Fraud Prevention:
Where do we start?

Pete Miller Profile

• Northwest native
• Graduate from Western Washington University
• Joined Clark Nuber right out of school
• Current practice focus:
  – Shareholder in audit practice
  – Leader of forensic accounting/fraud investigation practice
  – Pacific NW chapter ACFE board member
  – Focus on Fraud blog on clarknuber.com
  – Clark Nuber Fraud Reporting Center
Overall Objectives

- Understanding the problem
- COSO framework
- Risk assessments
- Solutions

The Problem
Fraud Study

- 2014 Report to the Nations on Occupational Fraud and Abuse
  - Conducted and published by the Association of Certified Fraud Examiners (ACFE)
  - Full copy of 2014 survey (and previous) is available at www.acfe.com

Executive Summary

- 1,483 cases in study from ~100 countries
- CFEs providing content based on real life cases
- 5% of annual revenues lost to fraud
- Gross World Product = $3,700,000,000,000
- Impact on small businesses
- Be intentional!
  - Hotlines/tips
  - Proactive data monitoring
Executive Summary

• Executives role
• First timers
• Showing signs:
  – 44% appeared to be living beyond their means
  – 33% had financial difficulties
  – 22% close relationships with vendors/customers
  – 21% demonstrated control issues
• “Perception of detection” as a deterrent

Types of Occupational Fraud

<table>
<thead>
<tr>
<th>Asset Misappropriation</th>
<th>Fraudulent Financial Reporting</th>
<th>Corruption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Theft or misuse of organization’s cash or assets</td>
<td>Deliberate misrepresentation of financial condition of the company through intentional misstatement or omission</td>
<td>Off-book frauds in the form of kickbacks, gifts or gratuities to employees, contractors or vendors</td>
</tr>
</tbody>
</table>
Methods of Fraud

<table>
<thead>
<tr>
<th>Average Size ($000s)</th>
<th>2014</th>
<th>2012</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset Misappropriation</td>
<td>$130</td>
<td>$200</td>
<td>$1,000</td>
</tr>
<tr>
<td>Corruption</td>
<td>$200</td>
<td>$250</td>
<td>$1,000</td>
</tr>
<tr>
<td>Financial Reporting</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$4,100</td>
</tr>
</tbody>
</table>

Misappropriation

Clark Nuber
### Misappropriation Details

<table>
<thead>
<tr>
<th>Scheme</th>
<th>$ per Case</th>
<th>% of Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>Check tampering</td>
<td>$120,000</td>
<td>10.9%</td>
</tr>
<tr>
<td>Billing</td>
<td>$100,000</td>
<td>22.3%</td>
</tr>
<tr>
<td>Non-cash</td>
<td>$95,000</td>
<td>21.0%</td>
</tr>
<tr>
<td>Payroll</td>
<td>$50,000</td>
<td>10.2%</td>
</tr>
<tr>
<td>Cash larceny</td>
<td>$50,000</td>
<td>8.9%</td>
</tr>
<tr>
<td>Skimming</td>
<td>$40,000</td>
<td>11.8%</td>
</tr>
<tr>
<td>Expense reimbursements</td>
<td>$30,000</td>
<td>13.8%</td>
</tr>
<tr>
<td>Register disbursements</td>
<td>$20,000</td>
<td>2.8%</td>
</tr>
<tr>
<td>Cash on hand</td>
<td>$18,000</td>
<td>11.9%</td>
</tr>
</tbody>
</table>

### Duration (months)

- Disb.
- Payroll
- FS
- Exp Reimb
- Corruption
- Cash on hand

- 2014
- 2012
- 2010
Frequency by Industry

Size of Loss by Industry

<table>
<thead>
<tr>
<th>Industry</th>
<th>Number of Cases</th>
<th>Percent of Cases</th>
<th>Median Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining</td>
<td>12</td>
<td>1.0%</td>
<td>$500,000</td>
</tr>
<tr>
<td>Real Estate</td>
<td>24</td>
<td>1.8%</td>
<td>$545,000</td>
</tr>
<tr>
<td>Oil and Gas</td>
<td>48</td>
<td>3.8%</td>
<td>$409,000</td>
</tr>
<tr>
<td>Wholesale Trade</td>
<td>31</td>
<td>2.3%</td>
<td>$364,000</td>
</tr>
<tr>
<td>Technology</td>
<td>29</td>
<td>2.3%</td>
<td>$294,000</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>116</td>
<td>8.5%</td>
<td>$261,000</td>
</tr>
<tr>
<td>Construction</td>
<td>43</td>
<td>3.1%</td>
<td>$246,000</td>
</tr>
<tr>
<td>Agriculture, Forestry, Fishing and Hunting</td>
<td>28</td>
<td>2.0%</td>
<td>$212,000</td>
</tr>
<tr>
<td>Transportation and Warehousing</td>
<td>48</td>
<td>3.6%</td>
<td>$202,000</td>
</tr>
<tr>
<td>Banking and Financial Services</td>
<td>244</td>
<td>17.0%</td>
<td>$200,000</td>
</tr>
<tr>
<td>Services (Professional)</td>
<td>37</td>
<td>2.7%</td>
<td>$180,000</td>
</tr>
<tr>
<td>Health Care</td>
<td>100</td>
<td>7.2%</td>
<td>$176,000</td>
</tr>
<tr>
<td>Arts, Entertainment and Recreation</td>
<td>22</td>
<td>1.6%</td>
<td>$168,000</td>
</tr>
<tr>
<td>Other</td>
<td>52</td>
<td>3.7%</td>
<td>$130,000</td>
</tr>
<tr>
<td>Services (Other)</td>
<td>48</td>
<td>3.2%</td>
<td>$128,000</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>36</td>
<td>2.5%</td>
<td>$120,000</td>
</tr>
<tr>
<td>Utilities</td>
<td>25</td>
<td>1.8%</td>
<td>$100,000</td>
</tr>
</tbody>
</table>
Healthcare Heat Map

Recent Healthcare Cases

- Billing schemes:
  - Services never rendered (7)
  - Medically unnecessary services (3)
- Non H/C related schemes (5)
- Prescription medicine (2)

COSO Framework

COSO joint initiative of:
- Institute of Management Accountants (IMA)
- American Institute of Certified Public Accountants (AICPA)
- American Accounting Association (AAA)
- Institute of Internal Auditors (IIA)
- Financial Executives International (FEI)
In May 2013, COSO issued an updated internal control framework. What changed?

5 things to know about the update:
1. Core concepts remain unchanged
2. Codification of underlying principles
3. Increased role of the reporting objective
4. More relevant context to today’s environment
5. Original framework will transitioned out in 2014
COSO Framework (Continuous Process)

- Precondition to controls is identifying the risks
- Risks evolve over time
- Process for risk management
  - Likelihood of Occurrence
  - Impact to the Organization
Control Environment

• “Tone at the Top”
• Core to sound integrity and ethical values of the Organization
• Foundation for all other components of internal control (the “umbrella”)

Poor Control Environments:
- Enron, WorldCom, HealthSouth

Control Activities

• Response to identified risks
• Occurs throughout the Organization
• Two Key Aspects:
  – Policy of what should be done
  – Procedures to accomplish the Policy
• Types of Controls:
  – Preventive vs. Detective Controls
  – Manual vs. Automated Controls
  – IT General and Application Controls
Categories of Control Activities

- Adequate separation of duties
- Proper authorization of transactions and activities
- Adequate documents and records
- Physical control over assets and records
- Independent checks on performance

Information and Communication

- Key Elements of Information Systems:
  - Identify
  - Capture
  - Process
  - Distribute
Monitoring

- Monitoring of controls
- Ongoing
  - Focus on deviations from norm
  - Leads to investigations or system changes
- Separate Evaluations
  - Objective look of controls as needed
  - Internal Audit can play a vital role

Internal Control – Big Picture

- Five COSO components of internal control must work together
  - One weak component most likely will lead to ineffective controls
- Objectives → Risks → Controls
- Evaluation of risks and controls is a continuous process
- Management override is always a risk
Risk Assessments

Elements of a good risk assessment:
• The right sponsor/facilitator
• Independence and objectivity
• Good working knowledge of the business
• People from all levels
• Engendered trust
• Ability to think the unthinkable
• Plan to keep it alive and relevant
• Consideration of high-risk frauds, regardless of dollar value
Risk Assessments

**Package it right:**
- Use the language of the business
- One size does not fit all
- Keep it simple

**Assemble the right team:**
- Diverse knowledge
- Skills (communication)
- Perspective
- Skeptical people

**Determine the best techniques to use/gather information:**
- Interviews
- focus groups
- Surveys
- Anonymous feedback

**Obtain the sponsor’s agreement up front:**
- Scope of what will be done
- Methods to use
- Participants
- Content of questioning
- Report format/distribution
Risk Assessments

**Identify potential inherent fraud risks:**
1. Incentives, pressures, opportunities
2. Management’s ability to override controls
3. Population risk – our business (fraud tree)
4. Regulatory and legal risk
5. Reputation risk
6. Risk to IT

**Build a heat map:**
- Assess the likelihood of occurrence of identified fraud risks
- Assess the significance of identified fraud risks
- Which positions/departments are riskiest; what methods
- Identify and map existing controls to relevant fraud risk (preventive and detective)
- Establish an acceptable level of risk (management)
- Calculate potential loss and rank them:

\[
\text{Likely cost} \times \text{Likelihood of occurrence} = \text{Potential loss}
\]
## Risk Assessments

### Response:
- Avoid the risk
- Transfer the risk
- Mitigate the risk
- Assume the risk
- Combination

### Report:
- Objective; just the facts
- Keep it simple
- Focus on what really matters
- Identify actions that are clear and measurable
Risk Assessments

**Use the results:**
- Begin a dialogue across the company
- Look for fraud in high-risk areas
- **Hold responsible parties accountable for progress**
- Keep assessment process alive and relevant
- Modify or create the code of conduct/ethics policy
- Monitor key controls

Solutions
Summary on Prevention

- In most cases, fraud can be prevented by eliminating one of the elements of the Fraud Triangle:
  - **Motivation**: Employee Assistance Programs, communication with employees
  - **Rationalization**: initial employee screening, incentives, discounts
  - **Opportunity**: strong internal controls, surprise audits (i.e. when employees are on vacation), fraud training, tone at the top, fraud hotline (whistleblower), appropriate response

Warning Signs

- Living beyond means
- Financial difficulties
- Control issues; unwilling to share duties
- Unusually close with vendor/customer
- Wheeler-dealer attitude
- Divorce/family problems
- Irritable/defensive
- Addiction problems
- Refuse to take vacations
- Past employment problems

[Graph showing percentage of warning signs from 2009 to 2014]
Age of Perpetrator

Initial Detection
Effectiveness of Anti-Fraud Measures

<table>
<thead>
<tr>
<th>Control</th>
<th>% of cases implemented</th>
<th>Yes (000s)</th>
<th>No (000s)</th>
<th>% Reduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proactive data monitoring</td>
<td>34.8%</td>
<td>$73</td>
<td>$181</td>
<td>59.7%</td>
</tr>
<tr>
<td>Employee support programs</td>
<td>52.4%</td>
<td>$90</td>
<td>$200</td>
<td>55.0%</td>
</tr>
<tr>
<td>Management review</td>
<td>62.6%</td>
<td>$100</td>
<td>$208</td>
<td>51.9%</td>
</tr>
<tr>
<td>Code of conduct</td>
<td>77.4%</td>
<td>$100</td>
<td>$200</td>
<td>50.0%</td>
</tr>
<tr>
<td>Internal audit</td>
<td>70.6%</td>
<td>$100</td>
<td>$180</td>
<td>44.4%</td>
</tr>
<tr>
<td>Formal fraud risk assessments</td>
<td>33.5%</td>
<td>$94</td>
<td>$168</td>
<td>44.1%</td>
</tr>
<tr>
<td>Surprise audits</td>
<td>33.2%</td>
<td>$93</td>
<td>$164</td>
<td>43.3%</td>
</tr>
<tr>
<td>External audit of IC</td>
<td>65.2%</td>
<td>$103</td>
<td>$180</td>
<td>42.8%</td>
</tr>
<tr>
<td>Fraud training for mngs/execs</td>
<td>47.8%</td>
<td>$100</td>
<td>$168</td>
<td>40.5%</td>
</tr>
<tr>
<td>Hotline</td>
<td>54.1%</td>
<td>$100</td>
<td>$168</td>
<td>40.5%</td>
</tr>
<tr>
<td>Dedicated fraud department</td>
<td>38.6%</td>
<td>$100</td>
<td>$164</td>
<td>39.0%</td>
</tr>
<tr>
<td>Fraud training for employees</td>
<td>47.8%</td>
<td>$100</td>
<td>$164</td>
<td>39.0%</td>
</tr>
<tr>
<td>Anti-fraud policy</td>
<td>45.4%</td>
<td>$100</td>
<td>$155</td>
<td>35.5%</td>
</tr>
<tr>
<td>Mgmt. cert. of financials</td>
<td>70.0%</td>
<td>$120</td>
<td>$184</td>
<td>34.8%</td>
</tr>
<tr>
<td>Job rotation/mandatory vac.</td>
<td>19.9%</td>
<td>$100</td>
<td>$150</td>
<td>33.3%</td>
</tr>
<tr>
<td>External audit of financials</td>
<td>81.4%</td>
<td>$125</td>
<td>$186</td>
<td>32.8%</td>
</tr>
</tbody>
</table>

Data Monitoring

- Get smarter
- Make better test selections
- Include 100% of the population
  - No longer a random walk
- Example:
  - Employee benefit plan census analysis
    - Old way v. new way
  - Private school
  - Cash disbursements cycle
Questions?

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