



66<sup>th</sup> Annual Conference: November 6-8, 2014

# ***Fraud Deterrence, Prevention, and Detection***

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**DAVID L. COTTON, CPA, CFE, CGFM**  
**COTTON & COMPANY LLP CHAIRMAN**

Dave Cotton is chairman of Cotton & Company LLP, Certified Public Accountants. Cotton & Company is headquartered in Alexandria, Virginia. The firm was founded in 1981 and has a practice concentration in assisting Federal and State government agencies, inspectors general, and government grantees and contractors with a variety of government program-related assurance and advisory services. Cotton & Company has performed grant and contract, indirect cost rate, financial statement, financial related, and performance audits for more than two dozen Federal inspectors general as well as numerous other Federal and State agencies and programs.

Cotton & Company's Federal agency audit clients have included the U.S. Government Accountability Office, the U.S. House of Representatives, the U.S. Capitol Police, the U.S. Small Business Administration, the U.S. Bureau of Prisons, the Millennium Challenge Corporation, the U.S. Marshals Service, and the Bureau of Alcohol, Tobacco, Firearms and Explosives. Cotton & Company also assists numerous Federal agencies in preparing financial statements and improving financial management, accounting, and internal control systems.

Dave received a BS in mechanical engineering (1971) and an MBA in management science and labor relations (1972) from Lehigh University in Bethlehem, PA. He also pursued graduate studies in accounting and auditing at the University of Chicago, Graduate School of Business (1977 to 1978). He is a Certified Public Accountant (CPA), Certified Fraud Examiner (CFE), and Certified Government Financial Manager (CGFM).

Dave served on the Advisory Council on Government Auditing Standards (the Council advises the United States Comptroller General on promulgation of **Government Auditing Standards**—GAO's yellow book) from 2006 to 2009. He served on the Institute of Internal Auditors (IIA) Anti-Fraud Programs and Controls Task Force and co-authored **Managing the Business Risk of Fraud: A Practical Guide**. He served on the American Institute of CPAs Anti-Fraud Task Force and co-authored **Management Override: The Achilles Heel of Fraud Prevention**. He is the past-chairman of the AICPA Federal Accounting and Auditing Subcommittee and has served on the AICPA Governmental Accounting and Auditing Committee and the Government Technical Standards Subcommittee of the AICPA Professional Ethics Executive Committee. He authored the AICPA's 8-hour continuing professional education course, **Joint and Indirect Cost Allocations—How to Prepare and Audit Them**.

Dave served on the board of the Virginia Society of Certified Public Accountants (VSCPA) and on the VSCPA Litigation Services Committee, Professional Ethics Committee, Quality Review Committee, and Governmental Accounting and Auditing Committee. He is member of the Greater Washington Society of CPAs (GWSCPA) and serves on the GWSCPA Professional Ethics Committee. He is a member of the Association of Government Accountants (AGA) and past-advisory board chairman and past-president of the AGA Northern Virginia Chapter. He is also a member of the Institute of Internal Auditors and the Association of Certified Fraud Examiners.

Dave has testified as an expert in governmental accounting, auditing, and fraud issues before the United States Court of Federal Claims and other administrative and judicial bodies.

Dave has spoken frequently on cost accounting, professional ethics, and auditors' fraud detection responsibilities under SAS 99, *Consideration of Fraud in a Financial Statement Audit*. He has been an instructor for the George Washington University masters of accountancy program (**Fraud Examination and Forensic Accounting**), and instructs for the George Mason University Small Business Development Center (**Fundamentals of Accounting for Government Contracts**).

Dave was the recipient of the AGA's 2006 Barr Award ("to recognize the cumulative achievements of private sector individuals who throughout their careers have served as a role model for others and who have consistently exhibited the highest personal and professional standards") as well as AGA's 2012 Educator Award ("to recognize individuals who have made significant contributions to the education and training of government financial managers").

## Why Don't Your Auditors Find More Fraud?<sup>1</sup>

- A. Most auditors do not WANT to find fraud.
- B. Auditors are too visible to see direct evidence of fraud.
- C. Fraud is just too difficult to detect during an audit because of many factors.
- D. Auditors are not actually required or expected to find fraud.
- E. Fraud is a legal determination that is usually made after a lengthy and expensive investigation and prosecution.
- F. The most auditors can or should be expected to do is find indicia of potential fraud.
- G. All of the above.

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## Not-for-Profit Organizations and Fraud, Waste, and Abuse

**3**

## Are not-for-profits vulnerable to fraud?

Google

Web Images Maps Shopping News More ▾ Search tools

About 472,000 results (0.34 seconds)

Google

Web Images Maps Shopping More ▾ Search tools

About 509,000 results (0.38 seconds)

**4**

## Are not-for-profits vulnerable to fraud?

Google

Web Images Maps Shopping More ▾ Search tools

About 39,700,000 results (0.42 seconds)

Google

Web Images Maps Shopping News More ▾ Search tools

About 48,000,000 results (0.37 seconds)

## Why are not-for-profits vulnerable to fraud?

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- A. Weak internal control?
- B. Use of volunteers?
- C. Hiring employees on the basis of trust?
- D. No direct connection between inputs (\$\$) and outputs?
- E. Weak governance?
- F. An “it can’t happen here” attitude?

## Fraud Happens ...

6

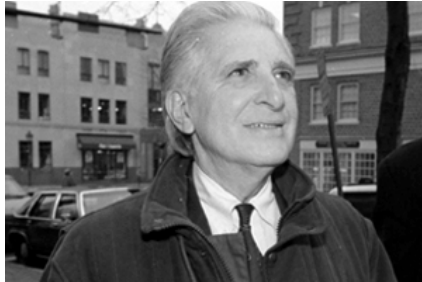
Four words precede EVERY fraud:

Eight words follow EVERY fraud:

Case Study

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## William Aramony and the United Way



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Case Study

8

## William Aramony and the United Way

- Aramony was CEO of the United Way of America from 1970 to 1992
- In 1992, Aramony, and two other United Way executives were indicted on 53 counts
- In 1995, Aramony was convicted on 23 counts including conspiracy to defraud, mail fraud, wire fraud, transportation of fraudulently acquired property, engaging in monetary transactions in unlawful activity, filing false tax returns, and aiding in the filing of false tax returns
- Sentenced to 8 years in prison; released in 2001
- Died in 2011

[[http://en.wikipedia.org/wiki/William\\_Aramony](http://en.wikipedia.org/wiki/William_Aramony)]

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## William Aramony and the United Way

*The Washington Post* November 14, 2011

- "... federal prosecutors charged, he used United Way money to support a luxurious lifestyle that included craps games in Las Vegas, frequenting velvet-rope dance clubs and eating lobster dinners in tony restaurants."
- "Prosecutors said his worst transgressions against United Way of America involved his relationship with Lori Villasor. She was 17 and Mr. Aramony was 59 and married when they began dating in 1986."
- "Mr. Aramony used United Way money to take vacations with Villasor and his other mistresses to Paris, London and Cairo. He bought his girlfriends manicures, bottles of champagne and bouquets of yellow roses. For Villasor, he purchased a fax machine so that she could send him love letters in his office."

## William Aramony and the United Way

- Needless to say, this scandal was not beneficial to United Way fundraising efforts
- Many local united ways took action to distance themselves from the national organization ...
- Including the United Way of the National Capital Area



Case Study

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## The United Way of the National Capital Area Ran this Full-Page Ad on April 3, 1992

DB Photo, April 3, 1992 The Washington Post

# They Look Alike *but* They're not the Same

**United Way**  
of the National Capital Area

**United Way**  
of America

**It's not just the fine print...**

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Case Study

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## The United Way of the National Capital Area Ran this Full-Page Ad on April 3, 1992

### Let's look at the facts.

**FACTS:**

- UNITED WAY OF the NATIONAL CAPITAL AREA is your local United Way whose sole purpose is to serve *this* community. It is one of over 2,000 *local* and *autonomous* United Ways across the nation.
- Your local United Way sees that more than 90 cents out of every dollar collected goes directly to services.

**FACTS:**

- UNITED WAY OF AMERICA is the national trade association for local United Ways. It is not a headquarters and neither raises nor allocates any funds.
- United Way of America sets no policy for local United Ways and is supported by dues of one percent from local United Ways.

**Our suspended dues will go to local services.**

We take our stewardship seriously. Our immediate response to this troubling controversy at the United Way of America was to suspend our payment of dues and call for a full and open investigation of the United Way of America and its spin-off operations.

In keeping with our dedication to serve this community, the suspended dues payments will now be made available for increased programs and services needed in our community.

Geoffrey Edwards Volunteers President United Way of the National Capital Area	Ronald Townsend Chairman of Trustees Assembly	Burt K. Fischer 1992 General Campaign Chairman	Sheldon W. Fantele Vice Chairman of Trustees Assembly and Campaign Advisory Chairman	Delano E. Lewis 1991 Campaign Chairman
Jean Ross Senior Vice President and Chairman of Membership and Allocations Committee	Rosa E. Byrd Alexandria Chairman	Mary Kay Parker Arlington Chairman	Gwendolyn E. Boyd District of Columbia Chairman	
Thomas D. Rust Fairfax-Falls Church Chairman	Paul C. Draine Loudoun Chairman	Jaqueline D. Simon Montgomery Chairman	Jane Gibson Prince George's Chairman	Kenneth Swenson Prince William Chairman

**United Way of the National Capital Area**

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## Case Study: *Orel Suer*



**Would you give your hard-earned money to this man?**



The Washington Post

May 1, 2004

## Ex-Chief Of Local United Way Sentenced



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The Washington Post

May 1, 2004

## Ex-Chief Of Local United Way Sentenced

- Former Chief of Area United Way Sentenced to 27 Months for Fraud
- Oral Suer pleaded guilty to defrauding the United Way of almost \$500,000 over a 6-7 year period

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The Washington Post

## Ex-Chief Of Local United Way Sentenced

May 15, 2004

- “ ... pleaded guilty in March to defrauding the charity of almost \$500,000.”
- “He admitted charging the organization for personal expenses such as bowling equipment and trips to Las Vegas, paying himself \$333,000 for annual leave he had already used and siphoning \$94,000 more than his share from the charity's pension plan.”

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The Washington Post

## Ex-Chief Of Local United Way Sentenced

May 1, 2004

- Lessons
  - Auditors and not-for-profits need to re-evaluate their focuses on *quantitative* materiality
  - Abuse is often the iceberg-tip that can reveal bigger problems (\$60,000 to sound-proof Orel's office *might* have been a good red flag)
  - Governance matters
  - It CAN happen to your organization.

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# The United Way of the National Capital Area Ran this Full-Page Ad on April 3, 1992

About that “90 cents of every donated dollar” promise ...

# The United Way of the National Capital Area Ran this Full-Page Ad on April 3, 1992

**Let's look at the facts**

**FACTS:**

- UNITED WAY of the NATIONAL CAPITAL AREA is your local United Way whose purpose is to serve this community. It is one of over 2,000 local and autonomous United Ways across the nation.
- Your local United Way sees that more than 90 cents out of every dollar collected goes directly to services.
- United Way of America sets no policy for local United Ways and is supported by dues of one percent from local United Ways.

**“Your local United Way sees that more than 90 cents out of every dollar collected goes directly to services.”**

**Our suspended dues will go to local services.**

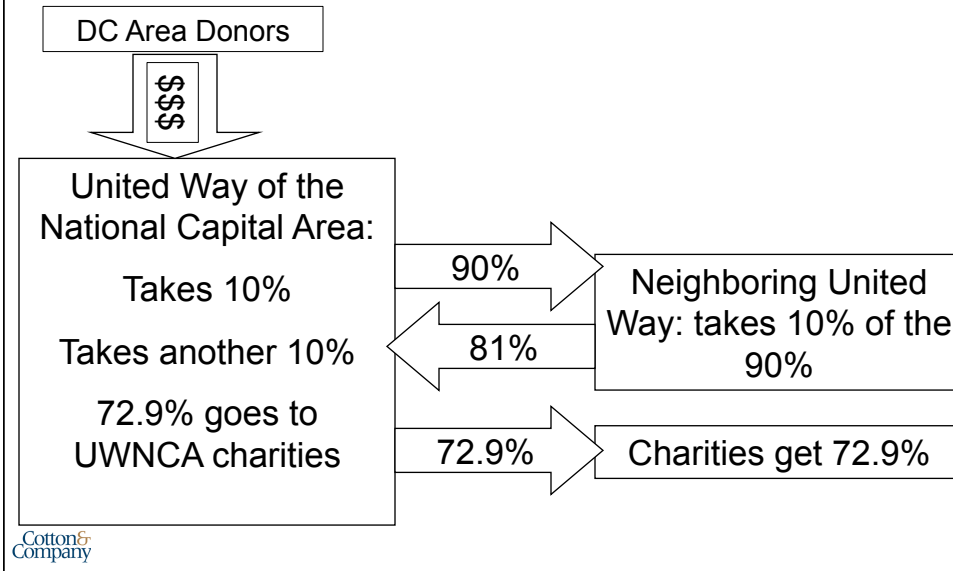
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**United Way of the National Capital Area**

## The Suer investigation revealed another scheme: Round-Tripping Receipts



## *The Case of the Trusted Treasurer*



Rita Crundwell

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## Rita Crundwell

- ◆ Born Jan 10, 1953
- ◆ Grew up on a family farm near Dixon, Illinois (population ~15,000; boyhood home of Ronald Reagan)
- ◆ Appointed treasurer/comptroller of Dixon in 1983
- ◆ Embezzled ~\$53 million from the city from 1990 to 2012
  - 1991--\$181,000;
  - 2008--\$5.8 million
- ◆ Arrested April 17, 2012
- ◆ Pled guilty on November 14, 2012
- ◆ Sentenced to 19 years and 7 months in prison on February 14, 2013

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**Dixon's 2012  
budget was  
~\$7 million**

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## How Did She Do It?

- ◆ Opened a bank account called Reserve Sewer Capital Development Account (RSCDA) with herself as the only signatory
- ◆ Moved City funds into a legitimate City account—Capital Development Account (CDA)
- ◆ Created phony invoices that she paid with CDA checks payable to “Treasurer”
- ◆ Deposited checks into the RSCDA
- ◆ Used funds to run her thoroughbred horse farm and business and on “prize-winning horses, expensive jewelry, luxury cars and even birthday bashes in Venice Beach, Fla.”\*

\*Source: [http://www.huffingtonpost.com/2013/02/06/rita-crundwell-sentencing\\_n\\_2633791.html](http://www.huffingtonpost.com/2013/02/06/rita-crundwell-sentencing_n_2633791.html)

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## How Did She Get Caught?

- ◆ While Rita was on vacation, another city employee stumbled upon the secret account.

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## Psychopath or Sociopath?



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## Psychopath or Sociopath?

... prosecutors noted that while Crundwell was stealing from the city, she repeatedly argued for painful spending cuts at budget meetings. She claimed the shortfalls were the result of an economic downturn and late payments from Illinois' state government, according to prosecutors.

"Day after day, for more than 20 years, (the) defendant would work with employees of the city of Dixon and interact with citizens in her capacity as comptroller while lying about the reason the city of Dixon lacked funds," U.S. Attorney Gary Shapiro wrote.

... the impact of the theft: Police could not afford to upgrade squad car radios or make new hires, streets could not be resurfaced, a waste water treatment facility had to be delayed and the city had to issue \$3 million in bonds to cover financial obligations.

"... prosecutors included a news article about Crundwell's 2010 birthday party in Venice Beach. Paid for with the help of stolen money, the party had live music, prime rib and jumbo shrimp cocktails.

"Rita was gorgeous as always in one of her trademark 'must have' coats," said the article in GoHorseShow.com.

Source: [http://www.huffingtonpost.com/2013/02/06/rita-crundwell-sentencing\\_n\\_2633791.html](http://www.huffingtonpost.com/2013/02/06/rita-crundwell-sentencing_n_2633791.html)

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[http://www.nbcnews.com/video/rock-center/  
49113424#49113424](http://www.nbcnews.com/video/rock-center/49113424#49113424)

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### Dixon, IL – Outcomes

- ◆ Attorneys fees for investigating the fraud and negotiating settlements with accounting firms and the bank totaled \$10 million
- ◆ Settlement with CliftonLaronAllen (the CPA firm that assisted Dixon with accounting and financial management): \$35.15 million
- ◆ Settlement with Janis Card Associates (the CPA firm that performed Dixon’s annual audit since 2006): \$1 million
- ◆ Settlement with Fifth Third Bank (the bank where Dixon’s accounts were maintained and where Crundwell set up the bogus account): \$3.85 million

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### Dixon, IL – Outcomes

- ◆ Bottom Line:
  - Amount misappropriated by Crundwell: ~\$54 million
  - Attorneys fees: ~\$10 million
  - Loss to Dixon: ~\$64 million
  - Recovery from sale of Crundwell assets: ~\$10 million
  - Settlement with CliftonLarsonAllen: ~\$35 million
  - Settlement with Janis Card Associates: ~\$1 million
  - Settlement with Fifth Third Bank : ~\$4 million
  - Dixon’s net monetary loss: ~\$14 million

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*What control procedure(s)  
would have thwarted Rita's  
fraud?*

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## *Fraud Deterrence, Prevention and Detection*

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- The Magnitude of Fraud
- Historical Perspective on Anti-Fraud Guidance
- Managing the Business Risk of Fraud: A Practical Guide
  - Anti-Fraud Principles
  - Fraud Risk Governance
  - Roles and Responsibilities
  - Fraud Risk Assessment
  - Fraud Prevention and Detection
  - Investigation and Corrective Action
  - Appendices

## The Magnitude of Fraud

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**REPORT TO THE NATIONS**  
ON OCCUPATIONAL FRAUD AND ABUSE  
2014 Global Fraud Study

Costs

Schemes

Detection

Victims

Perpetrators

## The Magnitude of Fraud

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- The typical organization loses 5% of its revenues to fraud each year [global loss to fraud ~\$3.7 trillion]
- Median loss caused by fraud in the cases studied was ~\$145,000
- Frauds lasted a median of 18 months before being detected
- Asset misappropriation:
  - 85% of cases; median loss ~\$130,000
- Financial statement (managerial) fraud:
  - 9% of cases; median loss of ~\$1 million
- Corruption schemes:
  - 37% of cases; median loss of \$200,000

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## The Magnitude of Fraud

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- Most common means of detection: tips from employees of the victim organization-- > 40% of cases
- Corruption and billing schemes pose the greatest risk
- Fraud is a significant threat to small businesses, with disproportionate losses
- Most commonly victimized industries:
  - Banking and financial services
  - Government and public administration
  - Manufacturing
- Presence of anti-fraud controls notably correlated with decreases in the cost and duration of frauds
- Perpetrators with higher levels of authority tend to cause much larger losses
- The longer a perpetrator has been with an organization, fraud losses tend to be higher

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## The Magnitude of Fraud

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- 77% of frauds committed by individuals in one of seven departments:
  - Accounting
  - Operations
  - Sales
  - Executive/upper management
  - Customer service
  - Purchasing
  - Finance
- Collusion results in higher losses: 1 perp, median loss \$80,000; 2 perps, \$200,000; 3 perps, \$355,000; 4 or more perps, > \$500,000

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## The Magnitude of Fraud

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- Organizations with hotlines are **MUCH** more likely to detect fraud by tips
- Organizations with hotlines had frauds that were 41% less costly
- Organizations with hotlines detected frauds 50% more quickly

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## The Magnitude of Fraud

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- In 92% of cases, the perpetrator displayed one or more red flags:
  - Living beyond means—43.8% of cases
  - Financial problems—33.0% of cases
  - Unusually close association with vendors/customers—21.8% of cases
  - Excessive control issues—21.1% of cases
  - “Wheeler-Dealer” attitude—18.4% of cases
- 58.4% of victim organizations do not recover ANY losses suffered

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## ACFE Conclusions

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- Fraud is universal
- Fraud reporting mechanisms—hotlines—are critical to effective anti-fraud programs
- External audits are useful in deterrence, but detect very few (~3%) frauds
- Fraud awareness training is critical to preventing and detecting fraud
- Small businesses are particularly vulnerable
- Most fraudsters exhibit behavioral red flags
- The cost of fraud—financially and reputationally—can be devastating

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## The Magnitude of Fraud

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### REPORT TO THE NATIONS

ON OCCUPATIONAL FRAUD AND ABUSE

2014 Global Fraud Study

Costs

Schemes

Detection

Victims

Perpetrators

<http://www.acfe.com/rtnn.aspx>

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## Our Focus as Auditors

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*Is it in the right place?*

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What do all of these entities  
have in common?

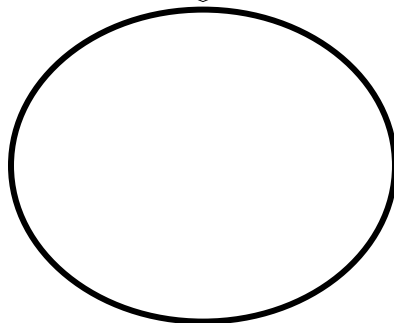


Most of the recent high-  
profile cases have been  
management fraud cases ...

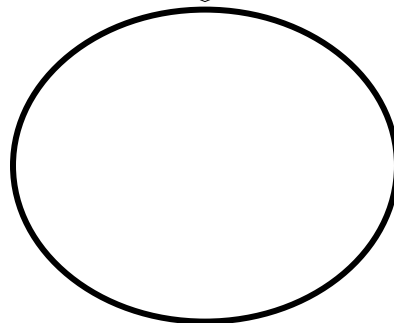
Are we doing enough to  
deter/prevent/detect  
management fraud cases or  
are we devoting too much  
time looking for small dollar  
thefts?

Fraud Types Per SAS 16, 53, 82, and 99

**Misappropriation  
of Assets**

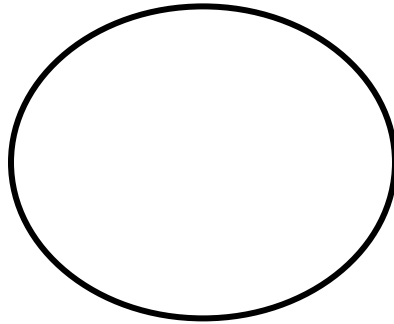


**Fraudulent  
Financial Reporting**

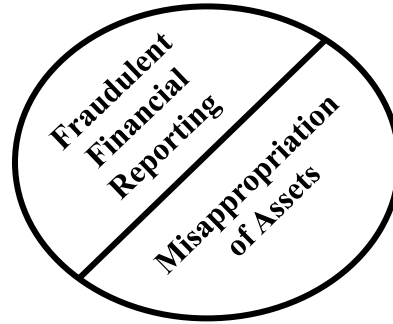


## A Better Delineation of Fraud Types

**Misappropriation  
of Assets**

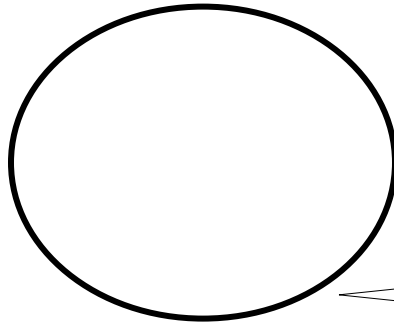


**Management  
Fraud/Override**

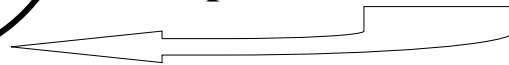


## A Better Delineation of Fraud Types

**Misappropriation  
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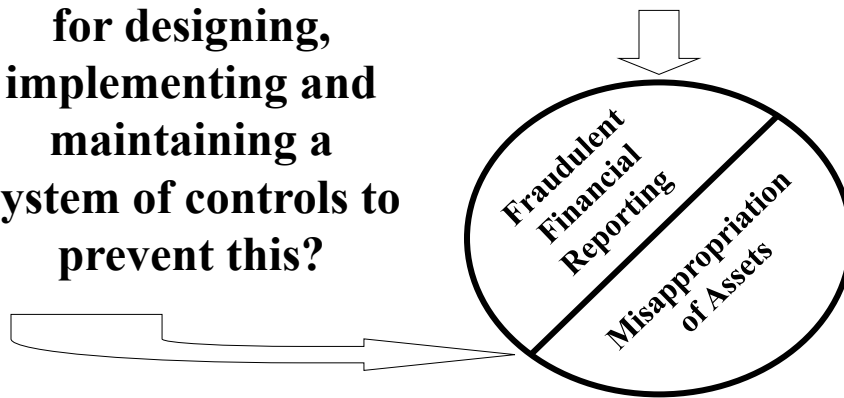
**Management is  
responsible for  
designing,  
implementing and  
maintaining a  
system of controls to  
prevent this**



## A Better Delineation of Fraud Types

**Who is responsible  
for designing,  
implementing and  
maintaining a  
system of controls to  
prevent this?**

**Management  
Fraud/Override**



Governance

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*How Important Is It?*

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# The Washington Post

SUNDAY, FEBRUARY 25, 2007

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## Smithsonian Head's Expenses 'Lavish,' Audit Says

By JAMES V. GRIMALDI  
*Washington Post Staff Writer*

**Board Calls Small's Charges 'Reasonable'**

Lawrence M. Small, the top official at the Smithsonian Institution, accumulated nearly \$90,000 in unauthorized expenses from 2000 to 2005, including charges for chartered jet travel, his wife's trip to Cambodia, hotel rooms, luxury car service, catered staff meals and expensive gifts, according to confidential findings by the Smithsonian inspector general.

"Many transactions were not properly documented or were not in accordance with Smithsonian policies," acting Inspector General A. Sprightley Ryan wrote on Jan. 16 to the Smithsonian Board of Regents Audit and Review Committee. "Some transactions might be considered lavish or extravagant."

Small, who in 2000 became the 11th Smithsonian secretary, will

earn \$915,698 this year in total compensation — more than that of the outgoing president of Harvard University, which has an endowment about 30 times the size of the Smithsonian's. Over the past seven years, Small has also received \$1.15 million for making his house available for official functions.

Small declined an interview. "Mr. Small is not going to talk about his

own compensation," said Smithsonian spokeswoman Linda St. Thomas. "The regents determine all secretaries' compensation."

Small, 65, reports to the institution's 17-member Board of Regents, which referred the inspector general's findings to its audit committee, made up of four regents. The board last month accepted the committee's decision to dismiss the findings and defended Small's expenses

*See SMITHSONIAN, A6, Col. 1*

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## The Smithsonian Board

- John G. Roberts, Jr., Chief Justice of the United States
- Richard B. Cheney, Vice President of the United States
- Thad Cochran, Senator from Mississippi
- Christopher Dodd, Senator from Connecticut
- Patrick J. Leahy, Senator from Vermont
- Xavier Becerra, Representative from California
- Sam Johnson, Representative from Texas
- Doris Matsui, Representative from California
- Eli Broad, Chairman of AIG Retirement Services, Inc.
- Anne d' Harnoncourt, Chief Executive Officer, Philadelphia Museum of Art
- Phillip Frost, former Chairman and CEO of IVAX Corporation
- Shirley Ann Jackson, President of Rensselaer Polytechnic Institute
- Robert P. Kogod, former CEO of the Charles E. Smith Companies
- Walter E. Massey, President of Morehouse College
- Roger W. Sant, Chairman Emeritus of The AES Corporation
- Alan G. Spoon, Managing General Partner of Polaris Venture Partners
- Patricia Q. Stonesifer, President of the Bill & Melinda Gates Foundation

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Can we rely on “those charged with governance” to stop fraud and abuse?

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## Historical Perspective on Anti-Fraud Guidance

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- 2000-2002 were traumatic years for the accountability profession
  - Enron, WorldCom, Tyco, Global Crossing, Waste Management, Baptist Foundation of America, Peregrine, AOL/Time Warner, HealthSouth, Adelphia, IMClone
  - Demise of Arthur Andersen
- In 2002, the AICPA, ACFE, and IIA formed a task force: *The Antifraud Programs and Controls Task Force*

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**Antifraud Programs and Controls Task Force**

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Ronald L. Durkin, *Chair*  
KPMG LLP

Dan L. Goldwasser  
Vedder, Price, Kaufman, & Kammholz, PC  
Audit Committee member

Mark Beasley  
North Carolina State University

Ronald B. Norris  
The Estée Lauder Companies Inc.

Toby J.F. Bishop  
Association of Certified  
Fraud Examiners

Zoe-Vonna Palmrose  
University of Southern California

David Cotton  
Cotton & Company LLP

Thomas M. Stemplar  
Arthur Andersen LLP (retired)  
Audit Committee member

George P. Fritz  
PricewaterhouseCoopers LLP (retired)  
Accounting & Auditing Consultants LLC

**AICPA Staff**

Charles E. Landes  
*Director*  
*Audit and Attest Standards*

Michael P. Glynn  
*Technical Manager*  
*Audit and Attest Standards*



## Historical Perspective on Anti-Fraud Guidance

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- The Task Force's Mandate: develop "attestable criteria" for an organization to follow in implementing anti-fraud programs and controls
- The Task Force rebelled against that mandate
  - More immediately important guidance was needed
  - Recent catastrophic frauds (Enron, WorldCom, Tyco, Global Crossing, Waste Management, Baptist Foundation of America, Peregrine, AOL/Time Warner, HealthSouth, Adelphia, IMClone) ***ALL*** caused by management override of internal control



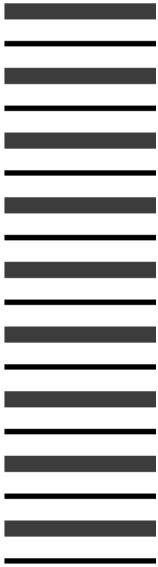
## New Guidance for Audit Committees

AICPA

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS


**MANAGEMENT  
OVERRIDE  
OF INTERNAL  
CONTROLS:**  
The Achilles' Heel  
of Fraud Prevention

The Audit Committee  
and Oversight of  
Financial Reporting



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Published in 2005




## Management Override: The Achilles' Heel of Internal Control

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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS


**MANAGEMENT  
OVERRIDE  
OF INTERNAL  
CONTROLS:**  
The Achilles' Heel  
of Fraud Prevention

The Audit Committee  
and Oversight of  
Financial Reporting



### TARGET AUDIENCE:

Those Charged with  
Governance






## Management Override: The Achilles' Heel of Internal Control

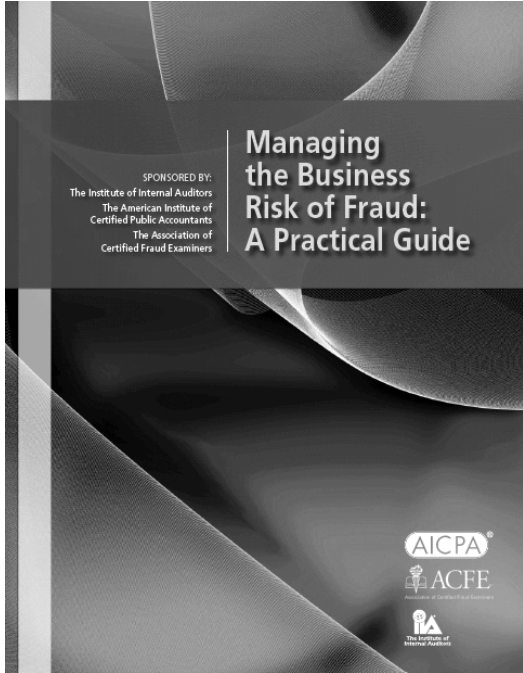
- The Audit Committee's Responsibilities
- Actions to Address the Risk of Management Override of Internal Controls
  - Maintaining Skepticism
  - Strengthening Committee Understanding of the Business  
Brainstorming to Identify Fraud Risks
  - Using the Code of Conduct to Assess Financial Reporting Culture
  - Cultivating a Vigorous Whistleblower Program
  - Developing a Broad Information and Feedback Network
- Appendix: Suggested Audit Committee Procedures: Strengthening Knowledge of the Business and Related Financial Statement Risks
  - Incentives or Pressures on Management
  - Opportunities Management Can Exploit

## A Restructured Task Force then Went Back to the Future <sup>62</sup>

- Under IIA leadership (President Dave Richards), a reconstituted task force returned to the original (attestable criteria) mandate

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*Is your organization fully  
committed to protecting  
stakeholder assets?*



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## Managing the Business Risk of Fraud: A Practical Guide

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## Managing the Business Risk of Fraud: A Practical Guide

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## Anti-Fraud Principles

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- Principle 1:** As part of an organization’s governance structure, a fraud risk management program should be in place, including a written policy (or policies) to convey the expectations of the board of directors and senior management regarding managing fraud risk.
- Principle 2:** Fraud risk exposure should be assessed periodically by the organization to identify specific potential schemes and events that the organization needs to mitigate.

## Anti-Fraud Principles

Principle 3: Prevention techniques to avoid potential key fraud risk events should be established, where feasible, to mitigate possible impacts on the organization.

Principle 4: Detection techniques should be established to uncover fraud events when preventive measures fail or unmitigated risks are realized.

Principle 5: A reporting process should be in place to solicit input on potential fraud, and a coordinated approach to investigation and corrective action should be used to help ensure potential fraud is addressed appropriately and timely.

## Wait, what happened to deterrence?

Fraud deterrence is a direct result and product of the organization making it known that it has:

- Written fraud risk management policies
- Performed a fraud risk assessment
- Strong prevention controls in place
- Strong detection controls and mechanisms in place
- Zero tolerance for fraud

## Fraud Risk Governance

- The governance body should
  - Set the tone at the top
  - Ensure that management is fully committed to the antifraud program
  - Monitor the effectiveness of the antifraud program
- A single, executive-level individual should be held responsible and accountable for the antifraud program
- The antifraud program should be documented

## Fraud Risk Governance

- Who should be involved?
  - Board of directors
  - Audit committee
  - Management
  - Staff
  - Internal audit

## Antifraud Program Documentation

- Roles and responsibilities
- Commitment
- Fraud awareness
- Affirmation process
- Conflict disclosure
- Fraud risk assessment
- Reporting procedures and whistleblower protection
- Investigation process
- Corrective action
- Quality assurance
- Continuous monitoring

## Fraud Risk Assessment

Different organizations face different fraud risks:

- Retail
- Manufacturing
- Service
- Governmental
- Academic
- Not-for-profit
- Centralized, decentralized
- Large, small
- New, mature
- Public, private

## Fraud Risk Assessment

Should include (at a minimum):

- Risk identification
  - Employee and management incentives, pressures, opportunities
  - Potential override of controls
  - Internal and external threats
- Identification of all *inherent risks*
- Assessment of *risk likelihood*
- Assessment of *risk significance*
  - Monetary
  - Legal and regulatory
  - Reputation
- Risk response

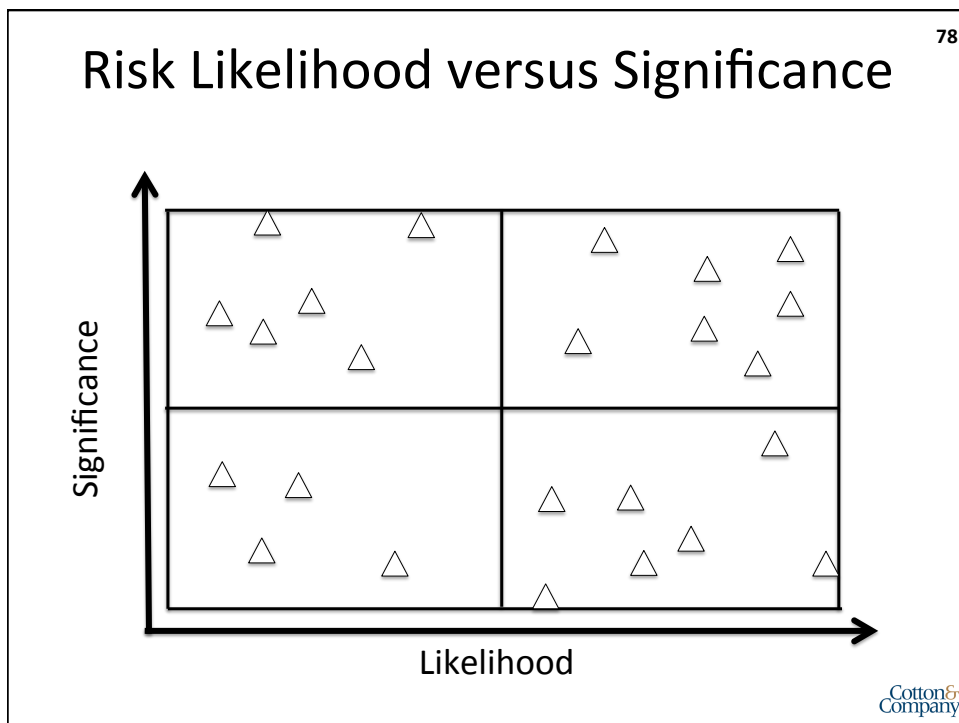
## Risk Assessment

- Risk assessment team
  - Accounting/finance
  - Nonfinancial business unit and operations
  - Risk management
  - Legal and compliance
  - Internal audit
  - External consultants
- Brainstorm to identify risks
  - Fraud triangle (motive—opportunity—attitudes)
  - Override of controls
  - Misappropriation of assets
  - Fraudulent financial reporting
  - Corruption
  - Regulatory and legal
  - Reputation



## Fraud Risk Assessment Documentation Framework 77

Identified Fraud Risks and Schemes	Likelihood	Significance	People and/or Department	Existing Anti-fraud Controls	Controls Effectiveness Assessment	Residual Risks	Fraud Risk Response
<i>Financial reporting</i> Revenue recognition - Backdating agreements - Channel stuffing - Inducing distributors to accept more product than necessary - Holding books open - Via recording detail transactions in a sub-ledger - Via recording top-side journal entries - Additional revenue risks							



## Organizational Risk Tolerance

- Mitigate the risk to varying degrees;
- Accept the risk—but monitor exposure;
- Design specific procedures to deal with each specifically-identified risk
- Follow a structured rather than haphazard approach
- Benefits should exceed costs
- “Zero tolerance for fraud” vs “zero tolerance” when fraud happens

## Prevention versus Detection

- **If we have sufficient prevention controls in place, do we even need any detection controls?**
- Theoretically, we should be able to design procedures to address *every* risk and thereby prevent *every* fraud.

## Prevention versus Detection

- Is it actually possible to identify *every* fraud risk?
- Prevention controls come with a cost
  - Monetary
  - Interference with business processes and objectives
    - **Example:** to prevent shoplifting, let's not allow customers to take any shopping or handbags into our store; let's install CCTV in dressing rooms; etc.

## Fraud Risk Assessment Documentation Framework

Identified Fraud Risks and Schemes	Likelihood	Significance	People and/or Department	Existing Anti-fraud Controls	Controls Effectiveness Assessment	Residual Risks	Fraud Risk Response
<i>Financial reporting</i> Revenue recognition - Backdating agreements - Channel stuffing - Inducing distributors to accept more product than necessary - Holding books open - Via recording detail transactions in a sub-ledger - Via recording top-side journal entries - Additional revenue risks							

Some are prevention controls; some are detection controls

## Fraud Prevention

- An important prevention (and deterrence) key is making everyone aware that the organization is actively engaged in fraud risk management. (Fear of getting caught is always a strong deterrent.)
- Internal control processes and procedures are the first line of defense against fraud; but may not adequately address fraud risks.

## Fraud Prevention Policies/Procedures

- Human resources measures
  - Background investigations
  - Anti-fraud training
  - Evaluating performance and compensation programs
  - Conducting exit interviews
- Appropriate authority limits
- Related-party transactions

## Fraud Prevention

- Document fraud prevention techniques, roles, and responsibilities

## Fraud Prevention Technique Documentation

Identified Fraud Risks and Schemes	Prevention Control/ Technique	Responsible Person(s)

From the  
Fraud Risk  
Assessment

## Fraud Prevention

- Document fraud prevention techniques, roles, and responsibilities
- Assessing the fraud prevention program (See Scorecard)

## *Preventing Fraud, Waste, and Abuse*

### APPENDIX D: FRAUD PREVENTION SCORECARD

To assess the strength of the organization's fraud prevention system, carefully assess each area below and score the area, factor, or consideration as either:

- Red: indicating that the area, factor, or consideration needs substantial strengthening and improvement to bring fraud risk down to an acceptable level.
- Yellow: indicating that the area, factor, or consideration needs some strengthening and improvement to bring fraud risk down to an acceptable level.
- Green: indicating that the area, factor, or consideration is strong and fraud risk has been reduced — at least — to a minimally acceptable level.

Each area, factor, or consideration scored either red or yellow should have a note associated with it that describes the action plan for bringing it to green on the next scorecard.

Fraud Prevention Area, Factor, or Consideration	Score	Notes
Our organizational culture — tone at the top — is as strong as it can possibly be and establishes a zero-tolerance environment with respect to fraud.		
Our organization's top management consistently displays the appropriate attitude regarding fraud prevention and encourages free and open communication regarding ethical behavior.		
Our Code of Organizational Conduct has specific provisions that address and prohibit inappropriate relationships whereby members of our board or members of management could use their positions for personal gain or other inappropriate purposes.		

## Fraud Prevention

- Document fraud prevention techniques, roles, and responsibilities
- Assessing the fraud prevention program (See Scorecard)
- Continuous monitoring of prevention controls
  - Separate from routine audits
  - Consider independent reviews

## Fraud Detection

- Conceptually, we allow for the fact that some frauds may get through the prevention controls
- Strong detection controls assure that frauds get discovered quickly, and before they become large
- **Visible and known** detection controls also support deterrence
- Having **“clandestine”** detection controls provides further deterrence
  - Occur in the ordinary course of business.
  - Draw on external information to corroborate internally generated information.
  - Formally and automatically communicate identified deficiencies and exceptions to appropriate leadership.
  - Use results to enhance and modify other controls.

## Fraud Detection

- Whistleblower hotlines—essential to organizations with a strong commitment to fraud detection
  - Expensive
  - Must provide for anonymity
  - All calls must be taken seriously
  - Periodic reports summarizing calls and results should be distributed to senior management and the governing board

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Jun 9, 2014 - "Annual report fulfillment and Whistleblower services are a key part of ...  
Whistleblower telephony and web-based report capture system for the ...

on  
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## Fraud Detection

- Process controls
  - Reconciliations
  - Independent reviews
  - Physical inspections/counts
  - Analyses
  - Audits

## Fraud Detection

- Proactive detection procedures
  - Data analysis
  - Digital analysis
  - Data mining
  - Continuous auditing
  - Email monitoring
  - Change procedures as technology changes

## Fraud Detection Documentation

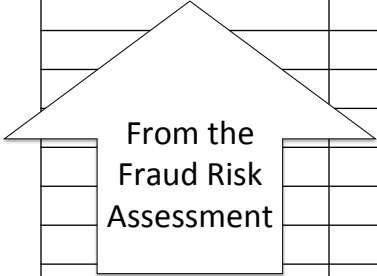
- Designate and document individuals and departments responsible for:
  - Designing and planning the overall fraud detection process.
  - Designing specific fraud detection controls.
  - Implementing specific fraud detection controls.
  - Monitoring specific fraud detection controls and the overall system of these controls for realization of the process objectives.
  - Receiving and responding to complaints related to possible fraudulent activity.
  - Investigating reports of fraudulent activity.
  - Communicating information about suspected and confirmed fraud to appropriate parties.
  - Periodically assessing and updating the plan for changes in technology, processes, and organization.


## Fraud Detection

- Document fraud detection techniques, roles, and responsibilities

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## Fraud Detection Technique Documentation


Identified Fraud Risks and Schemes	Detection Control/Technique	Responsible Person(s)
 <p>From the Fraud Risk Assessment</p>		



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## Fraud Detection

- Document fraud detection techniques, roles, and responsibilities
- Assessing the fraud detection program (See Scorecard)



## Detecting Fraud, Waste, and Abuse

### APPENDIX G: FRAUD DETECTION SCORECARD

To assess the strength of the organization's fraud detection system, carefully assess each area below and score the area, factor, or consideration as:

- Red: indicating that the area, factor, or consideration needs substantial strengthening and improvement to bring fraud risk down to an acceptable level.
- Yellow: indicating that the area, factor, or consideration needs some strengthening and improvement to bring fraud risk down to an acceptable level.
- Green: indicating that the area, factor, or consideration is strong and fraud risk has been reduced — at least — to a minimally acceptable level.

Each area, factor, or consideration that scores either red or yellow should have a note associated with it that describes the action plan for bringing it to green on the next scorecard.

Fraud Prevention Area, Factor, or Consideration	Score	Notes
We have integrated our fraud detection system with our fraud prevention system in a cost-effective manner.		
Our fraud detection processes and techniques pervade all levels of responsibility within our organization, from the board of directors and audit committee, to managers at all levels, to employees in all areas of operation.		
Our fraud detection policies include communicating to employees, vendors, and stakeholders that a strong fraud detection system is in place, but certain critical aspects of these systems are not disclosed to maintain the effectiveness of hidden controls.		

## Fraud Detection

- Document fraud detection techniques, roles, and responsibilities
- Assessing the fraud detection program (See Scorecard)
- Continuous monitoring of detection controls
  - Separate from routine audits
  - Consider independent reviews

## Some Policies/Procedures Can Promote<sup>101</sup> Deterrence, Prevention, and Detection

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*ABC is committed to honesty and transparency in business relationships. If any employee or agent of ABC asks you—either explicitly or implicitly—for anything of value in return for this contract or purchase order, please contact Mr. John Honest, Senior Vice President for Business Integrity, at 444-555-2323, or [jhonest@abc.com](mailto:jhonest@abc.com) immediately.*

## Fraud Investigation and Corrective Action<sup>102</sup>

- Do not wait until your organization has been victimized to decide what to do; have protocols in place well in advance.
- Action taken must be swift.
- Punitive actions must be appropriate.
- Punitive actions should, whenever possible, be made known to everyone.
- The same rules should be applied to everyone, ***including senior management.***

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## Fraud Investigation and Corrective Action

Investigation protocols must consider:

- Time-sensitivity.
- Notification.
- Confidentiality.
- Legal privileges.
- Compliance.
- Securing evidence.
- Objectivity.
- Goals.

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## Fraud Investigation and Corrective Action

The investigation team may include:

- Legal counsel.
- Fraud investigators.
- Internal auditors.
- External auditors.
- Accountants or forensic accountants.
- HR personnel.
- Security or loss prevention personnel.
- IT personnel.
- Computer forensics specialists.
- Management representative.

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## Fraud Investigation and Corrective Action

Possible corrective actions:

- Criminal referral.
- Civil action.
- Disciplinary action.
- Insurance claim.
- Extended investigation.
- Business process remediation.
- Internal control remediation.

## Not Quite Sure You Need This?

- ✓ Download the Guide
- ✓ Go to the Scorecards [Appendices F (Prevention) and G (Detection)]
- ✓ Self-assess at your next senior staff or governing board meeting (30-45 minutes)
- ✓ See how much **RED** there is in your organization ...
- ✓ Then decide ...

## Concluding Comments

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- Fraud is not a subject that any organization wants to deal with, but the reality is most organizations experience fraud to some degree.
- Dealing with fraud can be constructive, and forward-thinking, and can position an organization in a leadership role within its industry or business segment.
- Strong, effective, and well-run organizations exist because management takes proactive steps to anticipate issues before they occur and to take action to prevent undesired results.
- Implementation of this guide should help establish a climate where positive and constructive steps are taken to protect employees and ensure a positive culture.
- The dynamics of any organization require an ongoing reassessment of fraud exposures and responses in light of the changing environment the organization encounters.

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## ***Fraud Deterrence, Prevention and Detection***

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