Fraud Risk Management

The Institute of Internal Auditors CHICAGO

Power Comes from Being Understood℠

McGladrey

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Agenda

- ACFE 2010 Report to the Nations highlights
- Emerging trends in fraud risks
- Common fraud practices
- Fraud prevention and detection
- Fraud response protocol

ACFE 2010 Report to the Nations

- Survey participants estimated that the typical organization loses 5% of its annual revenue to fraud. Applied to the estimated 2009 Gross World Product, this figure translates to a potential total fraud loss of more than $2.9 trillion.
- The median loss caused by the occupational fraud cases in our study was $160,000. Nearly one-quarter of the frauds involved losses of at least $1 million.
- The frauds lasted a median of 18 months before being detected.

ACFE 2010 Report to the Nations

- Occupational frauds are much more likely to be detected by tip than by any other means. This finding has been consistent since 2002 when the ACFE began tracking data on fraud detection methods.
- Small organizations are disproportionately victimized by occupational fraud. These organizations are typically lacking in anti-fraud controls compared to their larger counterparts, which makes them particularly vulnerable to fraud.

ACFE 2010 Report to the Nations

- Manufacturing is one of the top 3 industries most commonly victimized.
- More than 80% of the frauds in the study were committed by individuals in one of six departments: accounting, operations, sales, executive/upper management, customer service or purchasing.
- More than 85% of fraudsters in the study had never been previously charged or convicted for a fraud-related offense. This finding is consistent with ACFE prior studies.

ACFE 2010 Report to the Nations

Anti-fraud controls appear to help reduce the cost and duration of occupational fraud schemes.

- The ACFE looked at the effect of 15 common controls on the median loss and duration of the frauds.
- Victim organizations that had these controls in place had significantly lower losses and time-to-detection than organizations without the controls.

Emerging Trends in Fraud Risks

- Significant increase of fraud occurrence since the onset of the financial crisis in 2008.
- Nearly 1/3 of the organizations have discovered fraudulent activities.
  - 43% have experienced increase of 1 to 10 percent.
  - 28% have experienced increase of 11 to 20 percent.
  - 14% have experienced increase of 21 to 30 percent.

Emerging Trends in Fraud Risks

Organizations have been significantly impacted by employee-related fraud.

Type of Fraud	%
Theft of company property and resources	52%
Embezzlement	38%
Expense-account fraud	37%
Third-party/vendor fraud	33%
Theft of company information and data	13%
Financial statement or accounting irregularities	7%
Foreign corrupt practices	4%

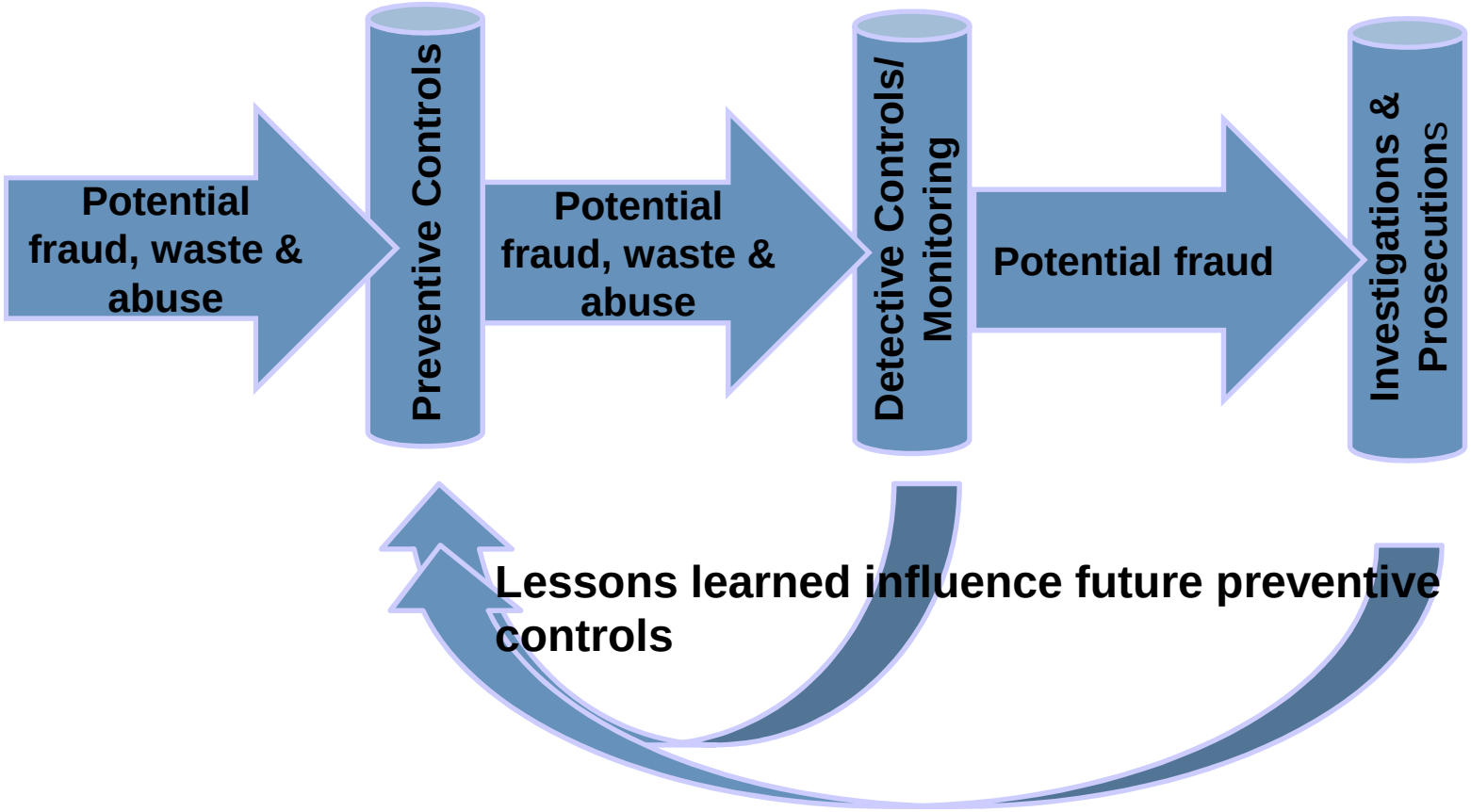
Emerging Trends in Fraud Risks

New types of financial fraudulent schemes:

- Inappropriate use of reward points on credit cards.
- Scams involving counterfeited check images, duplicated checks, or forged signatures.
- Customers using the company to apply for government guaranteed loans under false pretences.
- Duplicate billings for services using separate work orders and invoice numbers.
- Wire transfer fraud and credit card fraud by accessing the merchant's processing network.
- Use of electronic signatures on documents provided to support travel and entertainment approvals.

Expect continuation of same kinds of fraud.

Fraud Prevention & Detection



Fraud Prevention & Detection

Roles/Responsibilities for Fraud Prevention/Detection

- Board of Directors
- Audit Committee
- Management
- Legal Counsel
- Internal Auditors
- External Auditors
- Loss Prevention Managers
- Fraud Investigators

Fraud Prevention Elements

<u>TRUST</u> is not an element of an effective fraud management program.

Control Environment & Corporate Governance

- Code of conduct, ethics policy, fraud policy
- Ethics & whistleblower hotlines
- Hiring guidelines & practices
- Audit Committee oversight
- Senior management team evaluations, performance management, compensation and succession planning.
- Third-party relationships

Fraud Prevention Elements

Risk Assessment

Fraud risk exposure should be assessed periodically by the organization to identify specific potential schemes and events that the organization needs to mitigate.

- Fraud risk factors & schemes
- Assess in terms of likelihood & impact
- "Strategic reasoning"
  - Can internal control weaknesses be exploited?
  - Can controls be overridden or circumvented?
  - How might the fraud be concealed?
- Risk response
  - Cost-benefit analysis

Fraud Prevention Elements

Control Activities

- Policies & procedures for business processes
- Limits of authority, segregation of duties, transaction-level procedures

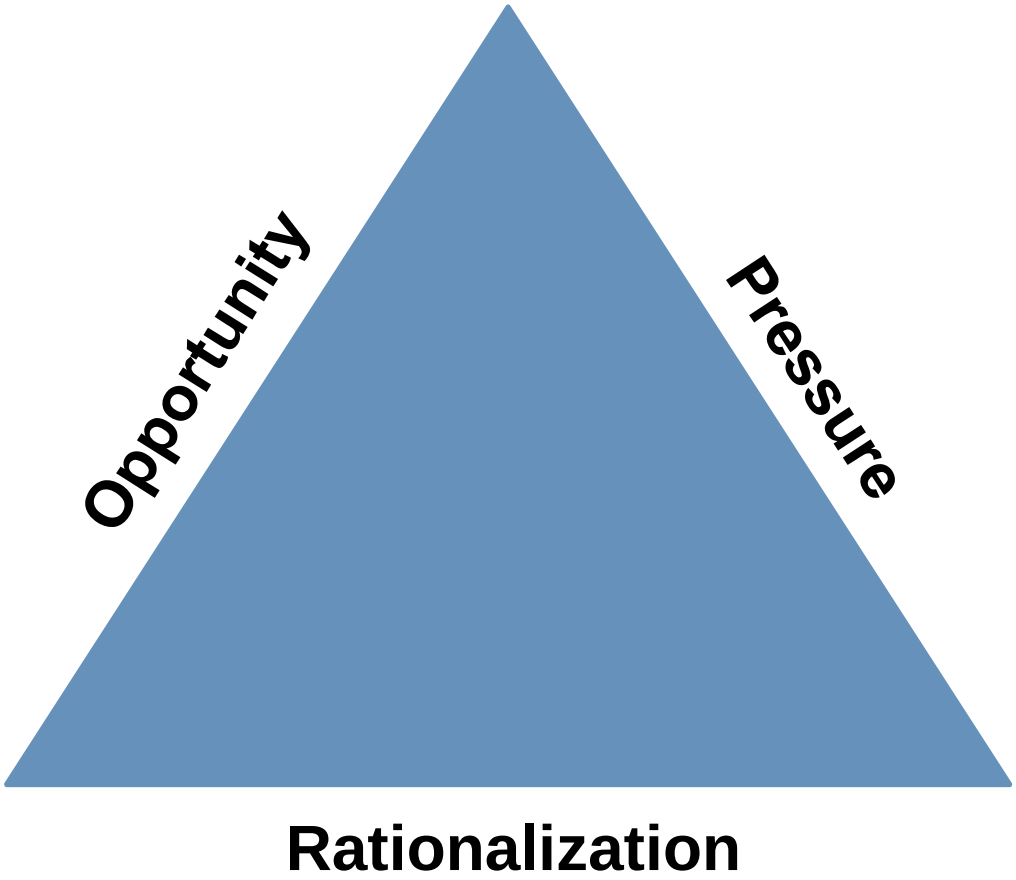
Information & Communication

- Fraud awareness training
- Affirmation / certification process

Monitoring

- Independent evaluations of the fraud risk management program
- Use of technology for continuous monitoring and detection activities

Fraud Triangle



Why are internal controls important?

Financial Reporting

- Promotes integrity of data used in making business decisions
- Assists in fraud prevention and detection through the creation of an auditable trail of evidence

Operations

- Promotes effectiveness with minimal setback of efficiency of operations through standardized processes
- Ensures the safeguarding of assets through control activities

Laws and Regulations

- Helps maintain compliance with laws and regulations through periodic monitoring

Examples of Effective Internal Controls

- Restricted access to computer system – User ID & Password
- Segregation of duties – Segregate custody, authorization, & recording
- Check stock secured
- Lockbox for customer/member payments
- Dual check signing authority
- Invoice approval – authorization levels defined
- Independent monthly review of variance reports & income/expense accounts
- Independent monthly account reconciliations
- Review and follow-up on exception reports

Proactive Fraud Detection Procedures

- Consider fraud as part of every audit
- Surprise audits
  - *Include 3rd-party relationships*
- Identify hidden relationships (people, organizations, and events)
- Identify suspicious transactions
- Validate segregation of duties
- Analyze journal entries
- Email

Investigations

Where do you start?

- Vetting of allegations
  - Develop predication for investigation
- Investigation protocols
- Collection, analysis and preservation of evidence
- Forming of conclusions
- Reporting

Investigations

Information gathering and fact finding:

- What do we need to know?
  - Bargaining agreements
  - Scope of fraud
  - Fraud methods
  - Accomplices
- How are we going to find out?

<u>This is the foundation for meeting objectives.</u>

Investigations

I think I may have found something, what do I need to do?

- Understand evidentiary issues:
  - What is evidence?
  - Direct versus indirect evidence
  - Documents
  - Who will testify
- Who to call (besides their boss):
  - Human resources director
  - Legal counsel
  - Law enforcement

Investigations

Verification and Analysis:

- This is where you really need the suspect
- Structured and unstructured interviews:
  - Behavioral interviews
- Admissions have a greater weight in employment law than in criminal law where its mostly corroborative

High Risk Environment

Honest people can become dishonest in an environment with:

- Low integrity
- Poor control
- High pressure
- Loose accountability

Cultural factors that contribute to high fraud environment

- Managers who are apathetic or behave inappropriately
- Inadequate pay and recognition for job performance
- Unreasonable budget expectations or short term focus
- Management by crisis
- Hostile work environment
- Poor training

Questions to Consider

- Does the organization have a fraud policy in place?
- Does the organization have a fraud hotline?
- Does management promote fraud awareness and training within the organization?
- Has management identified the types of potential fraud risks in its areas of responsibility?
- Has management incorporated appropriate controls to prevent, detect, and investigate fraud?
- Are fraud controls assessed for effectiveness and efficiency?
- Has the responsibility for fraud detection, prevention, response, and awareness been assigned within the organization?

Contact Information

Laura Cortier, CIA

Director, Risk Advisory Services

- D: 574.296.3736 C: 765.433.0022
- laura.cortier@mcgladrey.com