Fraud Prevention, Detection and Response

Dean Bunch, Ernst & Young Fraud Investigation & Dispute Services
Agenda

- Fraud Overview
- Fraud Prevention
- Fraud Detection
- Fraud Response
- Questions
Fraud Overview
Fraud – who are these people?
Bernard Madoff arrested and charged with creating a Ponzi Scheme – Losses could reach $50 Billion

Madoff, 70 of New York, was charged with securities in what federal prosecutors called a Ponzi Scheme that could involve losses of more than $50 billion.

India’s Biggest Fraud

Satyam Computer’s founder B. Ramalinga Raju admitted to inflating the cash balance by nearly $1 billion, incurred a liability of $253 million on funds arranged by him personally, and overstated quarterly revenues by 76% and profits by 97%.

The Justice Department accused Siemens of making bribes and trying to falsify its corporate books from 2001 to 2007.

Siemens AG, settled allegations of corruption of public officials with total fines and penalties of approximately €1 billion.

Parmalat, one of the world’s largest dairy manufacturers, defaults on a €150 million bond

Before investigators could announce that Parmalat overstated its 2003 Earnings by 530%, and understated its liabilities by €1.8 billion, the company declared that €7 billion in liquid assets, believed to exist in a Bank of America account, did not exist at all. By the end of January 2004, Parmalat filed for bankruptcy, with an audit classifying its debt near €14.5 billion.

GlaxoSmithKline settles largest health care fraud case in U.S. History

GlaxoSmithKline will pay $3 billion and please guilty to promoting two popular drugs for unapproved uses and to failing to disclose important safety information on a third in the largest health care fraud settlement in U.S. history.
Types of Fraud

Misappropriation of Assets
- Theft or misuse of tangible and intangible assets.
- Fraudulent expenditures.

Fraudulent Statements Schemes
- Misstatement or omission of material information/accounting records from financial statements.

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Corruption Schemes
- Utilizing influence in business transactions to obtain a personal benefit.
- Bribery and/or extortion.
- Aiding and abetting fraud.

Fictitious Vendor
Payroll Fraud
Employee Expense Fraud
Cash Skimming

Improper Capitalization/Deferral of Expenses
Improper Accounting of I/C Transactions
Improper Revenue Recognition
Asset/Liability Manipulation

Improper Manipulation of Tax Accounts
Improper Journal Entries
Management Estimates
Significant/Unusual Transactions

FCPA/UK Bribery Act
Conflicts of Interest
Procurement Fraud

Procurement Fraud

Employee Expense Fraud
Payroll Fraud
Fictitious Vendor
Cash Skimming
Asset/Liability Manipulation
Improper Journal Entries
Management Estimates
Significant/Unusual Transactions
Improper Revenue Recognition
Improper Accounting of I/C Transactions
Improper Capitalization/Deferral of Expenses

Fraudulent Statements Schemes
- Misstatement or omission of material information/accounting records from financial statements.
Why do people commit fraud?

Many studies suggest that employees who commit fraud do so because there is opportunity, pressure, and rationalization – Cressey’s “Fraud Triangle”.

This framework is a useful tool for those seeking to understand fraud risks.
Current Environment Increases Fraud Risk

- **Companies and organizations have downsized or are currently downsizing, which has an immediate effect on internal controls.**
- **Tight credit environment.**
- **Fear of layoffs.**
- **Stock prices are unstable.**
- **Budgets have decreased. Companies and organizations are doing more with less.**
- **Increased use of government funds.**
- **With increased pressure and decreased internal controls – People will explore more opportunities to create fraud.**

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**Pressure/Incentive**

- **Internal and External Pressure**

**Opportunity to Commit Fraud**

- **Internal Controls**

**Attitude/Rationalization**
Mitigating Fraud

Approaches used by companies to minimize and mitigate potential or existing fraud.

- **Fraud Prevention**
  - Setting strong tone at the top
  - Implementing policies and procedures in order to prevent fraud from occurring
  - Developing fraud training and awareness
  - Establishing strong Internal controls

- **Fraud Detection**
  - Internal controls
  - Hotline

- **Fraud Response**
  - Internal Investigation
  - Independent Investigation
## Components of an Anti-Fraud Program

### Elements of a successful corporate anti-fraud program

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<tr>
<th>Setting the Proper Tone</th>
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### Anti-fraud key activities

- Corporate compliance program design
- Corporate compliance assessment
- Gap analysis
- Future state design session
- Discovery response planning
- Records and information management
- Who owns fraud?
  - Assign roles and responsibilities
  - Fraud and risk committee formulation
  - Customized training
  - Corporate governance
  - Design sessions
  - Corporate anti-fraud roadmap
- Fraud risk assessment
- Targeted anti-fraud analytics
- Internal control monitoring
- Internal control testing
- Investigations
- Response plan
- Discovery and document review
- Forensic data analytics
- Assessment & remediation
- Continuous improvement
Components of an Anti-Fraud Program

Fraud Prevention

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Management Ownership and Involvement

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Fraud Prevention Overview

A pro-active fraud prevention program is key for every company in its battle against fraud. At minimum, the program must:

► Reduce risk of fraud
► Act as a deterrent
► Reduce opportunity
► Reduce internal and external pressures
► Align attitudes of employees
► Provide an avenue for communication and openness
► Save money and resources in the long run and reduce potential fraudulent activities
Fraud prevention measures

- Tone at the top
- Anti-fraud programs
- Code of ethics
- Policies and procedures
- Continuous communication and reinforcement of fraud prevention programs
- Anti-fraud training
- Fraud risk assessments
A robust anti-fraud program includes:

- Executive management involvement
- Employee code of ethics
- Clear company fraud prevention policies
- Communication and awareness of policies
- Continuous training and education on anti-fraud policies
- Disciplinary action and zero tolerance for violations
- Communication of violations and disciplinary actions
Code of Ethics

► Development
► Documentation
► Communication
► Disciplinary Actions
► Global Operations
► Monitoring
Fraud Prevention Policies & Procedures

Fraud prevention policies should also include internal controls preventing fraud, such as:

► Extensive background checks
  ► New-hires
  ► Promotion candidates
  ► Suppliers, customers and business partners (including international third parties)

► Segregation of duties
► Position rotations
► Limitations of physical access to assets
► Removal of unauthorized and old system users
Training & Communication

► After policies and procedures are developed they must be effectively communicated
  ► Management involvement in delivering the message
  ► In-person and web-based training
  ► Positive affirmation of policies
    ► Periodic reminders – once is not enough
    ► Consider annual confirmation for high risk functions
  ► Training people to recognize and report red flags
    ► Special training for finance professionals
    ► Special training for senior executives
    ► Special training for others in high-risk positions (i.e. business developers, sales and marketing)
  ► Broad rollout of anti-corruption measures
Purpose of fraud risk assessments

- To demonstrate that management is setting the proper tone within the organization regarding fraud
- To understand vulnerabilities within the company
- To identify and evaluate areas that pose a higher risk of fraud
- To identify where the company should focus its anti-fraud resources
- To identify areas of improvement
Fraud Detection
# Components of an Anti-Fraud Program

## Fraud Detection

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Fraud Detection Overview

- Detection is the key in mitigating fraud when there are gaps in companies’ fraud prevention programs or when perpetrators circumvent existing policies.

- Fraud detection measures include:
  - Established procedures and avenues for reporting suspicious and fraudulent activities
  - Financial statement analytics
  - Targeted anti-fraud analytics
  - Internal control monitoring
  - Internal control testing
Sources of Detection

Internal
► Hotline
► Whistleblower allegations
► Concerns raised by employees
► Internal Audit findings

External
► Industry issues and events
► External auditor (Section 10A)
► Analysts
► Regulator questions – e.g. SEC, DOJ, IRS
► Other business events (e.g., commercial disputes, loan defaults, business failure)
How is fraud detected?

50% by tip or accident

2012 ACFE Report to the Nation on Occupational Fraud
Forensic analytics maturity model
Beyond traditional “rules-based queries” – consider all four quadrants

- **Detection Rate**
  - Low
  - High

- **False Positive Rate**
  - High
  - Low

- **Structured Data**
  - Matching, Grouping, Ordering, Joining, Filtering
  - “Traditional” rules-Based Queries & Analytics
  - Statistical-Based Analysis

- **Unstructured Data**
  - Keyword Search
  - Traditional Keyword Searching
  - Data visualization, Drill-down into data, Text Mining
  - Data Visualization & Text Mining
Transaction Risk Scoring

Review breaches on targeted analytics

Filter by selected analytics
Finding hidden money...
Duplicative payments to fictitious vendors

<table>
<thead>
<tr>
<th>Vendor ID</th>
<th>VendorName</th>
<th>DocDate</th>
<th>Amt</th>
<th>Street Address</th>
<th>Invoice Number</th>
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<td>41932CM</td>
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Similar names
Some with same address
Travel & entertainment – an FCPA risk example

“Who entertained whom, where, what for and for how much?”
Fraud Response
## Components of an Anti-Fraud Program

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**Management Ownership and Involvement**
Fraud Response - Investigating fraud allegations

► Overview

► Components of an Anti-Fraud Program – Fraud Response

► Response Protocols

► Types of Investigations

► Steps to a Successful Investigation

► Reporting the Results

► Investigation Challenges
Fraud Response Overview

► Plan

► Execute

► Report
Response Protocols

► Receive the allegation

► Understand the nature of the allegation
  ► Determine whether it involves a potential violation of laws, rules, or company policy (establish privileged as appropriate)
  ► Ask the following questions:
    ► What is the source of the allegation
    ► When and where did the events occur and over what period of time
    ► What evidence may exist
    ► Who may be involved
    ► Who is likely to have relevant knowledge or information
    ► What will be the role of each stakeholder

► Determine the appropriate course of action
  ► Consult the necessary resources to determine the “next steps”
  ► Assemble the team to conduct the investigation
  ► Preserve the data, especially electronic data
Types of Investigations

► Internal Investigation – Conducted at the direction of management and the Company’s in-house or outside counsel.

► Independent Investigation – Conducted at the direction of a committee of the Board of Directors (e.g. Audit Committee or Special Committee) with outside counsel.

► “The Compelling Case” for an Independent Investigation
  ► Consistent with focus of Sarbanes-Oxley
  ► Credibility with regulators – i.e. SEC and DOJ
  ► Expectation of external auditor
  ► Expectation of regulators
  ► Best practice
Steps to a Successful Investigation

First Things First

► Preserve the environment, including electronic and hardcopy documentation

► Define scope of investigation
  ▶ Critical early step that needs to be articulated to keep investigation on track
  ▶ Develop process that enables input by appropriate stakeholders
  ▶ Understand that scope may need to be revised as facts are gathered
  ▶ Determine privilege

► Assemble an appropriate investigative team

► Develop investigative work plan

► Establish communication protocol
  ▶ Audit / Special Committee
  ▶ External auditor
  ▶ Regulatory bodies
Reporting the Results

► Consider appropriate format
  ► Oral or written
  ► PowerPoint, Word or other

► Report Contents
  ► Issues raised / Scope of investigation
  ► Timeline of investigation
  ► Procedures performed
  ► Data collected / considered
  ► Chronology of key events
  ► Issue-specific topics (e.g., specific transactions, sales activity, T&E policies)
  ► Findings & observations
  ► Remediation considerations

► Transmittal of report
  ► Distribute based on protocol established by counsel
  ► Disclosure to regulators, stakeholders, and other third parties (if applicable)
Questions?

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