

Fraud Detection and Prevention: Keeping Honest People Honest



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Agenda

1. The Fraud Triangle
2. Internal Controls
 - a. Preventive Controls
 - b. Detective Controls
3. Why internal controls often fail
4. Effective internal control systems

The COSO Model



Part 1: Keeping Honest People Honest

After angrily turning down a bribe, 'Honest Abe' Lincoln declared, "Every man has his price, and he was getting close to mine."



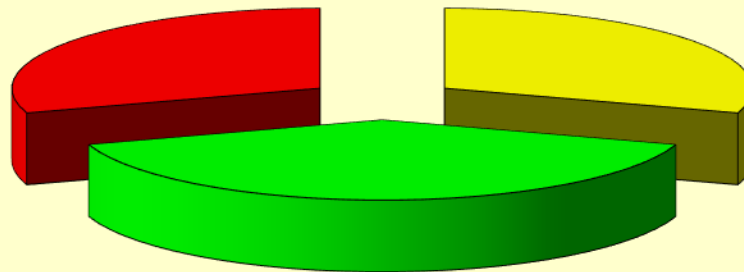
Likelihood workers will steal:

Dishonest

Honest

**Will steal
30%**

**Won't steal
30%**



Might steal, 40%

**Situationally
honest**

Why do people steal?

The Fraud Triangle

Rationalization

Justification of
dishonest actions.

FRAUD

Opportunity

Ability to carry out
misappropriation of cash
or organizational assets.

Pressure

Motivation or incentive
to commit fraud.

Opportunity

- Typically exploit job duties and responsibilities
- Perpetrators who think they will be caught rarely commit fraud
- Perception of detection is best deterrent to fraud



Opportunity-providing factors

- Inadequate internal controls
- Inability to judge the quality of work
- Lack of discipline
- Lack of access to information
- No audit trail
- Ignorance or apathy



Financial Pressure

- The right amount of financial pressure can induce even honest people to steal.
- Employees under pressure should not be given the opportunity to steal.



Common Financial Pressures

- Living beyond one's means
- Debt from vices:
 - Sex
 - Gambling
 - Drugs
- Poor credit
- Unexpected financial needs



Rationalization

A fraudster must be able to justify the fraud in order to make the fraudulent actions consistent with his/her personal code of conduct.



Common Rationalizations

- “I’m only borrowing the money; I’ll pay it back.”
- “Everyone does it, besides the owner can afford it.”
- “I’m not hurting anyone.”
- “It’s for a good purpose.”
- “It’s not that serious.”
- “They owe it to me. I deserve to get paid more.”

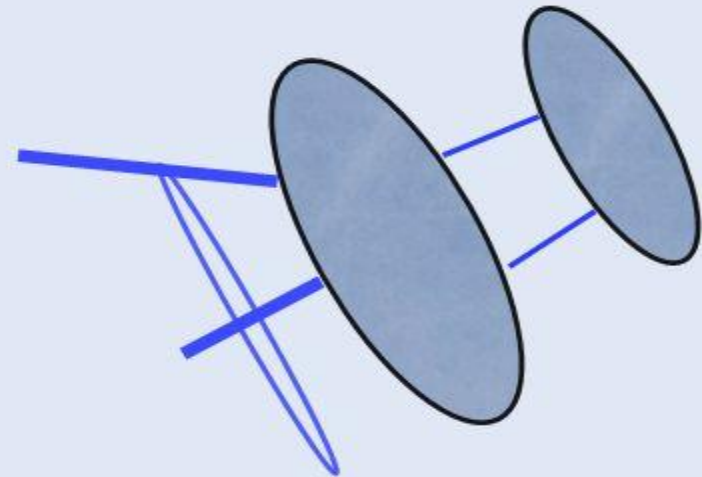


Fraud prevention tip

You can prevent fraud by eliminating any one of the points of the fraud triangle:

- Opportunity
- Pressure
- Rationalization

The Fraud Triangle as a Three Legged Stool



Take Away a Leg.....

Fraud and Internal Controls

- Most internal fraud schemes exploit one or more deficiencies in basic internal controls.
- Best way to prevent internal theft:
Implement and adhere to basic internal controls!



Types of internal controls

1. *Preventive controls*—Stop problems before they happen
2. *Detective controls*—Find problems after they happen



Preventive control examples

1. Physical safeguards like safes, locked rooms, and fences
2. Proper segregation of duties
3. Limited access to information system
4. Employment screening



Detective control examples

1. Variance reports
2. Reconciliations
3. Periodic audits
4. Examining check images



Why Internal Controls Often Fail

1. Not enforced or monitored
2. Poorly designed
3. Circumvented by dishonest employees



1. Not enforced or monitored

Problem:

Organizational failure to enforce/monitor compliance with controls

Solution: Actively monitor compliance with controls



Case #1: MDMS company

- MDMS is a provider of short-term loans (*aka payday loans*), retail financing, and other credit-related products.
- It employs about 55 people in 17 locations across two states.
- It is audited by Smith & Buckley, LLP—a Top 50 CPA firm with 12 offices in four states.



MDMS Background

- 1. Beverly, bookkeeper, embezzled \$2 million and ‘hung her debit’ in loan receivables.**
- 2. Jennifer, manager, knew about it, did nothing except earn a 5% commission on *bogus* loans.**
- 3. Robert, supervisor, discovered irregularities and visited the SB office.**



MDMS 'Irregularities'

- 1. Excessive # of loans with changed due dates**
- 2. Use of Robert's password without his consent**
- 3. Irregular loans lacked required documentation**



MDMS criminal action

- 1. Beverly tearfully confessed to Robert, then committed suicide**
- 2. Jennifer confessed, denied criminal intent**
 - a. Convicted of 'theft by taking as a fiduciary'**
 - b. Sentence to 15 years prison**
 - c. Ordered to pay \$1.92 million in restitution**



2. Poorly designed

Problem: Controls are poorly designed

Solution: Controls should be designed such that they achieve their intended objectives



Design FAIL

Don't blame us - it's not our fault!

Case #2: Stealing from a church?!

Senior Minister engaged us to conduct a forensic audit of the cash receipts and disbursements in connection with recent irregularities.



Engagement mandates

- 1. Examine existing controls over cash receipts and disbursements and identify any deficiencies.**
- 2. Develop and test fraud theories that would exploit those deficiencies.**
- 3. Recommend policies and procedures that will correct those deficiencies.**

Cash receipts

1. Audit team attended Sunday worship services to observe the donation collection process.
2. What is the huge deficiency in this process?



Cash receipts deficiencies

- 1. Member can make donations without completing a donation slip.**
- 2. The collected contributions put into the safe on Sunday are not counted by the two security officers.**
- 3. On Monday, Chelsea is left alone to count, process, record, and deposit the collected contributions.**

Fraud theory #1

In the past, Chelsea has stolen from the anonymous cash plate offerings.

Findings:

- 1.** Background Report contained nothing to suggest that Chelsea is living an extravagant lifestyle.
- 2.** Chelsea responded to three fraud assessment questions in a manner consistent with someone who is stealing from the church.
- 3.** Senior Minister would not allow us to examine Chelsea's personal bank statements.

Conclusion: High risk of fraud

Fraud assessment questions

- 1.** How could somebody steal from the church and get away with it?
- 2.** What punishment is appropriate for someone caught stealing from the church?
- 3.** Do you think they should be given a second chance?



Question

- **Do the Findings provide sufficient evidence to prove that Chelsea has been stealing?**
- **What should the next investigative step be?**



Cash Disbursement deficiencies

- No Approved Vendor List
- No Purchase Order system
- Receipt of items purchased not documented
- Check requests approved/signed by person submitting them.
- Inadequate supporting documentation for check requests (*e.g. no itemized receipts*)
- Signed checks are returned to the person who prepared them.
- Hundreds of thousands of dollars paid to many related-party vendors.



Fraud theory #2

The Church has made payments to vendors for inflated prices or for which nothing was received.

Findings:

- 1.** We found 19 vendor payment irregularities, including numerous undisclosed related-party transactions.
- 2.** Lack of documentation and poor record keeping practices made it difficult to test this fraud theory.
- 3.** Three employees responsible for approving vendor payments are under significant financial pressure and answered assessment questions suspiciously.

Conclusion: High risk of fraud

Question

- **Do the Findings provide sufficient evidence to prove vendor fraud?**
- **What should the next investigative step be?**



Church Epilogue

- **The Executive Director (a CPA) and two employees were fired.**
- **Recommendations were implemented, except one.**
- **No one prosecuted.**



3. Circumvented by dishonest employees

Problem: Controls are circumvented by dishonest employees

Solution: Employment screening should ferret out dishonest applicants

Employment Screening



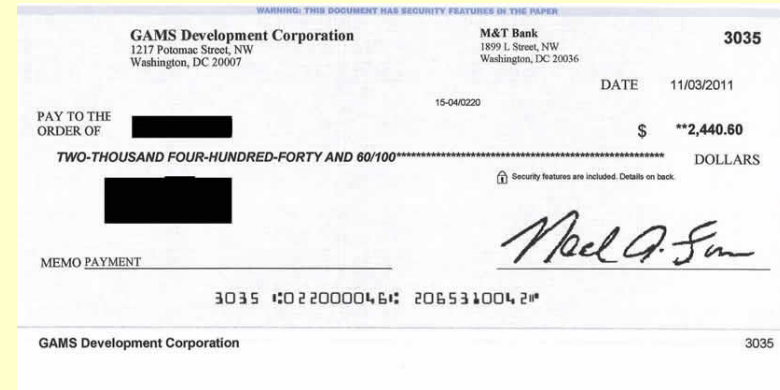
Case #3: Archdiocese of NY

- Anita Collins embezzled more than \$1 million over 7 years from the Archdiocese of New York.
- When hired she had already been twice convicted of grand larceny and was on probation.
- She stole money in all but one month of 7+ years.



Hid fraud in vendor payments

- She issued 468 checks to “KB Collins,” the initials of her son.
- After printing the check, she changed the payee on the computer to a legitimate vendor.
- She kept amounts under \$2,500 to preclude supervisor approval.



Detection and Epilogue

- Annual audit raised red flags and Ms. Collins was confronted and confessed.
- The money was gone, spent on expensive dolls, clothes, furniture, etc.
- Sentenced to 4 ½ to 9 years in prison
- Archdiocese now does background checks



Effective internal control systems...

1. Establish policies and procedures to safeguard assets.
2. Monitor compliance with prescribed policies and procedures.
3. Impose meaningful consequences on those violating policies and procedures.



Who has the first question?



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