

# Understanding the Impact of Ethics and Fraud in Business

October 23, 2019

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*Create Opportunities*

# Learning Objectives

**At the end of this session, you will be able to:**

- Define Fraud and begin to think forensically
- Learn about Fraud detection, cost, awareness and anti-fraud measures
- Discuss ethical challenges by today's society and personal accountability





# Introduction

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# Speaker Introduction

- Principal, Minneapolis, MN
- State and Local Governments
- 16 + years experience





# Agenda

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# Agenda

- **Ethical challenges in today's society**
  - Is a culture of high ethics and integrity in an organization even possible in today's society?
  - Personal Accountability
- **Fraud**
  - Fraud defined, cost and awareness
  - How Frauds are detected
  - Fraud examples
  - Anti-fraud measures



# Ethical Challenges in Today's Society

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# Is a Culture of High Ethics and Integrity in an Organization even Possible in Today's Society?

Raise you hand if you think so!





# Definition of High Ethics and Integrity

- Doing the right thing!
- Best interest of the organization
- Perception matters!
- Transparency matters!



# True or False?

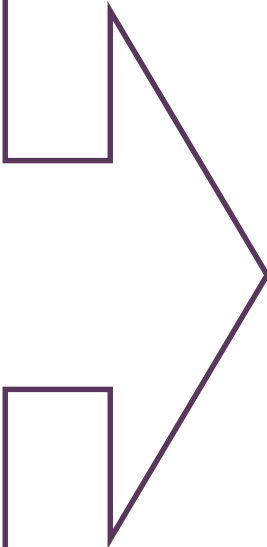
As long as your action is legal then it is ethically okay.



# Do Ethics Really Matter?

- Do “nice people finish last”?

- Do ethical organizations have advantage(s) over their competitors?
- Do ethical organizations have an advantage attracting and retaining talent?



In the long run... YES!

# Two Key Concepts to Ensure High Ethics and Integrity

- Personal accountability
  - Begins with YOU making the right choices!
- Organizational accountability
  - Tone at the Top
  - Code of Ethics

You are already aware because you have a mature program!

# Personal Accountability

Some examples:

- Vendor relationships
- Money seizures and arrest
- Badge/credentials to get you “perks”
- Construction industry: “Payoffs and favors is a way of doing business”



# Personal Accountability

Begins with YOU making the  
right choices!



# Is a Culture of High Ethics and Integrity in an Organization even Possible in Today's Society?

Yes!

Begins with personal and organizational accountability!





# Fraud and Ethical Lapses

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# Association of Certified Fraud Examiners (ACFE)

- World's largest anti-fraud organization and premier provider of anti-fraud training and education
- Reducing business fraud worldwide and inspiring public confidence in the integrity and objectivity of/within the profession
- Provides Certified Fraud Examiner (CFE) credential
  - Requires meeting professional, educational, and ethical standards and passing rigorous exam on the four major disciplines that comprise the fraud examination body of knowledge: fraud prevention and deterrence, financial transactions and fraud schemes, investigation, and law
- Headquartered in Austin, TX
- 80,000+ members



# ACFE Report to the Nations 2018

- Report to the Nations on Occupational Fraud and Abuse, 2018 Global Fraud Study
- Bi-annual report
- Analysis of 2,690 cases of occupational fraud across 125 countries in 23 industries
- Results based on 2017 Global Fraud Survey; opened to 41,788 CFEs about their largest fraud case investigation completed between January 2016 and October 2017
- First ACFE Report to the Nations was issued in 1996
- Facts about: cost of fraud, how fraud is committed, detected, victim organizations, and perpetrators



<http://www.acfe.com/report-to-the-nations/2018/>

## Seven Key Facts from the *Report to the Nations* and Our Experience

### I. Loss To Organizations

- Typical organizations lose 5% of revenue in a given year as a result of fraud
- Occupational Fraud:
  - The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets
  - The key to occupational fraud is that the activity:
    - Is clandestine
    - Violates the employee's fiduciary duties to the organization
    - Is committed for the purpose of direct or indirect financial benefit to the employee



# Seven Key Facts from the *Report to the Nations* and Our Experience

## II. Fraud Exists in Every Industry and Organization Type

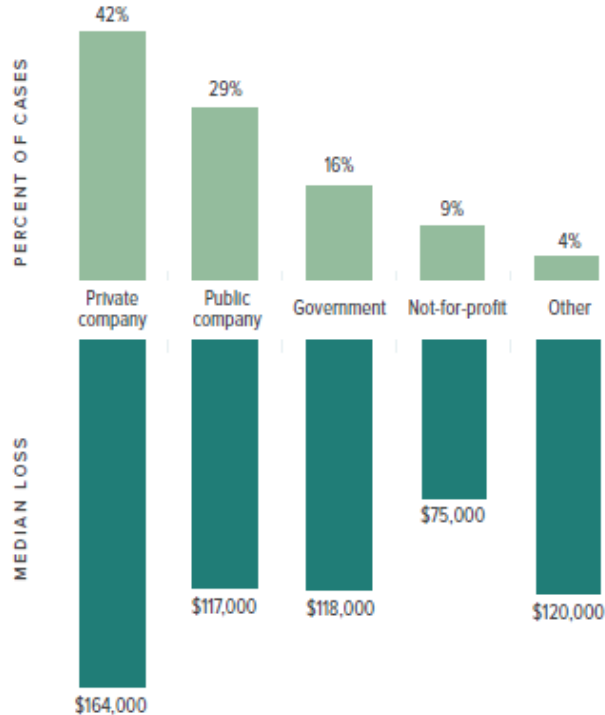
FIG. 15 How does occupational fraud affect organizations in different industries?



## Seven Key Facts from the *Report to the Nations* and Our Experience

### II. Fraud Exists in Every Industry and Organization Type

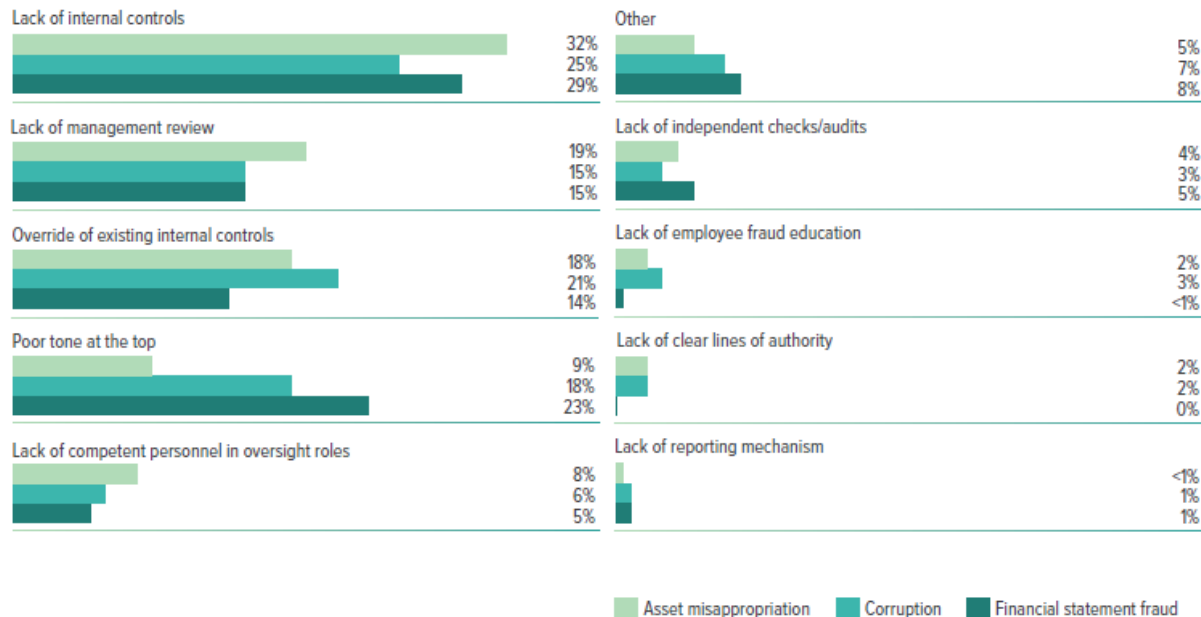
FIG. 14 How does an organization's size relate to its occupational fraud risk?



## Seven Key Facts from the *Report to the Nations* and Our Experience

### III. Prominent Organizational Weakness – Lack of Internal Controls

FIG. 23 How do internal control weaknesses vary by scheme type?

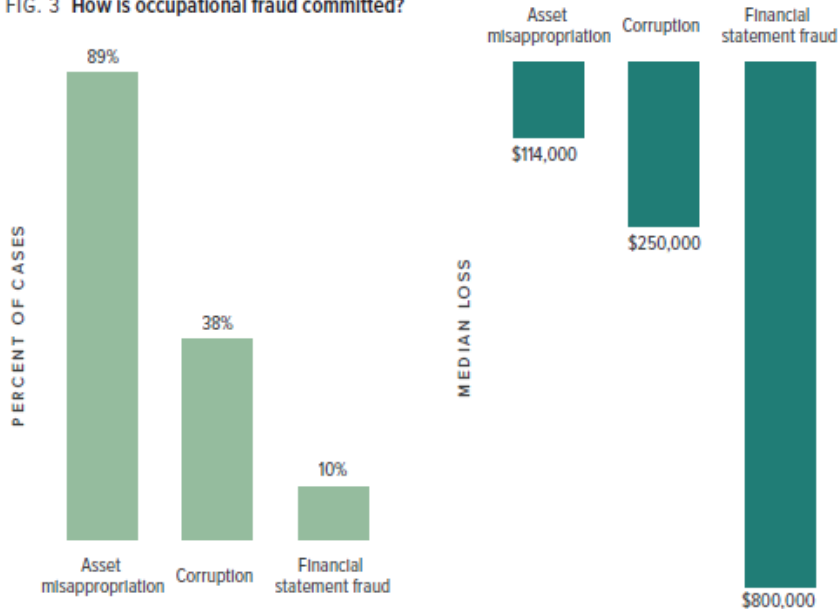


## Seven Key Facts from the *Report to the Nations* and Our Experience

### IV. Misappropriation of Assets

- Most common form of occupational fraud

FIG. 3 How is occupational fraud committed?

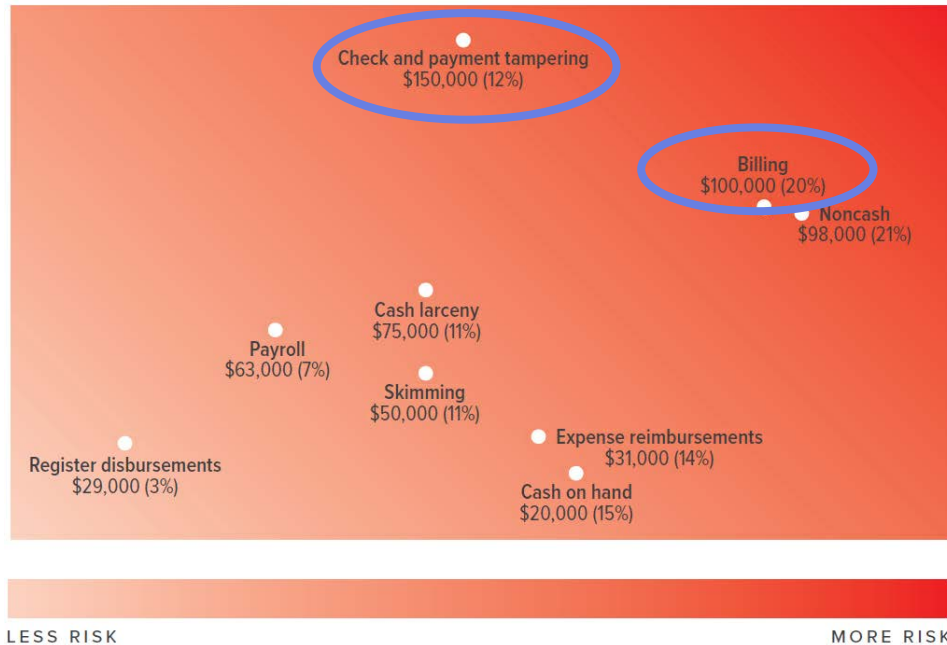


## Seven Key Facts from the *Report to the Nations* and Our Experience

### V. Misappropriation of Assets

Billing schemes and check tampering present the greatest risk to organizations

FIG. 6 What asset misappropriation schemes present the greatest risk?





## Seven Key Facts from the *Report to the Nations* and Our Experience

### VI. First Time Offenders

FIG. 36 Do perpetrators tend to have prior fraud convictions?

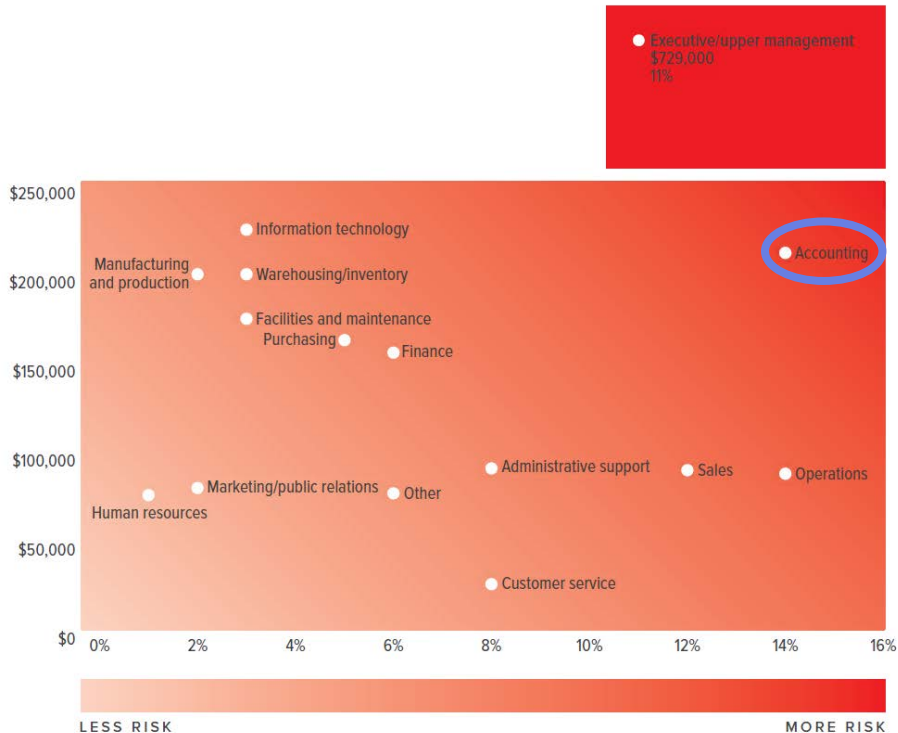


- Never charged or convicted (89%)
- Charged but not convicted (6%)
- Had prior convictions (4%)
- Other (1%)

# Seven Key Facts from the *Report to the Nations* and Our Experience

## VII. Origin – Accounting Department

FIG. 28 What departments pose the greatest risk for occupational fraud?





# How are Frauds Detected?

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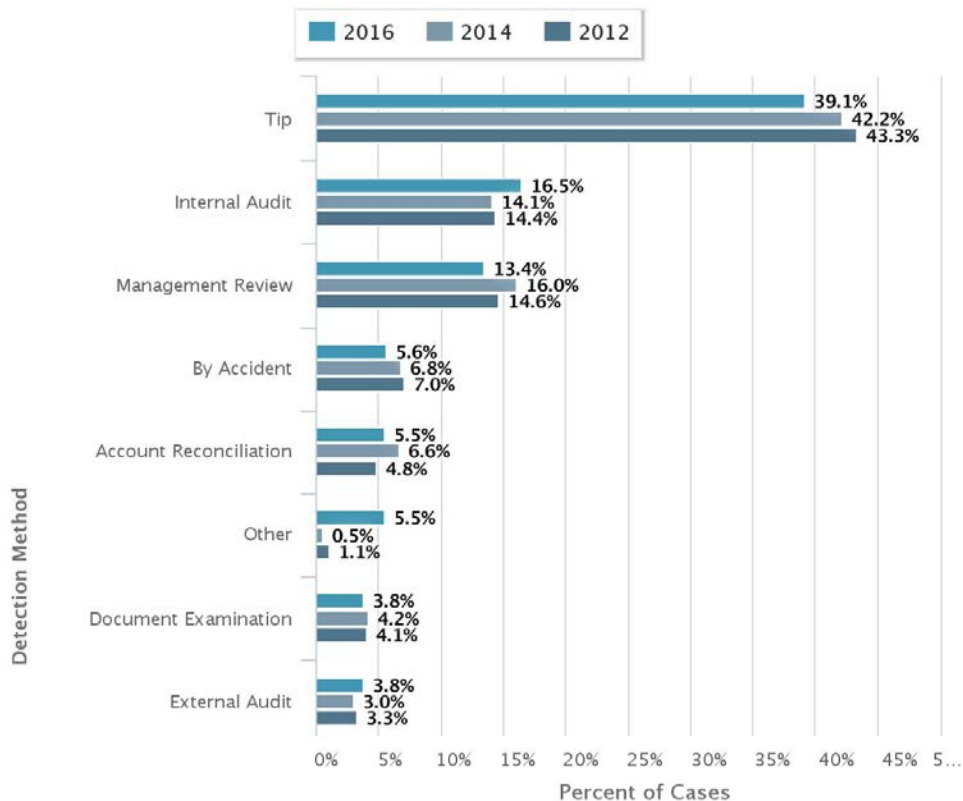
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# Maintaining Professional Skepticism

- Acknowledge that fraud risk exists
- Encourage open and candid discussion – Know your employees
- If I were to try to commit fraud, how would I do it?
- Continuously assess the risk of management and control override (think about collusion)
- Openly display your skepticism to set the tone at the top and spread awareness
- Take swift action when fraud event occur and make the response action (not the details) known internally



## Initial Detection of Occupational Frauds



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# Profile of a Fraudster

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# What does a fraudster look like?



# Who Can Commit Fraud?

**ANYBODY**  
is capable of committing  
**FRAUD**

## *Report to The Nations – Some Statistics on Perpetrators*

- Perpetrator's level of authority has been strongly correlated with the size of the fraud
  - Only 19% of frauds in the current study were committed by owners/executives, but the median loss in these cases was \$850,000
  - Employees and managers were much more likely to commit occupational fraud, but, the losses in these schemes were much lower—though still substantial
- Correlation between the fraudster's level of authority and the duration of the occupational fraud scheme
  - The typical fraud committed by an employee lasted 12 months before it was detected, whereas the typical fraud committed by an owner/executive lasted 24 months. Frauds committed by managers had a median duration of 18 months.



# The Fraud Triangle



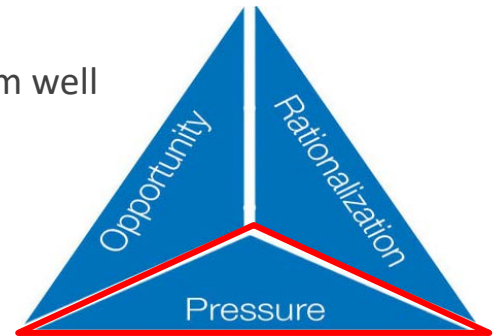
Understanding the Fraud Triangle is critical to:

- Minimize the risk of abuse
- Minimize the risk of fraud
- Develop strong internal controls

# The Fraud Triangle

## *Pressure*

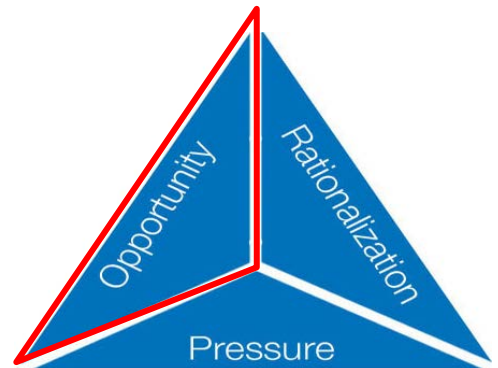
- Serious problem (financial) that requires immediate attention and cannot be resolved by ordinary financial resources:
  - Gambling, drinking, other addictions
  - Divorce, bankruptcy, medical issues
  - Unforeseen life change
  - Family emergency
  - Pressures from organization to perform well



# The Fraud Triangle

## *Opportunity*

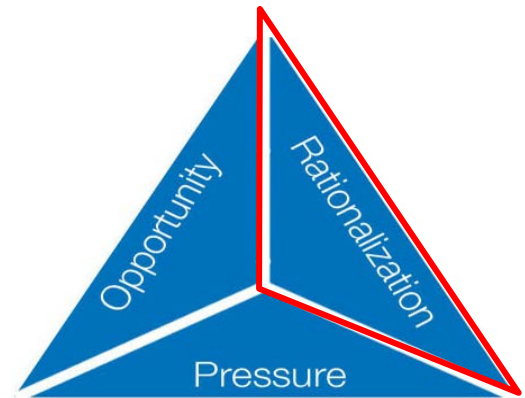
- Aware that financial problem can be solved by stealing from organization or falsifying organization's records:
  - Weaknesses in internal control
  - Lack of or poor documentation
  - Lack of or poor supervision
  - Poor segregation of duties



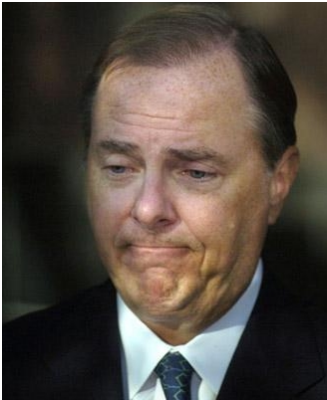
# The Fraud Triangle

## *Rationalization*

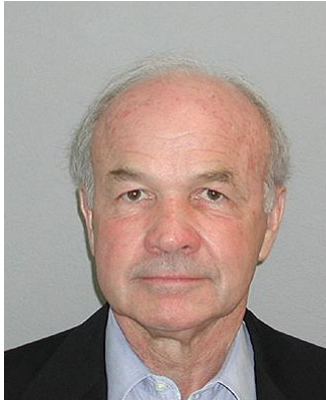
- Mindset that fraudulent action undertaken is justified:
  - “It’s just temporary, I’ll pay it back”
  - “Management doesn’t care”
  - “It’s just a little bit, no one will miss it”
  - “No one else is hurt”
  - “I deserve it”



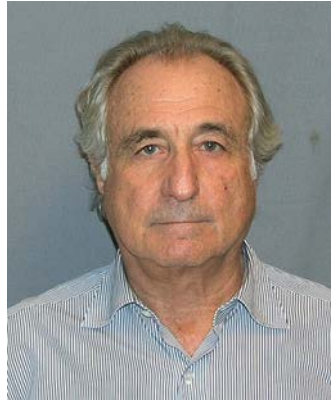
# FAMOUS EXAMPLES



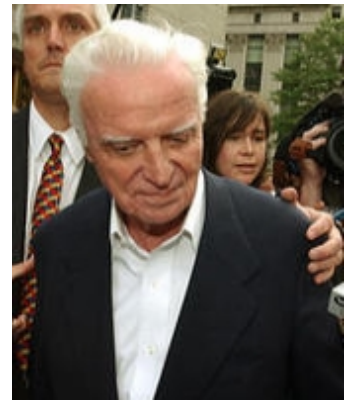
*Jeffrey Skilling*



*Ken  
Lay*



*Bernard Madoff*



*John Rigas*

# Victim | Private | Health Care

## Check Misappropriation

<b>Organization Size</b>	3,500 employees \$12.5 billion in revenue in 2017
<b>Perpetrator</b>	Trusted long-term employee, customer service rep, female, married Single income earner with family medical problems ( <a href="#">Pressure</a> ) Prior criminal history for theft from employer ( <a href="#">Rationalization</a> )
<b>Scheme</b>	<ul style="list-style-type: none"><li>• Submitted fictitious claims reimbursement forms and requested that checks be sent back to her office mailbox (<a href="#">Opportunity</a>)</li><li>• Supervisors did minimal review of check request forms (<a href="#">Opportunity</a>)</li><li>• Did not mail checks out but instead deposited into her bank account</li><li>• Forged and used stamp endorsements to deceive bank tellers</li><li>• Nearly <b>\$700,000</b> loss over a period of 15 years</li></ul>
<b>Results of Investigation</b>	Administrative: Employee was terminated; company had to reimburse self-funded groups \$680,000 for the amounts billed to them; implemented new internal controls Criminal: Referred to law enforcement; employee arrested; criminal proceedings underway Civil: Insurance claim under consideration



# Victim | Public Service | County

## Check Misappropriation/Fictitious Vendor/False Personal Expenses

<b>Organization Size</b>	\$1.5 million Public Works Department budget Serves a population of over 190,000 customers
<b>Perpetrator</b>	Accountant, long-term trusted employee, female, divorced, adult, children Alleged drug addiction and medical issues, financial issues (Pressures) Initially thought she would pay back (Rationalization)
<b>Scheme</b>	<ul style="list-style-type: none"><li>• Various schemes including:<ul style="list-style-type: none"><li>○ Targeted multiple County programs in three funds to generate refund checks by falsifying documents and having checks mailed to addresses perpetrator had access to for eventual deposit into personal accounts (used several accomplices outside of the County)</li><li>○ Use of purchase order system to generate checks/wire transfers paid for contracted services the County did not receive (fictitious vendor)</li><li>○ Personal expenses charged to County credit cards and theft of petty cash</li></ul></li><li>• Given access to various systems with minimal oversight (Opportunity)</li><li>• <b>\$2.05 million</b> loss</li></ul>
<b>Results of Investigation</b>	Administrative: Employee terminated Criminal: Referred to law enforcement; employee arrested; criminal investigation ongoing Civil: No civil action taken; insurance claim submitted





# Ethical Challenges for Organizations when Fraud Occurs

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# Ethical Challenges and Decisions

- When can an organization generally initiate a fraud investigation?
  - **Predication must exist**
- What factors will the organization consider when faced with fraud within the organization?

# Predication

“...the **totality of circumstances** that would lead a **reasonable, professionally trained, and prudent individual** to believe a **fraud** has occurred, is occurring, or will occur. Predication is the basis upon which a fraud examination/investigation is commenced. Fraud examinations should not be conducted without proper predication.”



# Examples of Predication

- Complaint from a “whistleblower” or other “tips”
- Internal audit findings
- External audit findings
- Difficulties in financial reporting/information/disclosure
- Issues involving customers or vendors
- Potential “conflict of interest” concerns
- Foreign Corrupt Practice Act (FCPA)
- Responding to regulatory action
- Unusual journal entries, transactions, or trends
- Others?

# Are These Sufficient Predications?

- Employee John Doe seems to be living beyond his means.
- Employee Mary Doe is a trouble maker and we want her fired.
- Our insurance expense costs seem to have increased significantly yet our business model hasn't changed.
- A new CFO has been hired and she wants to clean house.
- The Board wants to get rid of the Superintendent, so take a look at all payments to him and find us some dirt.



# Fraud Investigations

**When do companies call fraud investigators:**

**“I think we have a FRAUD”**

*A “suspicion of fraud” meaning possible embezzlement, misappropriation, financial wrongdoing, or financial irregularity by an employee(s) or third party*

**Benefits of calling a fraud investigator:**

- Assistance to scope out the issues
- Determination of fraud loss and identification of fraudster(s)
- Assistance with completing proof of loss for insurance reimbursement
- Assistance with providing human resources evidential materials for employee termination
- Recommendations for internal control improvements to minimize risk of fraud
- Assistance with criminal referral to law enforcement
- Assistance with civil litigation
- Recommendations for regulatory compliance



# Forensic Accounting Projects

## When do companies called forensic investigators:

“We may or may not have a FRAUD but we need to take a ‘deeper look’ into certain transactions”

## Examples of Forensic Accounting Projects:

- Forensic data analysis
- Billing, time and material issues (construction clients)
- Fictitious vendors and customers analysis
- Accounts payable irregularities or payment errors
- Vendor and possible related party transactions
- Travel and expense reimbursement irregularities
- Manual journal entry manipulations
- Refunds and credits
- Miscellaneous disbursements
- Client-specific analysis



# Factors Organizations Must Consider when Faced with Fraud

- **Administrative:** human resource issues – possible termination
- **Insurance:** proof of loss – get reimbursed!
- **Civil litigation:** suit against fraudster for recovery of fraudulent funds
- **Criminal referral:** see that “justice” is done
- **Internal controls:** implement internal controls so fraud doesn’t happen again
- **Contract dispute with vendor:** performance of contract
- **Regulatory compliance**
- Many others





# Fraud Program - Best Practices

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# FRAUD PROGRAM BEST PRACTICES



## Key Policies and Procedures





# Summary



# We have Discussed

- Ethical challenges in today's society
- Ethical, fiduciary and other challenges organizations face when they become aware of fraud and ethical lapses
- Fraud continues to grow in today's environment and there is an increased focus on addressing fraud.



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# Thank you!

## Questions?

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