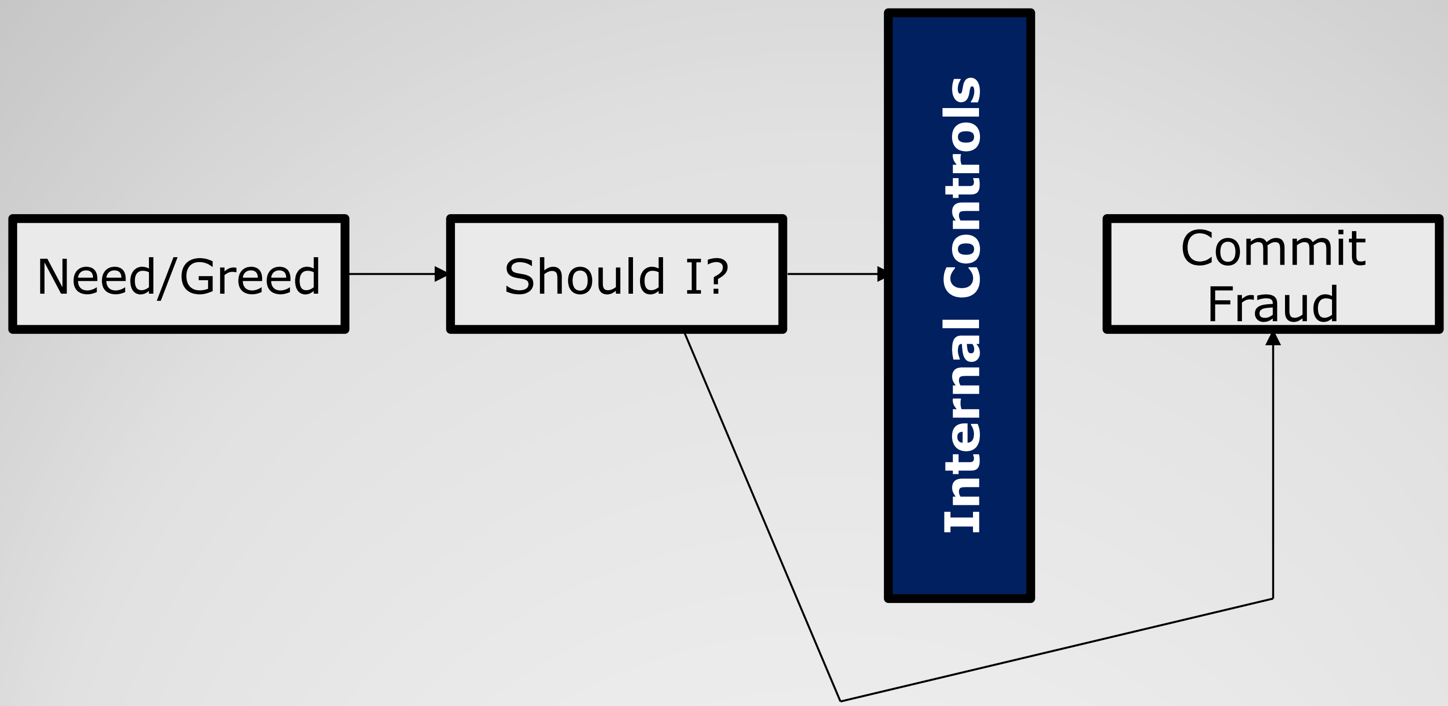
The Evolution of Thought



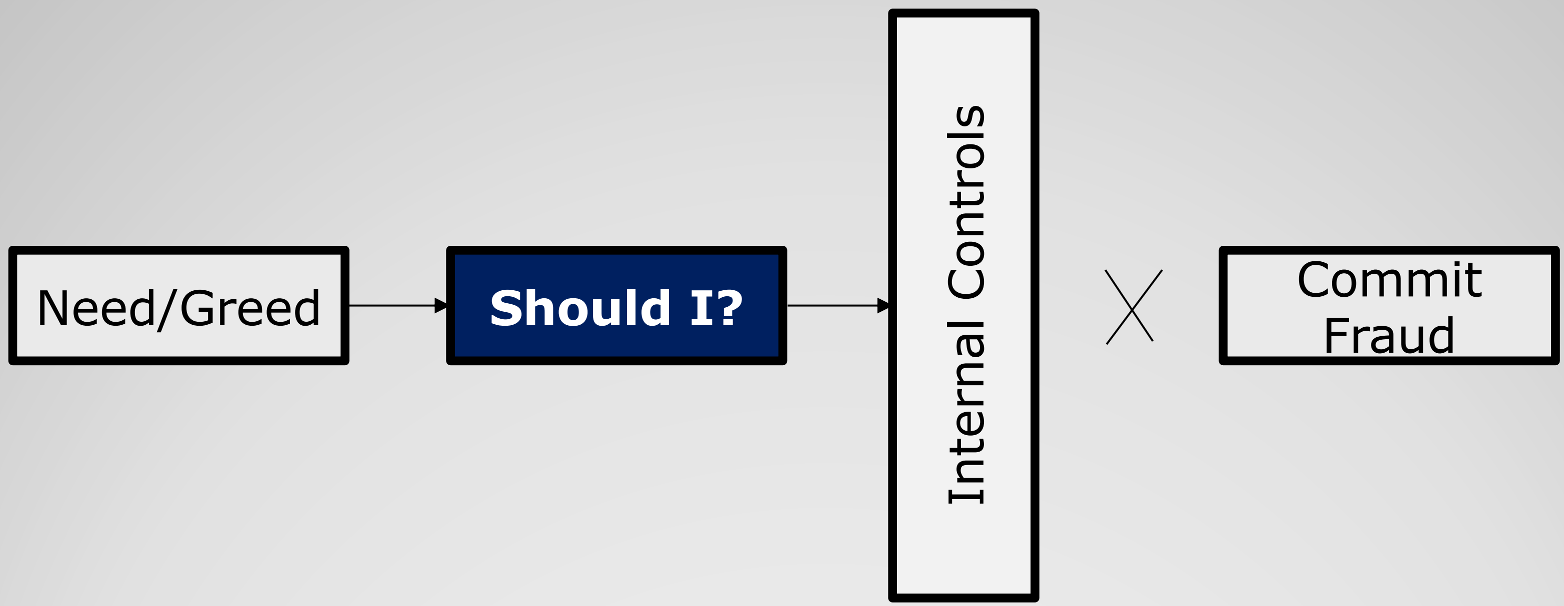
The Evolution of Thought

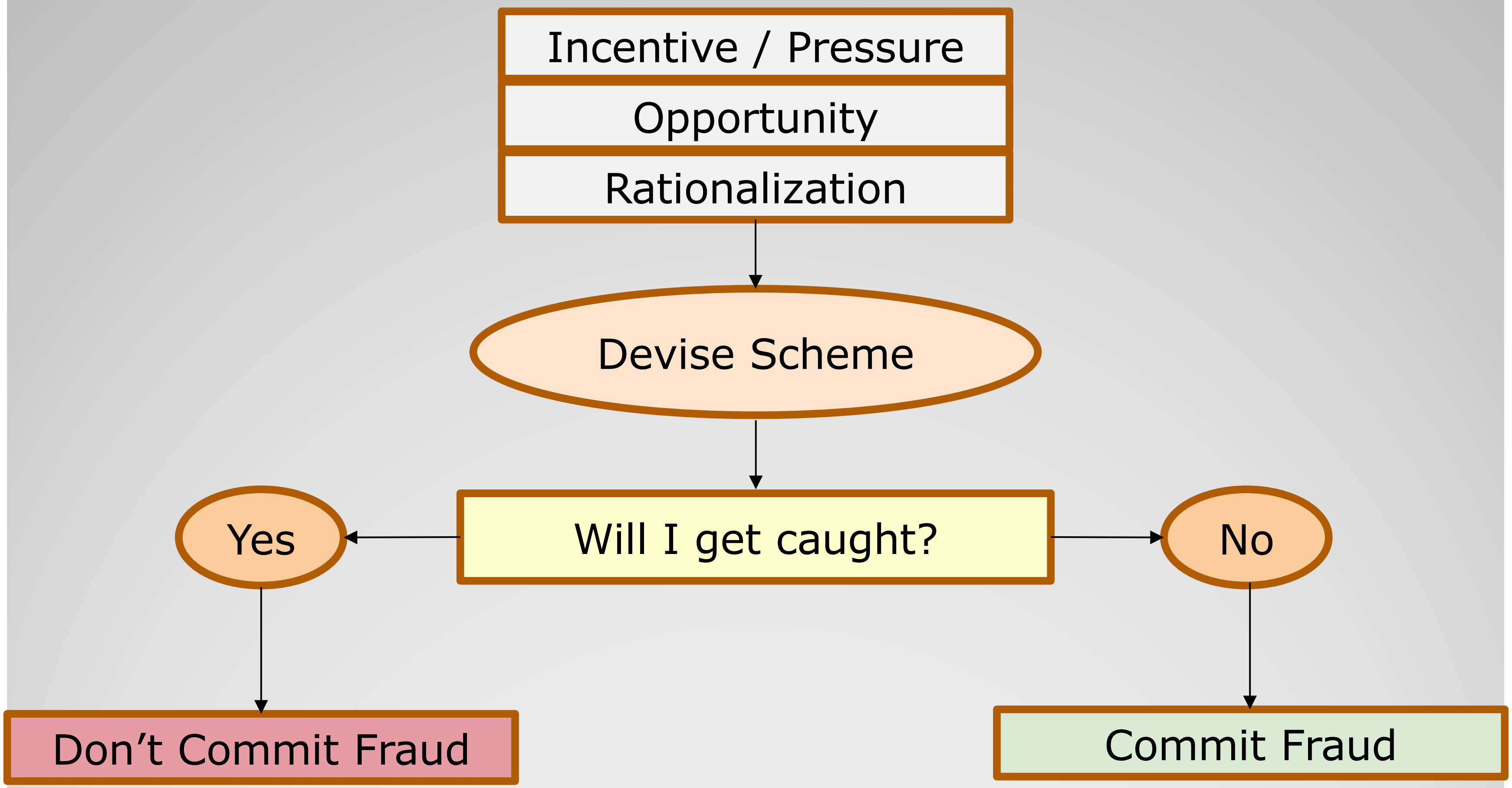


The Evolution of Thought



The Evolution of Thought





Incentive / Pressure
Opportunity
Rationalization
Devise Scheme
Will I get caught?
Yes
No
Don’t Commit Fraud
Commit Fraud

The #1 Internal Control that can be implemented in any company, regardless of size or complexity of operations is…

INCREASING THE PERCEPTION OF DETECTION

"Will I Get Caught?"

Increasing the PERCEPTION

Not…

Increasing the *Probability* of Detection,

Increasing the *Possibility* of Detection,

But…

INCREASING THE PERCEPTION OF DETECTION

Increasing the Perception of Detection

How?

A targeted focus on those controls, programs, or processes that speak to the MIND of our employees, the potential perpetrators!

Increasing the Perception of Detection

How?

Education

Targeted Control Activities

Effective Fraud Reporting Program

Modeling - Ethical Leadership

Other Physical Controls

Education

Education

FRAUD?

Do employees know what fraud is?

Education

Fraud committed against the organization by its own officers, directors, or employees

… an attack from within

… a betrayal of 

Education

The Cost of Fraud

- Fewer Pay Increases
- Increased Layoffs
- Decreases in Employee Benefits
- Low Employee Morale
- Negative Publicity
- Legal Fees / Investigation Costs
- 5% of Gross Revenue

Education

Other Potential Topics

- **Fraud Trends**
- **Industry-specific Fraud Issues**
- **Fraud Indicators for the Organization**
- **Suggestions for Improvement in the Anti-fraud Program (the process of INCLUSION)**
- **ACFE Report to the Nations – ACFE.com**

Question 2

The best internal control that any organization can implement is,

A. Increase the Perception of Detection

B. Lock all cash drawers

C. Do not have a petty cash fund

D. Prepare monthly bank reconciliations

Targeted Control Activities

Targeted Control Activities

Fraud Risk Assessment

"The process aimed at proactively identifying and addressing an organization's vulnerabilities to fraud"

A process of INCLUSION… that increases the *perception* of detection

Targeted Control Activities

Mandatory Consecutive Days Vacation

Rewards for Whistleblowers

Surprise Audits

Targeted Control Activities

Job Rotation

Mandatory *Annual* Completion of the Conflict of Interest Form

Conflict of Interest Form

<u>Useless or Useful?</u>

Annual required completion by all employees, officials, etc.:

- ❑ **Family relationships**
- ❑ **Personal relationships**
- ❑ **Business relationships**
- ❑ **Financial relationships**

Targeted Control Activities: Implementation Trends
ACFE Report to the Nations

Hotline
Anti-Fraud Training - Employees
Fraud Policy
Code of Conduct – Code of Ethics
Management Review
Surprise Audits
Anti-Fraud Training – Managers/Executives
Independent Audit Committee
Management Certification of Financial Stmnts
Rewards for Whistleblowers

Targeted Control Activities – Implementation Trends
ACFE Report to the Nations

Job Rotation/Mandatory Vacation
External Audit of ICOFR
Employee Support Programs

Effective Fraud Reporting Program

Effective Fraud Reporting Program

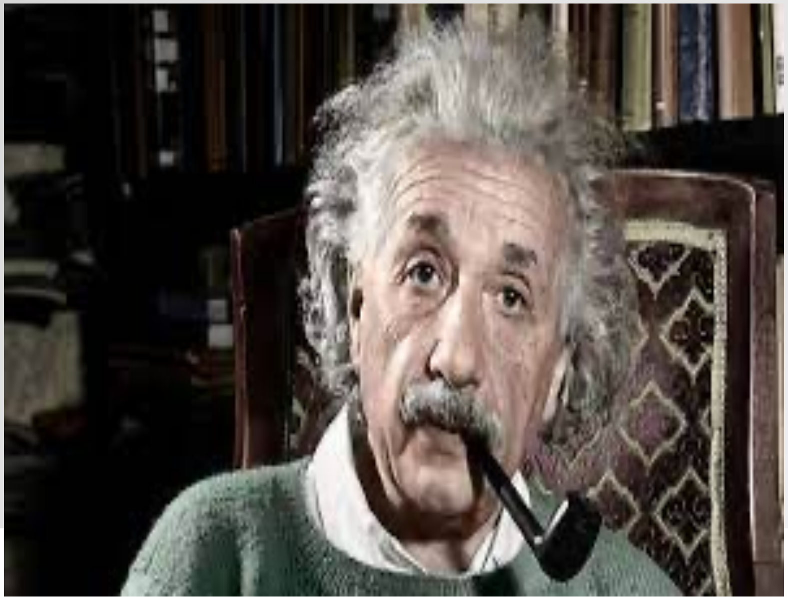
Do employees know where to go to report suspicions?

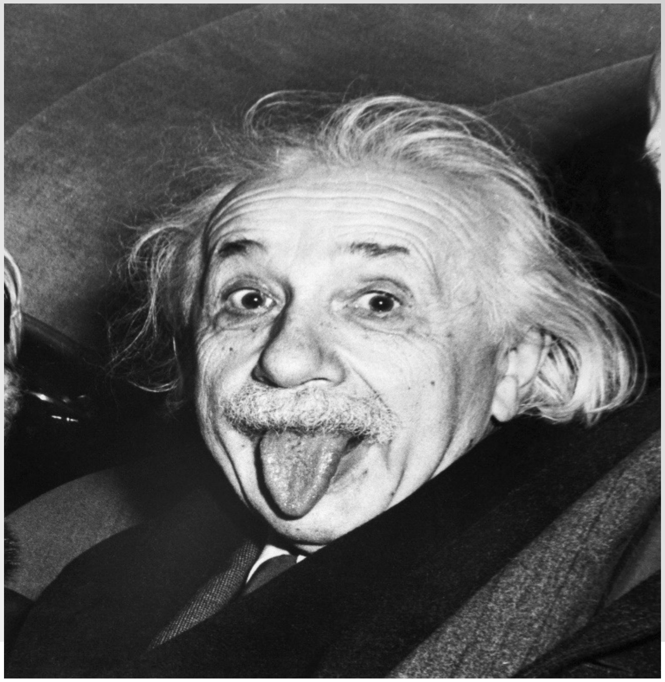
- **Is there an anonymous reporting structure in place?**
- **Do employees know they can report without fear?**
- **Do employees believe tips will be investigated?**

Modeling: Ethical Leadership

"Setting an example is not the main means of influencing another, it is the ONLY means"

Albert Einstein





Modeling: Ethical Leadership

Foundational Policies

- **Code of Ethics**
- **Fraud / Fraud Reporting Policy**
- **Provisions for Removal of Employee Presumption of Privacy**

Presumption of Privacy Policy Provisions

"To facilitate the performance of employees' job functions, employees will be provided with a proper workspace, including but not limited to: Desks, file cabinets, credenzas, and other office document hard copy storage furniture. All items on location in these assigned workspaces, *including any personal effects* stored on Company property, *will be subject to search* as determined necessary, and *employees have no reasonable expectation of privacy* in these workspaces".

Presumption of Privacy Policy Provisions

"To facilitate business communications and work-related research, the Company provides staff access to various types of equipment, including but not limited to: Internet, telephones, cell phones, voice mail, email, computers and related equipment. All materials, information and/or software created, transmitted, downloaded or stored on these Company-provided means of communication are the property of the Company, and *employees have no reasonable expectation of privacy* in such information".

Other Physical Controls

Bubble Lens Security / Surveillance Cameras

Other Physical Controls

EMPTY Bubble Lens Security / Surveillance Cameras

Other Physical Controls

Reminding employees that emails and internet usage are monitored…

Text Analytics

- **Text categorization**
- **Text clustering**
- **Sentiment analysis**
- **Lexical analysis**

Increasing the Perception of Detection

Even if internal controls are weak, if they are perceived to exist, fraud can be prevented.

Increasing the Perception of Detection

Shift our focus to the "Should I?" stage of the decision-making process

Increasing the PERCEPTION of Detection addresses this "Should I?" Stage

BEC – Business E-mail Compromise

Image from phishprotection.com

MAN-IN-THE-MIDDLE ATTACK

MAN-IN-THE-MIDDLE ATTACK

Business E-Mail Compromise

BEC is Successful Because…

- **Insufficient Security Protocols**
- **Social Engineering**
- **Lack of Employee Awareness**

Business E-Mail Compromise

<u>What Can We Do?</u>

Awareness Training

Cross-reference sender's E-mail address with known Vendor's E-mail address

<u>jeff.smith@dfgcompany.com</u>
<u>jeff.smith@dgfcompany.com</u>

Don't reply to risky e-mails or click on links!

Keyword Flag – "payment", "urgent", "sensitive", "secret", "kindly"

Business E-Mail Compromise

<u>What Can We Do?</u>

Avoid using free, web-based email services for company accounts

Be mindful of social media posts – yes, personal social media

HR be aware – job information posted on company website (job descriptions, organizational charts, etc.)

Business E-Mail Compromise

<u>What Can We Do?</u>

Vendor Establishment: Assign a "code" to be used for vendor information changes (bank routing number or account number changes)

Phishing testing: …and then retraining

Business E-Mail Compromise

<u>**What Can We Do?**</u>

Train Employees

Software controls to identify all emails coming from an outside source

Business E-Mail Compromise

<u>What Can We Do?</u>

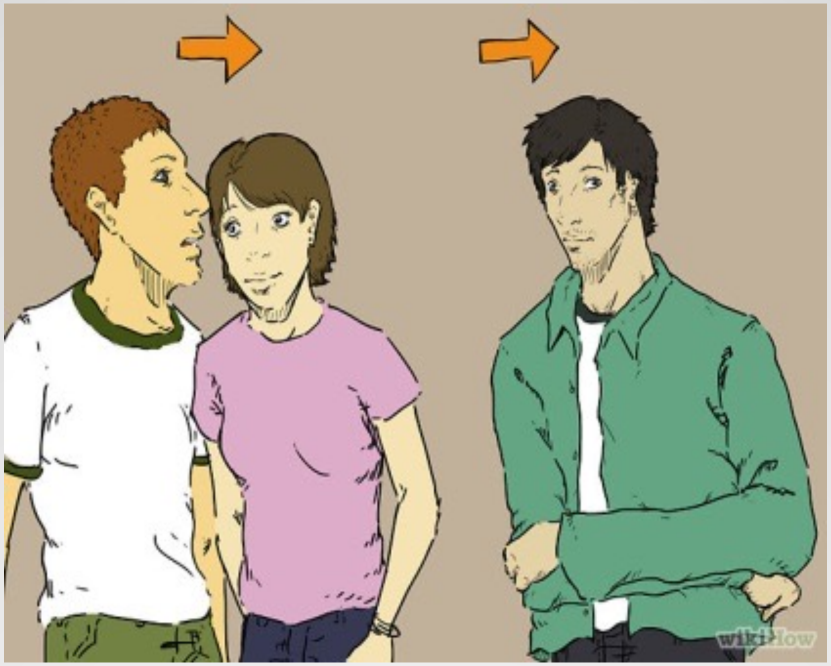
Always validate and authenticate who you are talking to

Never give out passwords or secure information over the phone or email

Information: Program Documentation
Installing the Ceiling

Information: Program Documentation

Telephone Party Game!



Information: Program Documentation

The Elements of High-Quality Documentation

- **Keep it simple**
- **Narrative in Design**
- **Schedules Referenced**

Communication: The Anti-Fraud Training Program

Installing the Ceiling

Fraud Awareness Training

- Increase the level of fraud awareness
- Increase the perception of detection
  (the #1 internal control in existence)

Communication: The Company Fraud Training Program

Annual Must Have Training!

Review and Re-acknowledgment of the Code of Ethics

Review and Re-acknowledgment of the Fraud Policy

Review and Re-acknowledgment of the Fraud Reporting Policy

Re-completion of the Conflict of Interest Form

Question 3

True or False?

Mentioning “Fraud” in a staff meeting is a good idea because it gives staff ideas of how to steal.

Monitoring and Routine Maintenance

Monitoring and Routine Maintenance

Putting on the Roof

(VERIFY, VERIFICATION)

"Trust, but Verify"

Monitoring and Routine Maintenance
Putting on the Roof

The 2 Questions of Monitoring…

Are processes and controls working as intended?

Are there processes or activities that we need to refine, add, or delete?

Flush with Cash…

<u>Controls in Place</u>

Expense report was required

- **Description of the disbursement**
- **GL Account to be charged**
- **Individual requesting the disbursement**
- **Signature of approval on requisition**

Flush with Cash…

Controls in Place

Expense report, along with supporting documentation to be included with the check when presented for authorized signature

Monthly comparison of budget to actual expenses

CFO had no ability to make a journal entry into the general ledger

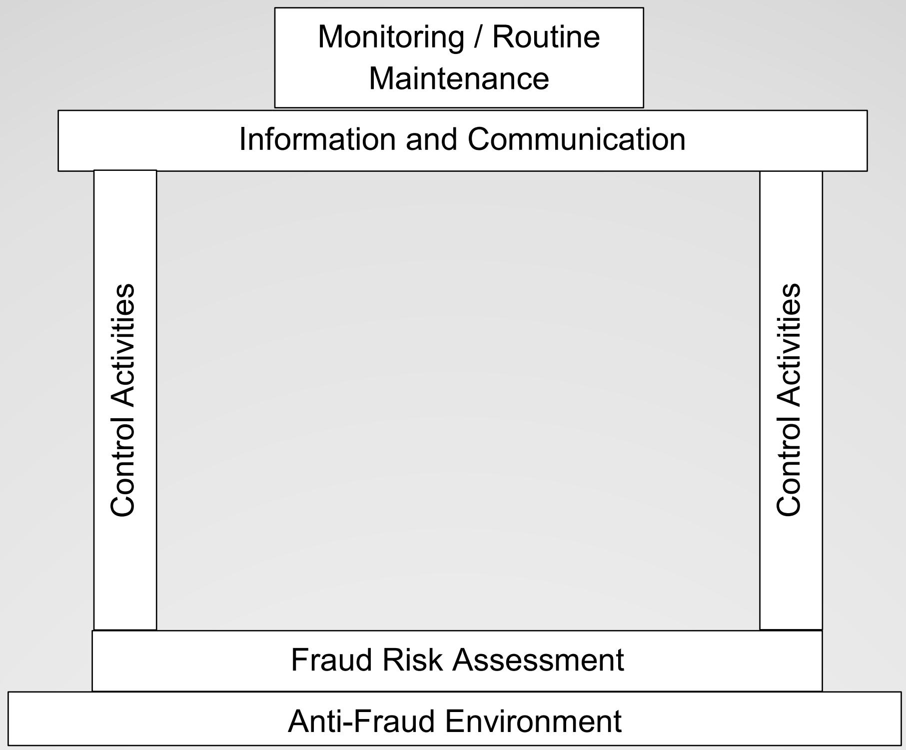
Monitoring

The Leadership Requires Staff to Administer the Anti-Fraud Program

Report Back to the Leadership “How its going”

Develop an Anti-Fraud Program Report

The Completed Anti-Fraud Program



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