What You Need to Know to Protect Your Organization From Fraud

Ron Steinkamp, CPA, CIA, CFE
314.983.1238 | rsteinkamp@bswllc.com

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1050 N. Lindbergh Blvd. | St. Louis, Missouri 63132 | 314.983.1200 1551 Wall St., Ste. 280 | St. Charles, Missouri 63303 | 636.255.3000
1000 Broadway, Ste. 300 | Highland, IL 62249
888.279.2792 | www.bswllc.com

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2012 ACFE Global Fraud Study

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2012 Report to the Nations on Occupational Fraud and Abuse

About the ACFE

- **World's largest anti-fraud organization and premier provider of anti-fraud training and education.**
- **Over 50,000 members in more than 140 countries.**
- **Provides educational tools and practical solutions for anti-fraud professionals through initiatives including:**
  - Global conferences and seminars led by anti-fraud experts
  - Instructor-led, interactive professional training
  - Comprehensive resources for fighting fraud, including books, self-study courses and articles
  - Leading anti-fraud periodicals including *Fraud Magazine®, The Fraud Examiner* and *FraudInfo*
  - Local networking and support through ACFE chapters worldwide
  - Anti-fraud curriculum and educational tools for colleges and universities
- **Offers its members the opportunity for professional certification – the CFE credential is preferred by businesses and government entities around the world and indicates expertise in fraud prevention and detection.**

What Is Occupational Fraud?

- **Occupational Fraud** = The use of one's occupation for personal enrichment through the deliberate misuse or application of the employing organization's resources or assets.
- **Violation of trust.**
- **Three general categories:**
  - **Asset misappropriations** = those schemes in which the perpetrator steals or misuses an organizations resources. Most frequent and least costly scheme.
  - **Corruption** = employee's use of his or her influence in business transactions in a way that violates his or her duty to the employer for the purpose of obtaining benefit for him or herself or someone else.
  - **Financial Statement Fraud** = intentional misstatement or omission of material information in the organization's financial reports. Least frequent and most costly scheme.

Study Methodology

- **Based on results of an online survey distributed to 34,275 CFEs in October 2011.**
- **1,388 usable survey responses were received.**
- **Respondents were asked to provide a detailed narrative of the single largest fraud case they investigated that met four explicit criteria:**
  - Case involved occupational fraud
  - Investigation occurred between January 2010 and the time of the survey.
  - The investigation was completed.
  - CFE was reasonably sure the perpetrator(s) was/were identified.
- **Respondents were also presented with 85 questions to answer.**
- **Professionals who took part in the survey had a median of 11 years of experience in fraud examination**

Summary of Findings

1. Typical organization loses 5% of annual revenue to fraud – applied to 2011 Gross World Product translates to potential fraud loss of more than $3.5 trillion annually.

2. Median loss in the study was $140,000 with more than 20% of the cases involving losses over $1 million.

3. Fraud lasted a median of 18 months.

4. Asset misappropriation schemes (fraudulent disbursements, theft of cash receipts, other asset misappropriations) were the most common form of fraud, representing 87% of the cases and least costly at a median loss of $120,000.

5. Financial statement fraud schemes were the least common form of fraud, representing 8% of the cases and most costly at a median loss at $1 million.

Summary of Findings (cont.)

6. Corruption schemes fell in the middle, comprising just over 33% of cases and causing a median loss of $250,000.

7. Occupational frauds are most likely to be detected by tips (43%) followed by management review (15%) and Internal Audit (14%).

8. Small organizations are disproportionately victimized by occupational fraud.

9. Banking/financial services, manufacturing and government/public administration were the most commonly victimized industries.

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

11. High-level perpetrators cause the greatest damage to their organizations.

Summary of Findings (cont.)

12. 80% of frauds were committed by individuals in one of six departments:
    - Accounting
    - Operations
    - Sales
    - Executive/upper management
    - Customer service
    - Purchasing

13. More than 85% of fraudsters had never been previously charged or convicted for a fraud-related offense.

14. Fraud perpetrators often display warning signs – most common behavioral red flag reported in the survey were perpetrators living beyond their means (36%) and experiencing financial difficulty (27%).

15. Nearly half of victim organizations do not recover any losses that they suffer due to fraud.

Conclusions and Recommendations

Occupational fraud is a global problem – trends in fraud schemes, perpetrator characteristics and anti-fraud controls are similar regardless of where the fraud occurred.

Fraud reporting components are a critical component of an effective fraud prevention and detection system. Implement **hotlines** to receive tips from both internal and external sources.

Organizations over-rely on audits. External audits were the control mechanism most widely used by victims in the survey.

Employee **education** is the foundation of preventing and detecting occupational fraud. Most frauds are detected by tips and anti-fraud training for employees and managers results in lower fraud losses.

Surprise audits are an effective, yet underutilized, tool in the fight against fraud. Useful in detecting fraud, but most important benefit is in preventing fraud by creating a **perception of detection**.

Small business are particularly vulnerable to fraud due to far fewer controls in place. Need to focus on **hotlines** and setting an **ethical tone.**

Internal controls alone are insufficient to fully prevent occupational fraud.

Conclusions and Recommendations (cont.)

Fraudsters exhibit **behavioral warning signs** of their misdeeds. For example:

- Living beyond their means.
- Financial difficulties.
- Exhibiting control issues – unwillingness to share duties.
- Unusually close relationship with vendor/customer.
- Wheeler dealer attitude.
- Family problems.
- Irritability, suspiciousness or defensiveness.
- Addiction problems.
- Refusal to take vacation.
- Etc.

Auditors and employees should be **trained** to recognize the common behavioral signs that a fraud is occurring.

Effective **fraud prevention** measures are critical

Reasons for Fraud

Based on: IIA Practice Guide – Internal Auditing and Fraud

Common Characteristics of Fraud

- **Pressure or incentive –** need the fraudster is trying to satisfy.
- **Opportunity –** ability to commit the fraud.

  Organizations can influence this characteristic the most = strong internal controls that avoid putting employees in positions to commit fraud and that detect fraudulent activities if they occur.
- **Rationalization –** ability to justify the fraud.
- **AKA =** Fraud Triangle

Red Flags

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Pressure or Incentive (NEED) "Red Flags"

- High personal debts
- Live beyond means
- Excessive investment speculation
- Excessive gambling
- Substance abuse
- Extra-marital affairs
- Job frustration
- Resentment of superiors

Opportunity "Red Flags"

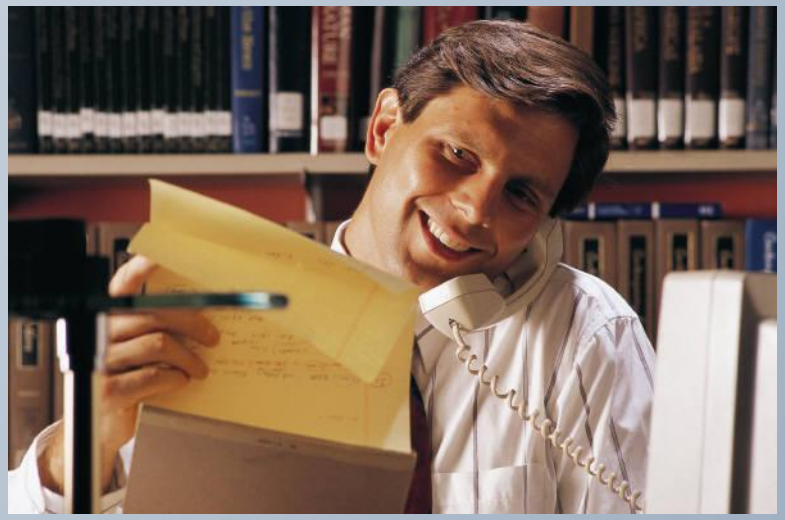
- Inadequate internal controls
- Too "cozy" with suppliers
- Annual vacations or sick days not taken
- Weak management or excessive turnover
- Ineffective or no internal audit
- No rotation of job duties among employees
- Procedures not well understood/always in "crisis mode"
- Large amounts of cash on hand or processed

Rationalization "Red Flags"

- Not compensated fairly
- Everyone else does it
- Intended to pay it back
- Needed the money
- Felt cheated and wanted revenge
- Bribe or kickback was too tempting

Typical Fraudster

- Middle aged male, employed by the organization for a number of years and in a position of trust.
- Educated.
- Works in in the financial department.
- Member of management.
- Driven by money and opportunity



How to Prevent Fraud in Your Organization

Based on:

Management Antifraud Programs and Controls - Commissioned by the Fraud Task Force of the AICPA's Auditing Standards Board

And

IIA Practice Guide – Internal Auditing and Fraud

How to Prevent Fraud in Your Organization

- **Create an Anti-Fraud Environment**
- **Know Your Fraud Risks**
- **Develop an Oversight Process**

Create an Anti-Fraud Environment

Setting the Tone at the Top (Corporate Culture)

- Responsibility of Directors and Officers.
- Lead by example.
- Behave ethically and openly communicate expectations to employees.
- Zero tolerance = show through words and actions that dishonest or unethical behavior will not be tolerated, even if to the benefit of the organization.
- All employees treated equally, regardless of position.
- Formalized code of conduct founded on integrity and communicated to all employees.

Create an Anti-Fraud Environment (cont.)

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Creating a Positive Workplace environment

- Poor employee morale can affect an employee's attitude about committing fraud.
- Factors that help create a positive work environment and reduce the risk of fraud include:
  - Recognition and reward systems that are in tandem with goals and results
  - Equal employment opportunities
  - Team-oriented, collaborative decision-making policies
  - Professionally administered compensation programs
  - Professionally administered training programs and an organizational priority of career development
- HR is instrumental in helping to build a positive work environment.
- Employees should be empowered to help create a positive workplace.
  - Input to development and updating the Code of Conduct
  - Means to obtain advice internally before making decisions that appear to have significant legal or ethical implications.
  - Encouraged and given means to communicate concerns (anonymously) = hotline

Create an Anti-Fraud Environment (cont.)

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Hiring and Promoting Appropriate Employees

- Conduct background investigations before hiring or for a promotion to a position of trust.
- Thoroughly check candidate's education, employment history, and references.
- Periodic training of all employee's on values and code of conduct.
- Incorporate into regular performance reviews an evaluation of how each individual has contributed to creating an appropriate workplace environment in line with the entity's values and code of conduct.
- Continuous objective evaluation of compliance with the entity's values and code of conduct, with violations being addressed immediately.

Create an Anti-Fraud Environment (cont.)

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Fraud Awareness/Training

- All new employees should be trained at time of hiring about values and code of conduct.
- Training should include:
  - Their duty to communicate certain matters
  - A list of the types of matters to be communicated along with examples
  - Information on how to communicate those matters
  - Affirmation from senior management regarding employee expectations and communication responsibilities
- Refresher training periodically

Create an Anti-Fraud Environment (cont.)

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Confirmation

- Management needs to clearly articulate that all employees will be held accountable to act within the code of conduct.
- All employees within senior management and the finance function, as well as other employees in areas that might be exposed to unethical behavior (for example, procurement, sales and marketing) should be required to sign a code of conduct statement annually.

Discipline

- The way an entity reacts to incidents of alleged or suspected fraud sends a strong message throughout the entity.
- The following actions should be taken in response to an alleged incident of fraud:
  - A thorough investigation of the incident should be conducted
  - Appropriate and consistent actions should be taken against violators
  - Relevant controls should be assessed and improved
  - Communication and training should occur to reinforce the entity's values, code of conduct, and expectations
- Expectations about the consequences of committing fraud must be clearly communicated throughout the entity.

Know Your Fraud Risks

- **Identify and Measure Fraud Risks**
- **Mitigate Fraud Risks**
- **Implement and Monitor Appropriate Internal Controls**
- **Identify and Measure Fraud Risks**
  - Management has primary responsibility for establishing and monitoring all aspects of the entity's fraud risk-assessment and prevention activities.
  - The fraud risk-assessment process should consider the vulnerability of the entity to fraudulent activity (fraudulent financial reporting, misappropriation of assets, and corruption) and whether any of those exposures could result in a material misstatement of the financial statements or material loss to the organization.
  - Consider organizational, industry, and county-specific characteristics that influence the risk of fraud.
  - Nature and extent of risk assessment activities should be commensurate with the size of the entity and complexity of its operations.
  - Oversight should be provided by the Board of Directors or Audit Committee.

Know Your Fraud Risks (cont.)

Mitigate Fraud Risks

- Reduce or eliminate some fraud risks by making changes to the entity's activities and/or processes.

Implement and Monitor Appropriate Internal Controls

- Evaluate whether appropriate internal controls have been implemented in any areas that have been identified as posing a higher risk of fraudulent activity, as well as controls over the financial reporting process.

Develop an Oversight Process

To effectively prevent or deter fraud, an entity should have an appropriate oversight function in place that includes the following:

- Audit Committee or Board of Directors
- Management
- Internal Auditors
- Independent Auditors
- Certified Fraud Examiners

Develop an Oversight Process (cont.)

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Audit Committee or Board of Directors

- Evaluate management's identification of fraud risks, implementation of antifraud measures, and creation of the appropriate "tone at the top."
- Ensure that senior management implements appropriate fraud deterrence and prevention measures to better protect investors, employees, and other stakeholders.
- Deterrent to senior management engaging in fraudulent activity.
- Consider the potential for management override of controls or other inappropriate influence over the financial reporting process.
    - Obtain from internal auditors and independent auditors their views on management's involvement in the financial reporting process and ability to override information processed by the financial reporting system.
    - Review reported information for reasonableness compared with prior or forecasted results as well as with peers or industry averages.
    - Information received from the auditors can assist the audit committee in assessing the strength of the entity's internal control and the potential for fraudulent financial reporting.

Develop an Oversight Process (cont.)

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Audit Committee or Board of Directors (continued..)

- Encourage management to provide a mechanism for employees to report concerns about unethical behavior, actual or suspected fraud, or violations of the code of conduct or ethics policy.
- Receive periodic reports on reported concerns and disposition.
- All audit committee members should be financially literate, and each committee should have at least one financial expert.

Management

- Responsible for overseeing, implementing and monitoring processes and controls.
- Set the ethical tone.
- Train employees
- Provide a mechanism for employees to report concerns about unethical behavior, actual or suspected fraud, or violations of the code of conduct or ethics policy.

Develop an Oversight Process (cont.)

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Internal Auditor

- Identify indicators that suggest fraud has been committed.
- Identify fraud risks.
- Evaluate fraud risks and controls
- Recommend actions to mitigate risks and improve controls.
- Investigate potential frauds.

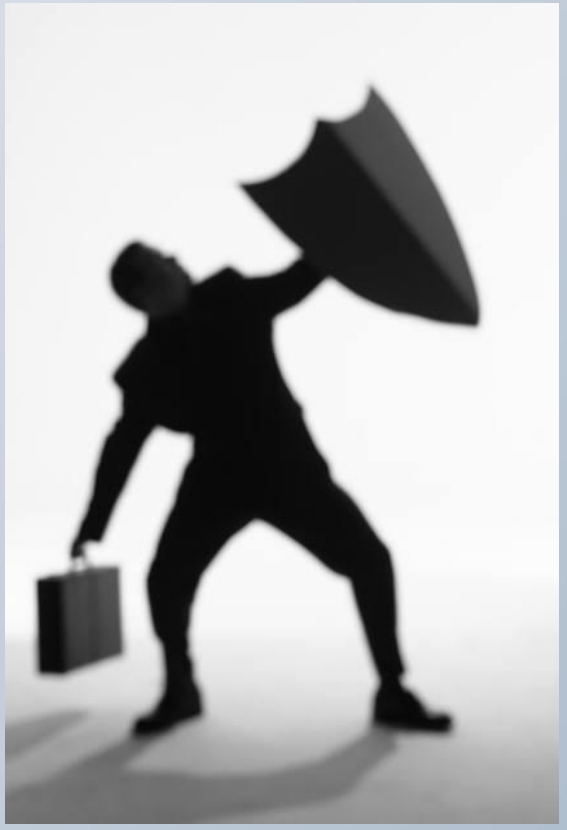
Independent Auditors

- Provide an assessment of the process for identifying, assessing, and responding to the risks of fraud.
- Open and candid dialogue with the Board.

Certified Fraud Examiner

- Assist the audit committee as part of the team of internal auditors or independent auditors.
- Extensive knowledge and experience about fraud.
- Experts on antifraud controls.
- Assist with evaluating the risk of fraud.
- Conduct examinations to resolve allegations or suspicions of fraud.

Fraud Protection Tools



Code of Conduct (AKA – Antifraud Policy)

- **Based on the organization's core values.**
- **Established by Executive Management and the Board with input from employees.**
- **Consists of:**
  - Clear guidance on what behavior and actions are permitted and which are prohibited.
  - Details employee responsibilities in the prevention and detection of fraud
  - Procedures for how employees should seek additional advice when faced with uncertain ethical decisions.
  - Process for communicating concerns about known or potential wrongdoing.
- **All employees should be trained on the Code of Conduct when hired.**
- **Annual refresher training with affirmation.**

Anti-fraud Hotline

- **Communication system that enables employees, vendors, customers and others to communicate concerns about known or potential/suspected wrongdoing.**
- **Telephone, email, web site.**
- **Anonymous.**
- **Adequately publicized.**

Fraud Prevention Checkup

- **ACFE developed tool.**
- **High level assessment of an organization's fraud health.**
- **Designed to identify major gaps in fraud prevention processes and fix them before it is too late.**
- **Focus of assessment is:**
  - Fraud risk oversight
  - Fraud risk ownership
  - Fraud risk assessment
  - Fraud risk tolerance and risk management policy
  - Anti-fraud controls
  - Proactive fraud detection
- **Should be completed by a CFE.**

Fraud Risk Assessment

- **Assists management in systematically identifying where and how fraud may occur and who may be in a position to commit fraud.**
- **Focus on fraud schemes and scenarios to determine the presence of internal controls and whether or not the controls can be circumvented.**
- **Five general steps:**
  - Identify relevant fraud risk factors.
  - Identify potential fraud schemes and prioritize based on risk.
  - Map existing controls to potential fraud schemes and identify gaps.
  - Test operating effectiveness of fraud prevention and detection controls.
  - Document and report the fraud risk assessment.

Fraud Monitoring Using Data Analysis

- A systemic and efficient way of verifying transactions and reducing operational, compliance and financial risks - 100% transaction testing.
- Highlights red flags and identifies potential errors, fraud, inefficient operations and audit targets.
- Identify control weaknesses/breakdowns before they cause too much damage.
- Great for trend analysis to identify unusual items and changes to operations.
- Enhance control environment as employees become aware of the level of detail review.
- No limit to the size of data that can be analyzed.
- Customize to your risks.

Fraud Review/Investigation

- **Results from a concern or suspicion of wrongdoing.**
- **Consists of gathering sufficient information about specific details and performing procedures necessary to determine whether:**
  - fraud has occurred
  - the loss or exposure associated with the fraud
  - who was involved, and how it happened.
- **Must prepare, document, and preserve evidence sufficient for potential legal proceedings.**
- **Must carefully manage in accordance with laws.**
- **Include legal counsel.**
- **Include internal audit.**
- **Include expertise – Certified Fraud Examiner (CFE)**

Who Is Brown Smith Wallace?

- **Celebrating our 38th Year**
- **6th Largest Accounting Firm in St. Louis**
- **2nd Largest Locally Based Firm in Missouri**
- **Fastest Growing Firm in the Midwest per *Practical Accountant* magazine**
- **Only St. Louis-based firm recognized by *Accounting Today* as 'Best Accounting Firm to Work For'**
- **Winner of the Missouri Society of CPA's Work/Life Balance award**
- **200 Professionals and Growing**
- **Independent Firm Associated with Moore Stephens International**
  - Top 10 of all CPA Firms
  - $600 Million in Revenue, 34 domestic firms
  - $1.35 Billion in Revenue, 540 offices, 93 countries
- **Diverse service mix and expanding**
- **High touch, energized firm with a focus on quality**

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