

Asset Misappropriation/ Fraud

ICPAK Forensic Audit Conference

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Introduction to Fraud

Asset Misappropriation: Introduction

- ▶ What is Fraud?
- ▶ and what is Asset Misappropriation?

What is Fraud?

Definition of fraud

- ▶ A false representation of a matter of fact, whether by words or by conduct, by false or misleading allegations, or by concealment of that which should have been disclosed, which deceives and is intended to deceive another so that he shall act upon it to his legal injury.” -*Black’s Law Dictionary*
- ▶ Common classifications of fraud: **corruption, asset misappropriation and fraudulent financial statements.**

Corruption: Definition

- ▶ Corruption means any dishonest activity in which an organization's employee **abuses** his/her position of trust in order to achieve some **personal gain** or advantage for him or herself or for another person or entity. Examples:
 - ▶ Conflict of interest which puts a person's interest ahead of the interest of the organization.
 - ▶ Inappropriate application of the tender and procurement process.
 - ▶ Accepting or seeking anything of value from any contractor, vendor or person providing services or materials to the organization.
 - ▶ Bribing, or attempting to bribe, any public official, vendor, customer or other person.

Elements of Fraud



A representation about a material fact, which is false



Made intentionally, knowingly, or recklessly



Is believed

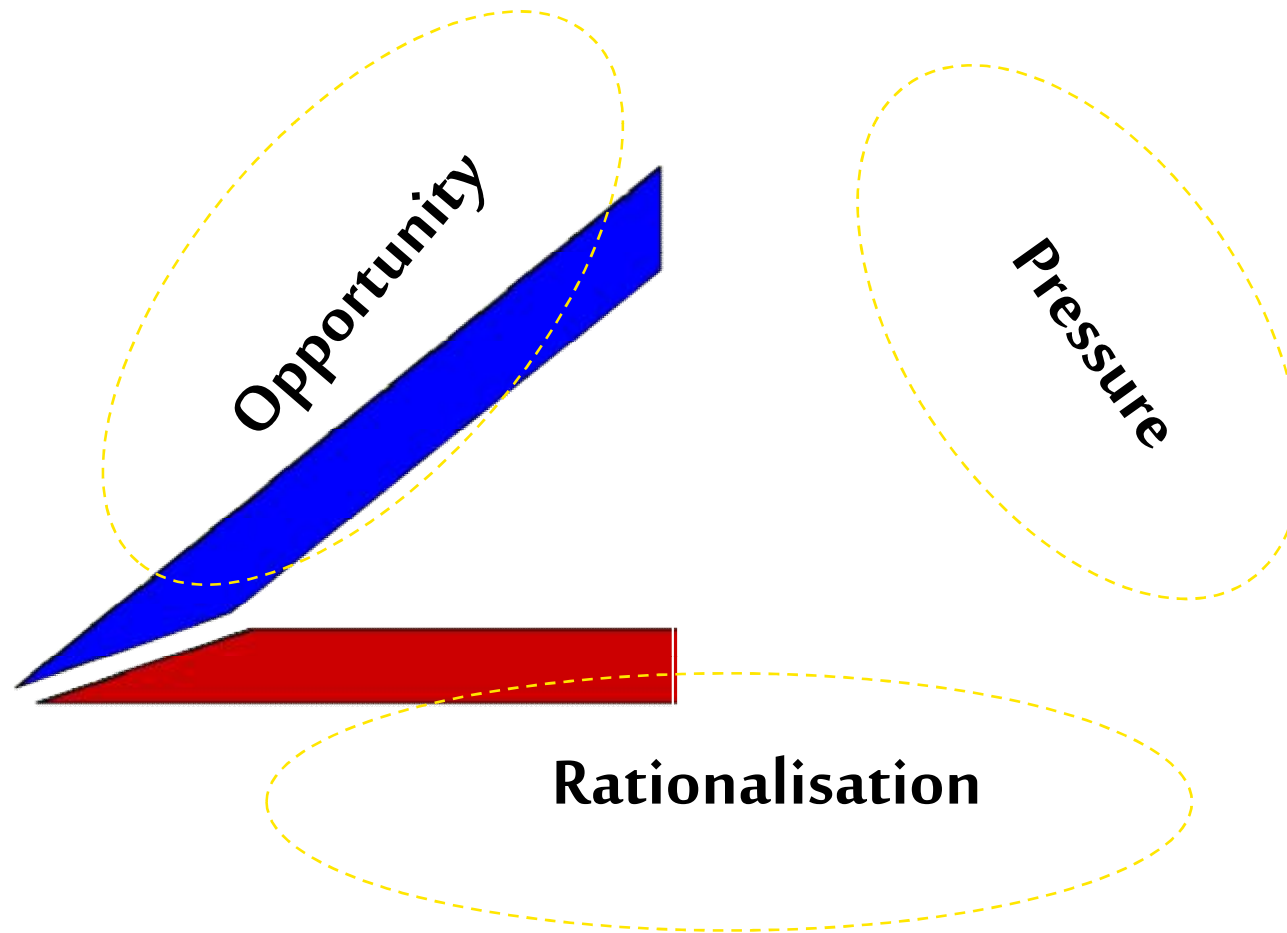


And acted upon by the victim



To the victim's detriment

Why do people commit fraud: Fraud triangle



Why do people commit fraud: Fraud triangle

Work Pressure

- ▶ Performance targets
- ▶ Poor financial performance
- ▶ Threat of job loss

Personal pressure:

- ▶ Extravagant Life style
- ▶ To meet society's expectation
- ▶ To cover errors
- ▶ Intellectual challenge
- ▶ Financial problems
- ▶ Drugs or gambling
- ▶ Greed
- ▶ Medical bills

Opportunity

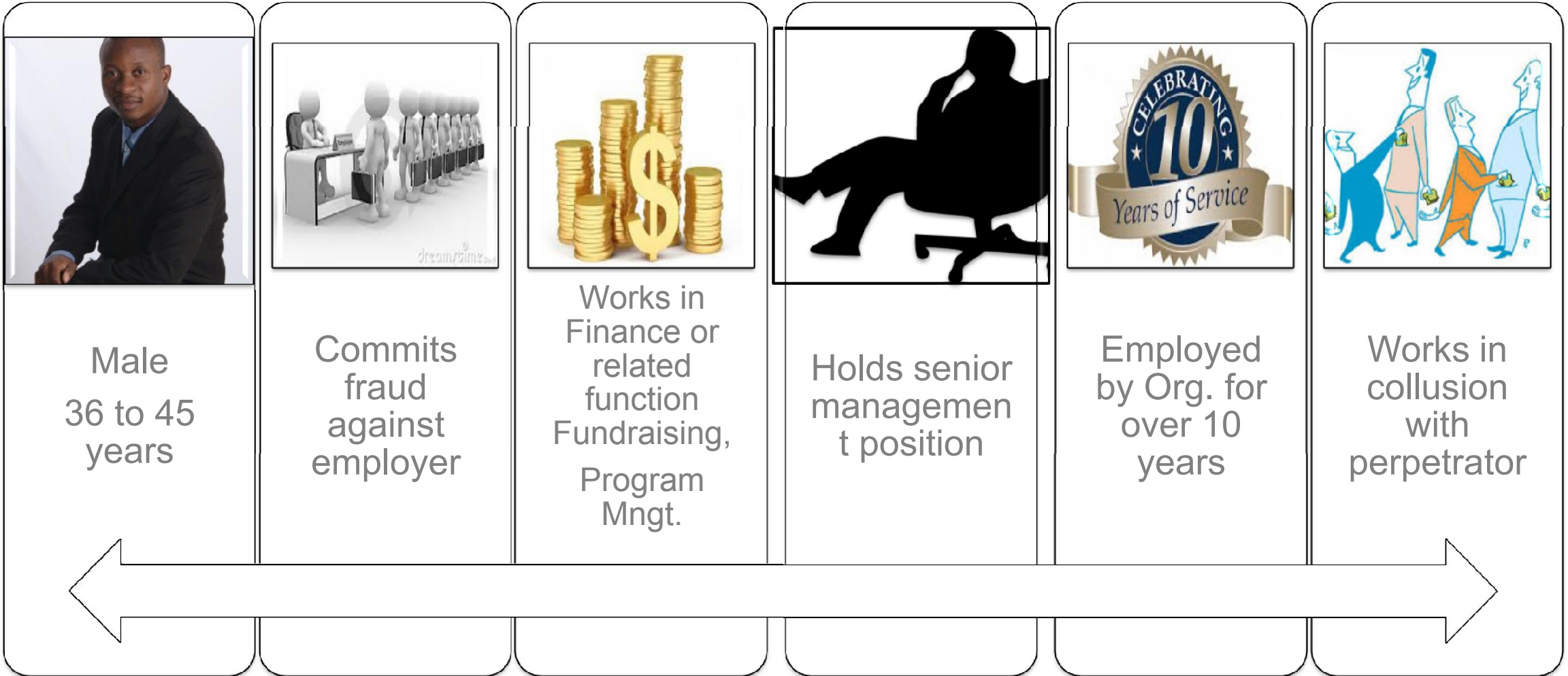
- ▶ Weak organizational policies and procedures
- ▶ Poor organizational corporate governance

Rationalization

Is justifying a behavior
i.e. I stole

- ▶ To save a family member who was sick or in jail.
- ▶ To save my home, car, etc. from being auctioned by the bank
- ▶ To reward myself because the organization does not pay me enough.
- ▶ To take my children to school.

...a Typical Fraudster



Asset Misappropriation

- ▶ Asset misappropriation fraud happens when people who are entrusted to manage the assets of an organisation steal from it.
- ▶ Asset misappropriation fraud involves third parties or employees in an organisation who abuse their position to steal from it through fraudulent activity. It can also be known as insider fraud.
- ▶ This type of fraud can be committed by company directors, or its employees, or anyone else entrusted to hold and manage the assets and interests of an organisation.

Asset Misappropriation

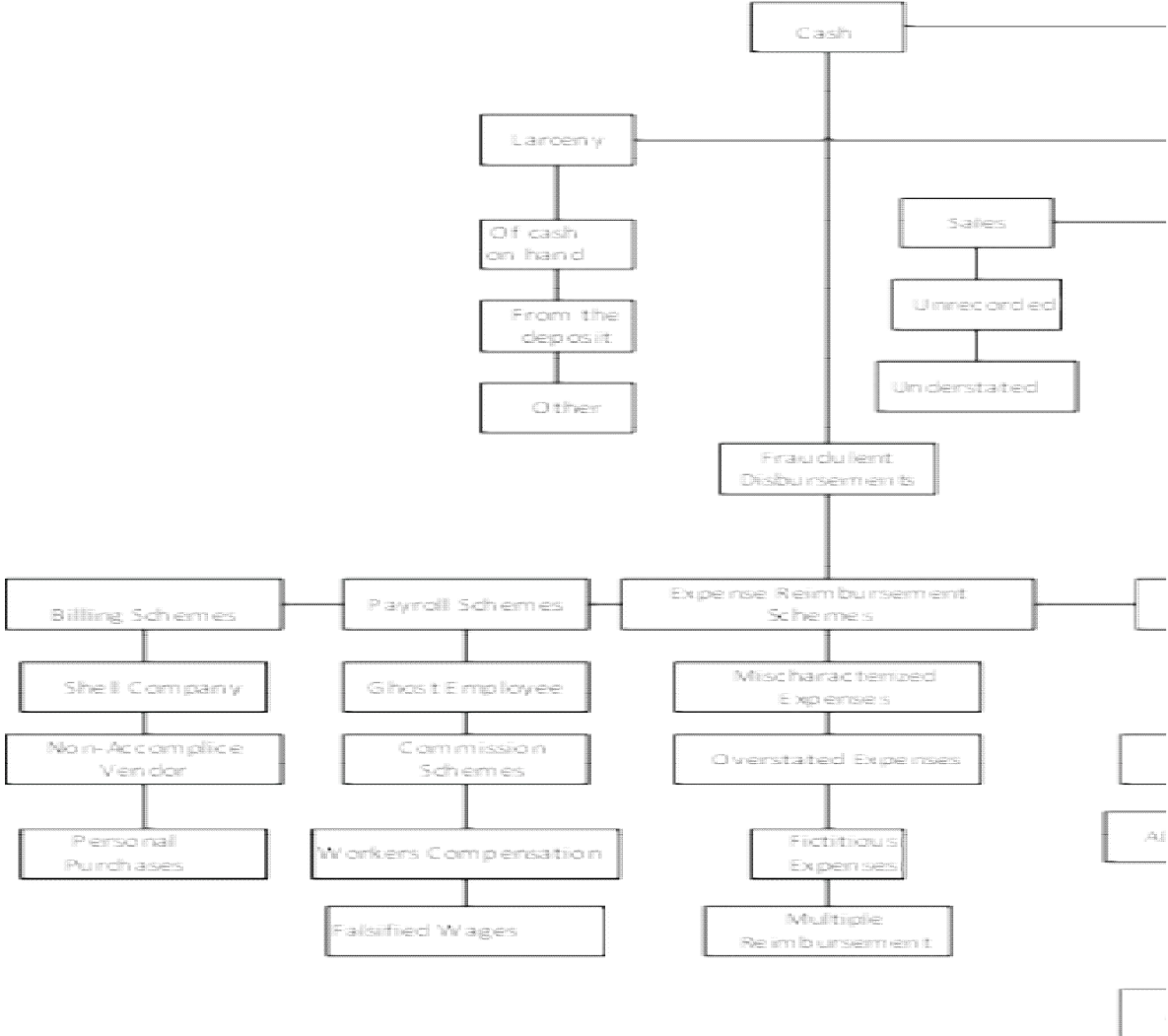
- ▶ Typically, the assets stolen are cash or cash equivalents, such as credit notes or vouchers. However, the fraud can extend to include company data or intellectual property.
- ▶ At one end of the scale, asset misappropriation fraud may be limited to isolated cases of expense fiddling or an employee lying about his or her qualifications to get a job.
- ▶ At the other end, it might involve organised crime groups infiltrating organisations to take advantage of weak processes and inadequate internal systems and controls.

Asset Misappropriation Schemes

Asset Misappropriation Schemes

- ▶ Cash receipts schemes
- ▶ Inventory and all other assets schemes

Asset Misappropriation Schemes



Assessing the Culture and Addressing Entity-Wide Risks

Assessing the Culture and Addressing Entity-Wide Risks

- ▶ Communication and enforcement of integrity and ethical values;
- ▶ Commitment to competence:
- ▶ Participation by those charged with governance:
 - ▶ Attributes including independence from management, experience, extent of involvement and scrutiny of entity activities and appropriateness of their actions including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
- ▶ Management's philosophy and operating style:
 - ▶ Characteristics such as management's approach to taking and managing business risks, attitudes and actions toward financial reporting, attitudes toward information processing and accounting functions and personnel.

Assessing the Culture and Addressing Entity-Wide Risks

- ▶ Organizational structure:
 - ▶ Important considerations are clarity of lines of authority and responsibility; the level at which policies and procedures are established; adherence to these policies and procedures; adequacy of supervision and monitoring of decentralized operations; and appropriateness of organizational structure for size and complexity of the entity
- ▶ Assignment of authority and responsibility:
 - ▶ Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established; and
- ▶ Human resource policies and practices:
 - ▶ Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counseling, promotion, compensation, and remedial actions.

Controlling Risks in Sales and Accounts Receivable

Cash Receipts Schemes

- ▶ Two types;
 - ✓ Skimming and;
 - ✓ Larceny

Skimming

- ▶ Skimming happens when cash has not been recorded in the books of the org (off-book fraud).
- ▶ Skimming is the most common form of occupational fraud and occurs most frequently in the retail industry during the point of sale when an employee first receives cash from a customer.

How Sales Skimming happens (Modus Operandi)

- ▶ Register manipulation
 - ▶ Ring a no sale and open cash drawer then steal the money
- ▶ Skimming during non business hours
 - ▶ Open business on weekends or after hours without management's knowledge.
- ▶ Skimming of off-site sales
 - ▶ Salespersons do not submit cash collected field visits
- ▶ Understated sales-
 - ▶ Lower amount is posted than what is actually received
- ▶ False discounts-
 - ▶ Employee receives full amount but records as if customer was given discount and pockets the alleged discount amount.
- ▶ Theft of sales received through mail
 - ▶ Employee steals cheques from customers and fails to post them to customer accounts.
- ▶ Cheque for currency substitution
 - ▶ Swap cheques for cash

Receivables Skimming

- ▶ Cash expected from account customers is stolen.
- ▶ How to conceal:
 - ▶ Forcing account balances
 - ▶ Destruction of transaction records
 - ▶ Lapping
 - ▶ Stolen statements
 - ▶ False account entries
 - ▶ Debits to expense accounts
 - ▶ Debits to aging or fictitious receivables
 - ▶ Writing off account balances
- ▶ Lapping involves crediting of one account through abstraction of money from another account (i.e. robbing John to pay Peter)

How to detect Skimming Schemes

- ▶ Analytical procedures such as vertical and horizontal analysis of sales accounts and ratio analysis
- ▶ Review and analysis of all journal entry in cash and inventory accounts
- ▶ Examination of source documents such as bank deposit slips; checking for dates of customer payments with the dates customer accounts are posted
- ▶ Confirmation of customer accounts(large ones)

Skimming Red Flags

- ▶ Missing transaction records
- ▶ Inventory shortage
- ▶ Cash receipts or deposit totals differ from expected patterns
- ▶ Unusual journal entries or unusual items on the bank reconciliation
- ▶ Unusual behaviour of suspects
- ▶ Inadequate segregation of duties
- ▶ Different dates between deposits and entries to accounting books
- ▶ Differences between deposits slip names and amounts of credits to accounts
- ▶ Unauthorized write-offs of pledges or promises to give
- ▶ Unusual journal entries
- ▶ Inadequate segregation of duties

Prevention of Skimming Schemes

- ▶ Segregation of duties
 - ▶ Require that employees with similar duties regularly alternate specific tasks
 - ▶ Separate the custodial, record keeping and supervisory functions of the cash collection process.
 - ▶ Make sure individuals handling receipts do not have access to posting, write-offs or other accounting functions
 - ▶ Require a person who is not responsible for handling or recording cash to perform bank records
- ▶ Increase Supervision and Monitoring
 - ▶ Place a video camera in a visible location
 - ▶ Make sure a manager or supervisor is present at all times
 - ▶ Make sure employees are informed about the audits that will be conducted

Prevention of Skimming Schemes

- ▶ Don't just look at the numbers! Make sure your organization's accounts receivables are valid by:
 - ▶ Obtaining a bank deposit detail and comparing to cash and A/R posting on a periodic and surprise basis
 - ▶ Comparing freight bills or shipping documents to sales records
 - ▶ Comparing employee addresses and phone numbers to vendor master files
 - ▶ Conducting a Cut-off Analysis
 - ▶ Confirming receivables on a regular and surprise basis
 - ▶ Reviewing exception reports and investigate deviation/exception files such as changes to Master File
 - ▶ Requiring supervisory approval for write-offs
 - ▶ Performing regular financial ratio analysis
 - ▶ Switching to lock-box receipts
 - ▶ Investigating long standing deposits-in-transit and unreconciled items on bank reconciliation
 - ▶ Considering a lock-box for receivables
 - ▶ Performing financial ratio analysis
 - ▶ Eliminating off-book receivables

Cash Larceny



Cash Larceny

- ▶ Larceny happens when cash has already been recorded in the books of the org.
- ▶ How it happens:
 - ▶ Cash theft at cash collection points
 - ▶ Cashier/ employee opens the cash drawer and steals the money or cheque.
 - ▶ Transactions reversing.
 - ▶ Employee may process reverse transactions which cause the books to reconcile to cash after the theft
 - ▶ Register manipulation
 - ▶ Employee alters the cash register to reconcile it to the cash
 - ▶ Altering cash counts
 - ▶ When cash from the register is totalled and prepared for deposit, employee simply records the wrong amount so that cash on hand appears to balance with the total on the register tape.
 - ▶ Destroying cash register tapes.
 - ▶ Employee destroys the register tapes if he/she discovers that the cash and the tapes don't reconcile to avoid being caught
 - ▶ Deposit lapping.
 - ▶ Employee steals deposits for day one and replaces with deposits for day two
 - ▶ Deposit in transit.
 - ▶ Employee may carry the cash missing as deposits in transit

Detection of Cash Larceny

- ▶ In-depth analysis of cash receipts and recording process
- ▶ Review and analysis of the relationship between sales, cost of sales and returns and allowances
- ▶ Regular analysis all journal entries made to cash accounts

Prevention of Cash Larceny

- ▶ Segregation of duties
- ▶ Assignment rotation and mandatory vacations
- ▶ Surprise cash counts and supervision
- ▶ Physical security of the cash-lockable drawers

Cash Register Disbursements

▶ False refunds

- ▶ It happens when a refund is allegedly processed for a customer who returns an item to the company but in actual sense no refund was made to the customer or the refund was actually requested the customer and item returned to the store but an employee processing the refund overstates it and pockets the excess

▶ How to conceal it:

- ▶ Destroy the refund records-cash register
- ▶ Ensure that refunds made are below the review threshold
- ▶ Conceal shortages to inventory through forcing inventory totals, write of inventory as obsolete or lost, charge inventory to existing A/R, pad inventory, false credits to perpetual inventory

False Voids

- ▶ Employee fails to give the customer a sale receipt and uses that receipt to void the sale. He/she obtains the approval for the void sale by forging supervisors approval, use the supervisor's rubber stamp approval, abuses his/her approval authority or concludes with supervisor
- ▶ Receipt is usually attached for voided sale.
- ▶ Cash is then removed from the cash register
- ▶ **How to conceal it:**
 - ▶ Similar to false refund

Detection of Register Disbursement Schemes

- ▶ Evaluate refunds or discounts given by each cashier or sales person and check that all refunds are appropriate and properly documented
- ▶ Review and analysis of the relationship between sales, cost of sales and returns and allowances

Register Disbursement Scheme Red Flags

- ▶ Inappropriate employee segregation of duties i.e. register counting and reconciliation done by one individual
- ▶ Cashiers rather than supervisors have access to control keys for refunds and voids
- ▶ Register employees have authority to void own transactions
- ▶ Register refunds are not methodically reviewed
- ▶ Multiple cashiers operate from a single cash drawer without separate access codes
- ▶ Personal cheques from cashier found in the register
- ▶ Voided sales are not properly documented or are not approved by supervisor
- ▶ Voided cash receipts forms are not retained on file
- ▶ Missing or obviously altered register tapes
- ▶ Inventory totals appear forced

Prevention of Register Disbursement Schemes

- ▶ Review segregation of duties of key employees
- ▶ Access to the register must be closely monitored and access codes must be kept secure
- ▶ Perform unannounced cash counts
- ▶ Maintain the presence of manager or supervisor near the area of cash register as a deterrent to theft
- ▶ Review support documentation for voided and refunded transactions for legitimacy
- ▶ Quantity of refunds should be analysed to detect multiple small refunds
- ▶ Random service calls to customers for refunds or voided sales
- ▶ Maintain signs at the register asking customers to ask for and examine their receipts

Controlling Risks in Cash Disbursements

Expense Reimbursement Schemes

▶ Mischaracterized expenses

- ▶ Requesting for reimbursements for personal expenses by claiming they are business related expenses e.g. claiming personal expense as a business trip, listing dinner with a friend as business development.

▶ Overstated expenses

- ▶ Employees overstate the actual cost of business expenses through altering receipts, over purchasing, overstating another employee's expenses.

▶ Fictitious expenses

- ▶ Employee "invents" an expense and requests that be reimbursed. This can be by producing fictitious receipts, obtaining and using blank receipts from vendors, claiming expenses of others.

▶ Multiple reimbursements

- ▶ Involves submission of a single expense several times e.g. submission of several types support for the same expense.

Detection of Expense Reimbursement Schemes

- ▶ Review and analysis of expense accounts- historical comparisons or comparisons with budgeted amounts
- ▶ Detailed review of expense reports

Prevention of Expense Reimbursement Schemes

- ▶ Set policy that requires proof of expense reimbursement requests.
- ▶ Require expenses over a designated amount to have advance management approval.
- ▶ People who process requests for expense reimbursement should not be allowed to issue checks.
- ▶ Payments made for expenses should also be audited monthly.
- ▶ Detailed review of expense reports bearing in mind the following points:
 - ▶ Receipts and other support documentation
 - ▶ Specific business purpose
 - ▶ Time period of when the expense was incurred
 - ▶ Place of expenditure
 - ▶ Amount

Controlling Risks in Purchasing and Accounts Payable

Billing Schemes

- ▶ Invoicing via shell companies
 - ▶ The perpetrator forms a shell company; submits false invoices; self approves the fraudulent invoices or steals rubberstamp of approver or colludes with approver; shell company mostly provides services rather goods
- ▶ Invoicing via non-accomplice vendors
 - ▶ The perpetrator intentional pays a legitimate vendor twice and later calls the vendor requesting for the other cheque to be returned only for him/her to intercept it and convert it to him/herself; or over pay legitimate vendor and request for refund of excess; or intentionally purchase excess goods, return the excess and pocket the refund
- ▶ Personal purchases with company funds
 - ▶ The perpetrator buys personal items and falsifies invoice to appear its legitimate company expense; or make purchases through credit cards or on running accounts with the vendor

Detection of Billing Schemes

- ▶ Analytical review-review general ledgers accounts for unusual events
- ▶ Check for vendors with matching addresses
- ▶ Site visits-observation
- ▶ Review of complaints from vendors and customers

Prevention of Billing Schemes

- ▶ Training purchasing personnel on ethical standards
- ▶ Sufficient compensation for purchasing staff to reduce the motive and rationalisation for the fraud
- ▶ Proper documentation-pre-numbered and controlled purchase requisitions; purchase orders; receiving reports; cheques
- ▶ Proper approvals-for vendor additions; Local Chart of Authority with limits-”who can approve what”
- ▶ Segregation of duties-purchasing separate from payment functions
- ▶ Invest in hotlines
- ▶ Enforce policies on competitive bidding
- ▶ Purchases and inventory levels should be compared and analysed
- ▶ Credit card statements should be reviewed periodically for any irregularities
- ▶ Receiving and shipping reports should be reviewed for completeness and accuracy
- ▶ Accounts payable list of vendors should be periodically reviewed for strange vendors and addresses

Cheque Tampering Schemes

- ▶ Forged maker
 - ▶ This happens when an employee misappropriates a cheque and fraudulently affixes the signature of an authorized maker thereon.
- ▶ Forged endorsements
 - ▶ This happens when an employee intercepts a company cheque intended to pay a third party and converts the cheque by endorsing it in the third party's name. In some cases the employee also signs his own name as a second endorser.
- ▶ Altered payee
 - ▶ This happens when an employee intercepts a company cheque intended to pay a third party and alters the payee designation so that the cheque can be converted by the employee or an accomplice.
- ▶ Authorized maker
 - ▶ This happens when an employee with signature authority on a company account writes fraudulent cheques for his/her own benefit and signs his/her own name as the maker

How to conceal Cheque Tampering Schemes

- ▶ How to conceal forged maker schemes?
 - ▶ Force reconciliation
 - ▶ Alter forged cheque by inserting legitimate payee
 - ▶ Remove forged cheque from bank statement
- ▶ How to conceal forged endorsement schemes?
 - ▶ Remove dual endorsed cheques from bank statement
 - ▶ Erase second endorsement- employee's signature
 - ▶ Destroy/falsify cheque delivery forms
 - ▶ Issue manual cheque for recipient
 - ▶ Re-enter recipient's claim for payment e.g. invoice
- ▶ How to conceal altered payee schemes?
 - ▶ Same as forged maker/forged endorsement
- ▶ How to conceal authorized maker schemes?
 - ▶ Same as forged maker/forged endorsement

How to Detect Cheque Tampering Schemes

- ▶ Account analysis through cut off statements-request and review bank cut off statements for 10-15 days after closing date of the balance sheet
- ▶ Bank reconciliations
- ▶ Bank confirmations

Cheque Tampering Red Flags

- ▶ Cheques payable to employees
- ▶ Customer complaints regarding payments not being made to their accounts
- ▶ Too many returned cheques
- ▶ Unusual behaviour of suspects
- ▶ Theft of cheques, missing cheques or cheques out of sequence
- ▶ Altered cheques
- ▶ Voided or cancelled cheques
- ▶ Unusual payees such as cash payees or unapproved vendors
- ▶ Unusual endorsements on cheques
- ▶ Stale cheques on the bank reconciliations
- ▶ Unlimited access to unused cheques or cheque printing machines
- ▶ Missing or unusual support documentation
- ▶ Differences between payee on cheques and cheque register

Prevention of Cheque Tampering Schemes

- ▶ Cheque disbursement controls
 - ▶ Segregation of duties
 - ▶ Review of vendor information changes
 - ▶ Bank reconciliations and review by senior management
- ▶ Bank assisted controls
 - ▶ Set limits for cheques drawn
 - ▶ Providing bank with list of cheques and amounts written each day (positive pay banking controls)
- ▶ Physical tampering controls
 - ▶ Signature line void safety band- the word VOID appears on the cheque when photocopied
- ▶ Cheque theft controls
 - ▶ Safe custody of unused cheques
 - ▶ Securely store cancelled cheques
 - ▶ Report stolen or lost cheques immediately

Controlling Risks in Payroll and HR

Payroll Schemes

- ▶ Ghost employees.
 - ▶ The perpetrator adds someone to payroll who does not work for the victim organization; the perpetrator is paid
- ▶ Commission schemes.
 - ▶ Falsify the amount of sales made or increase the commission rate in order to receive higher commission
- ▶ Falsified hours and salary schemes.
 - ▶ Overstating hours worked and forging supervisor's signature or colludes with supervisor or increasing the daily rate for salaried persons

Detection of Payroll Schemes

- ▶ Analysis of deductions from payroll
- ▶ Review of overtime for proper authorizations
- ▶ Perform random checks on customers to confirm sales for the commission paid
- ▶ Comparative analysis of commissions earned by salespersons
- ▶ Analysis of payee addresses and accounts

Payroll Schemes Red Flags

- ▶ Theft of cheques, missing payroll cheques or cheques out of sequence
- ▶ Cheques to employees with incomplete or no personnel records
- ▶ Duplicate pay cheques or entries on payroll records
- ▶ Employee complaints about improper pay or withholdings
- ▶ Employee complains about excess compensation on P9 Form
- ▶ Unusual payees or endorsements of cheques
- ▶ Uncontrolled unclaimed payroll cheques
- ▶ Unauthorized electronic funds transfers
- ▶ Unusual or unexpected fluctuations from budget in payroll expense or hours
- ▶ Unapproved timesheets or time cards
- ▶ Tax authority notices about failure to make timely deposits
- ▶ Late tax deposits
- ▶ Unusual endorsements on tax deposits
- ▶ Unusual behaviour of suspects
- ▶ Inadequate segregation of duties

Prevention of Payroll Schemes

- ▶ Establish internal controls requiring separation of payroll duties.
 - ▶ Personnel who create or maintain payroll data and lists should not be allowed to make changes or add employees without management approval.
 - ▶ Payroll changes should be approved by two designated individuals.
 - ▶ People who compute pay rates and accumulated hours for payroll should not be allowed to write payroll checks or submit the hours for payment by a payroll service without supervisory approval.
- ▶ Have payroll accounts reconciled monthly and reviewed by management. Audit payroll information for duplicate deposit account information and repeated Social Security numbers or addresses.
- ▶ Most banks provide a positive pay service where check numbers, amounts and employee names provided by the company are checked against any incoming payroll check.
- ▶ If direct deposit is used exclusively, require employees to pick up their paychecks in person with photo ID at least once per year at human resources or another designated department.
- ▶ Small business should consider outside sourcing of payroll to a contractor, but this does not remove the requirement for a monthly audit of all disbursements made to assure that only certified employees are being paid.

Controlling Risks Related to Physical Assets

Inventory and Other Assets Schemes

- ▶ Employees may target inventory, equipment, supplies and other non cash assets for theft
- ▶ Misuse of company assets
 - ▶ Employee might use his/her laptop/computer at work to write letters, print invoices, or do other work connected to his/her side business
- ▶ Theft of inventory and other assets.
 - ▶ This may include larceny, asset requisition and transfer schemes, purchasing and receiving schemes, false shipment schemes
- ▶ Larceny
 - ▶ involves employee simply takes inventory or other assets from the company premises without attempting to conceal the theft in the records and books. It can also happen through false sale by an accomplice of the employee where a sale is not actually realised.

Inventory and Other Assets Schemes

- ▶ Asset requisitions and transfers
 - ▶ Employee requisitions materials for some work related project then makes off with the materials. Employee may also overstate the amount of supplies or equipment needed and pilfers the excess or he/she may invent a fictitious project which necessitates the use of certain assets he/she intends to steal.
 - ▶ Can also falsify asset transfer forms.
- ▶ Purchasing and receiving schemes
 - ▶ Employee charged with receiving goods may falsify records of incoming shipments or marks some goods as substandard and keeps them instead of sending to the vendor
- ▶ False shipment of inventory and other assets
 - ▶ Employees may create false shipping documents and false sales documents to make it appear that the inventory they take was sold rather than stolen. This creates a fake accounts receivable in the books hence delinquency.

Detection of Inventory and Other Assets Schemes

- ▶ Review of perpetual inventory records for any unexplained entries
- ▶ Undertaking physical inventory counts
- ▶ Matching sales to respective shipping documents
- ▶ Analytical review of cost of sales, sales, purchases and purchase prices

Prevention of Inventory and Other Assets Schemes

- ▶ Have proper documentation
 - ▶ Pre-numbered and controlled.
- ▶ Segregation of duties
 - ▶ Different personnel for requisition, receiving, disbursement
- ▶ Conduct independent checks for the inventory and other assets
 - ▶ Be done by different staff who are knowledgeable about the inventory concerned
- ▶ Institute physical safeguards
 - ▶ Limited access
 - ▶ Guarded and locked
 - ▶ Having CCTV cameras for surveillance

Questions

