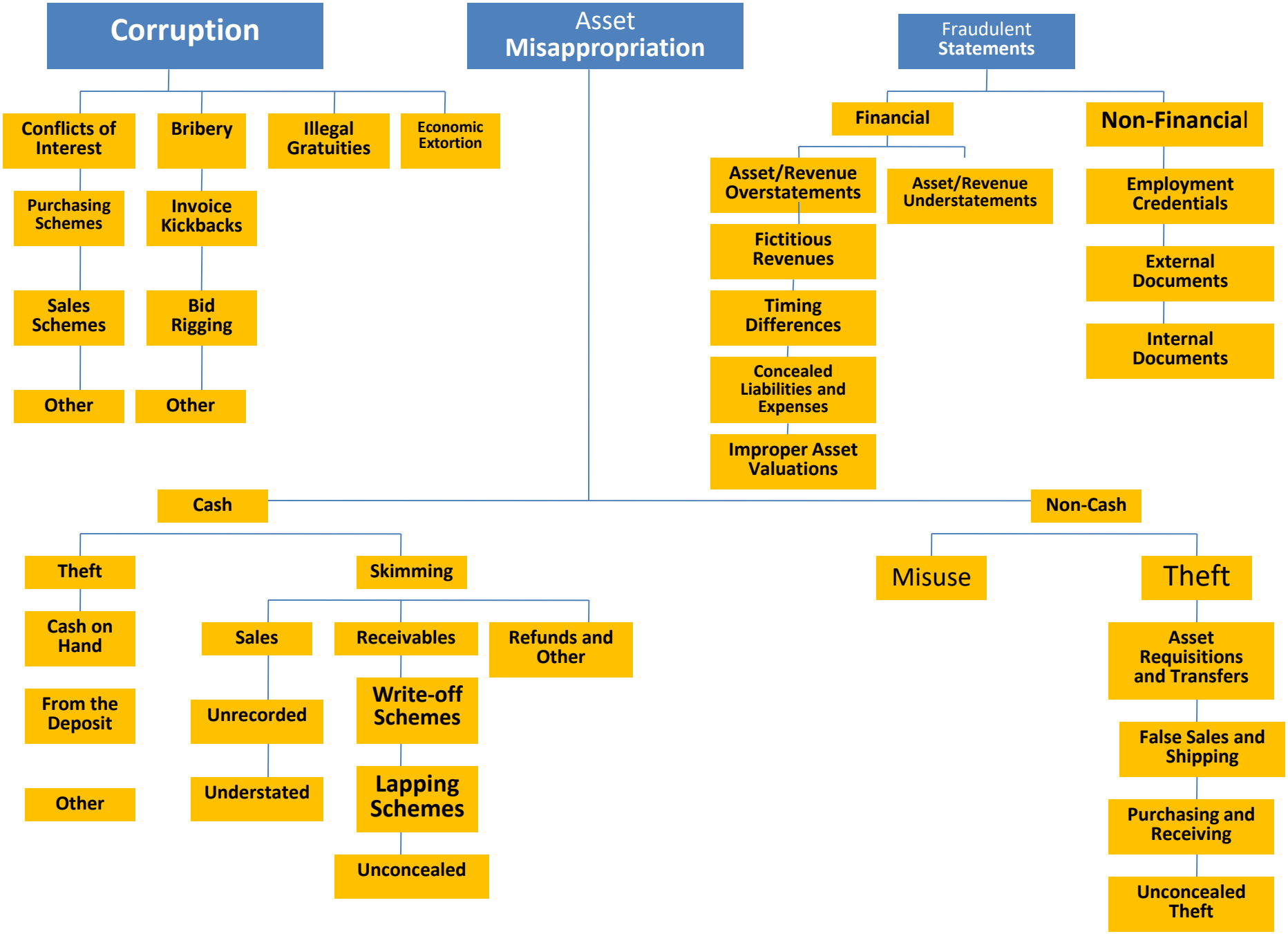
Asset Misappropriation

Peter N. Munachewa, CICA, CFIP, CFE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Asset Misappropriation

- Asset misappropriations is using company property or cash without authorization, or stealing cash and property
- Asset misappropriations are the most common occupational frauds.
- Nearly 86% of the fraud cases handled involve asset misappropriation.
- There are three major categories of asset misappropriation:
- **Cash theft schemes,**
- **Fraudulent disbursements of cash, and**
- **The abuse or theft of inventory** and other noncash assets.

Cash Receipt Schemes

- There are two types of cash receipt schemes:
  Skimming and
  Cash Theft.

- Skimming is the theft of cash that has not yet been recorded in the accounting system.

- Cash theft is the theft of money that has already appeared on the company's books.

- Both schemes involve the theft of cash that belongs to a victim organization;

- The difference depends completely on when the cash is stolen.

Cash Receipt Schemes - Skimming

- Skimming fraud schemes are known as off-book frauds, because they don't leave an audit trail.
- This type of fraud is typically perpetrated by accounting staff who deal closely with the company's cash or receivables.
- Employees who skim from their companies **steal sales or receivables before they are recorded in the company books**.
- People who are in a position to skim cash include salespeople, tellers, waitpersons, cashiers, and anyone else **who receives cash directly from customers.**

Cash Receipt Schemes - **Unrecorded Sales**

- The most basic skimming fraud scheme occurs when an employee sells goods or services to a customer, collects the customer's payment, but **makes no record of the sal**e.

- The employee simply pockets the money received from the customer instead of turning it over to his employer.

Cash Receipt Schemes - Unrecorded Sales Example

- For a simple of example of an unrecorded sale, imagine the sale of goods at a cash register.
- An employee decides he wants to steal Shs 10,000. Throughout the day, he makes shs 90000 in sales at his register;
- one sale is for shs 10000.
- However, the employee does not record the shs10,000 transaction at his register.
- The customer hands his money to the employee and the employee pockets the cash instead of putting it in the register drawer.
- The employee might ring a no-sale transaction on the register to make the scheme less obvious to observers and security cameras.
- Since the employee recorded a no-sale, no revenue will be recorded on the books for the shs 10,000 transaction.

Understated Sales

- An understated sales scheme is a slightly different type of skimming in that the transaction in question is posted to the books, but for a lower amount than what the fraudster actually collected.

- Employees might commit understated sales schemes by altering receipts or preparing false receipts

Skimming Receivables Example

- For instance, a company might be owed shs. 50,000, but the receivable is recorded as shs 30,000 (which would understate sales by shs.20,000).
- When the customer makes payment on the account, the employee will skim shs 20,000 and post the remaining shs 30,000 to the account.
- The account will appear to have been paid in full.

Skimming Receivables - Cash Receipt Schemes

- To conceal a skimmed receivable, a fraudster might use the following tactics:

- Forcing account balances or destroying transaction records

- Lapping, which is the practice of crediting one account through the abstraction of money from another account

- False account entries

- Intercepting a customer's account statement or late payment notice

Fraudulent Disbursements

- Fraudulent disbursement schemes are the second type of asset misappropriation fraud.
- In these schemes, an employee makes a distribution of company funds for a dishonest purpose. Examples include:

- Register disbursement schemes
- Cheque tampering
- Billing schemes
- Payroll fraud
- Fraudulent expense reports

Register Disbursement Schemes

- A fraudulent disbursement might take place at the cash register, much like skimming or cash larceny.
- The difference, however, is that when cash is stolen as part of a register disbursement scheme, the removal of the cash is recorded on the register tape.
- A false transaction is entered so it appears that the disbursement of money was legitimate.

False Refunds

- One type of fraudulent disbursement is a false refund.
- A refund is processed at the register when a customer returns an item.
- A false refund, however, is a scheme whereby an unscrupulous employee processes such a transaction but there is no item being returned to inventory.
- The register tape will show a return was processed and that cash was removed.
- The fictitious item will be added back to the inventory account on the books, thereby overstating inventory.

Cheque Tampering

- In a cheque tampering scheme, the perpetrator takes physical control of a cheque and makes it payable to himself through one of several methods.

- Cheque tampering depends upon factors such as access to company checks, access to bank statements, and the ability to forge signatures.

- There are four types of check tampering:

• Forged maker schemes

• Forged endorsement schemes

• Altered payee schemes • Authorized maker schemes

Fraudulent Disbursements - Forged Maker Scheme

- The **person who signs a cheque** is known as **the "maker"** of the cheque.
- In a forged maker scheme, an employee misappropriates a check and fraudulently affixes the signature of an authorized maker.
- To forge a cheque, an employee must have access to a blank check, be able to replicate the signature of an authorized signatory, and be able to conceal his crime.
- To conceal a forged maker scheme, the fraudster might alter the bank reconciliation, enter false information in the disbursements journal, or create bogus supporting documentation.

Fraudulent Disbursements - Forged Endorsement Scheme

- Forged endorsements are those cheque tampering schemes in which 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.
- The challenge is obtaining a cheque after it has been signed.
- The fraudster must either steal the cheque between the point where it is signed and the point where it is delivered, or he must re-route the cheque so that it is delivered somewhere he can retrieve it.

Fraudulent Disbursements -Altered Payee Scheme

- In an altered payee scheme, an employee intercepts a company cheque intended for a third party and alters the payee designation so that the cheque can be converted by the employee.
- The employee inserts his own name (or that of a fictitious company) on the payee line so that he can deposit it.
- The employee might also alter the existing payee name. For example, a check made to “John Musomba” could be altered to say “John Musudi.”
- The employee would then cash the cheque in the name of the fraudulent payee.

Fraudulent Disbursements - Authorized Maker Scheme

- An authorized maker scheme occurs when an authorized signatory writes fraudulent cheques for his own benefit and signs his name as the maker.
- In most organizations, cheques signers are high-ranking members of management, and thus have access to blank cheques stock.
- Even if a control is in place that prevents a cheque signer from handling a blank cheque, the perpetrator can likely use his influence to overcome this hindrance.
- Since a common cash disbursements control is that cheques are signed by an authorized signatory, this scheme might be very difficult to detect.

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Fraudulent disbursements - **Detection** of Cheque Tampering

- There are several ways to uncover a cheque tampering scheme.
- To start, obtain the bank reconciliations and bank statements.
- Perform the following tests:

✓ Recalculate the reconciliation.
✓ Examine the bank statement for alterations.
✓ Always ask for original copies.
✓ Trace the balance on the statement back to the bank confirmation.

Detection of Cheque Tampering

- Another effective procedure commonly performed is **obtaining a sample of canceled cheque** copies and requesting the **supporting documentation** (typically an invoice or expense report).

- Trace the amount and payee of each cheque and verify that the cheques were signed by an authorized maker.

- Often a fraudster will write himself a cheque and not produce any phony supporting documentation.

Fraudulent disbursements - Detection of Check Tampering

Be alert for the following irregularities that might point to cheque fraud:

- Unexplained gaps in the sequence of checque numbers
- Dual endorsements of returned cheques
- Cheques made to employees who are not related to payroll or expense reimbursement
- Cheques made payable to “cash”
- An unfamiliar payee
- Customer complaints regarding payments not being applied to their accounts

Billing Schemes

- A different type of fraudulent cash disbursement occurs under a billing scheme, which involves an individual submitting false invoices to a company.

- This type of scheme allows a perpetrator to misappropriate company funds without ever actually handling cash or cheques while at work.

- There are three main types of billing schemes:

  - Shell companies
  - Non-accomplice vendors
  - Personal purchases with company funds

Shell Companies

- Shell companies are business entities that typically have no physical presence, no employees and generate little, if any, economic value.
- They can serve a legal business purpose, but **they are often used by fraudsters to collect disbursements from false billings** that appear to be legitimate to the victim organization.
- A fraudster will submit false invoices to a victim company under the shell company's name.
- Such schemes are especially effective when the fraudster is an employee of the victim company who has the ability to approve invoices for payment.

Non-Accomplice Vendors

- Rather than using shell companies, some fraudsters (typically in the accounts payable department) might generate fraudulent disbursements by using the invoices of non-accomplice vendors.
- In a pay-and-return scheme, for instance, fraudsters do not prepare and submit vendors' invoices;
- Rather, they intentionally mishandle payments that are owed to the legitimate vendors.
- One way to do this is to **purposely double-pay an invoice, then request the recipient to return one of the cheques.**
- The fraudster can then deposit the cheque into his own account.

Detection of Billing Schemes

- The source documentation for purchases can be statistically sampled and examined for irregularities.
- Complaints from customers, vendors, and others are good detection tools that can lead the forensic auditor to further inquiry.
- Keep an eye out for vendors and employees with matching addresses, unusual charges, or vendors with employees who are family members.
- Analytical review, and specifically computer assisted analytical review, is useful in the detection of billing schemes

Fraudulent disbursements - Payroll Fraud

- Payroll schemes are similar to billing schemes, except the perpetrator gets the victim company to make a disbursement to an employee rather than an external party.
- This is accomplished by falsifying timecards or altering information in the payroll records.
- The most common payroll fraud schemes are:

- Ghost employee schemes
- Falsified hours and salary schemes
- Commission schemes

Fraudulent disbursements -Ghost Employees

- A ghost employee is someone on the payroll who does not work for the company.
- The fraudster causes pay cheques to be generated to a “ghost” and then converts these paycheques.
- The ghost employee might be a fictitious person, or it might be a real individual who does not work for the victim employer and is colluding with the fraudster.

Fraudulent Disbursements - Commission Schemes

- Commission is a form of compensation calculated as a percentage of the amount of transactions a salesperson or other employee generates.
- Establishing unrealistic sales quotas that employees think are arbitrary will increase the pressure to establish fictitious performance levels.
- If the pressure becomes significant, the employee might resort to adding fictitious sales and accounts receivable to meet sales quotas.
- Such a scheme will affect not only payroll, but the financial statements will be fraudulently overstated as well.

Detection of Payroll Schemes

- Several simple analyses can aid in the detection of a payroll scheme.
- For instance, compare employee addresses, bank deposit accounts.
- Duplicate information might reveal a ghost employee.
- Scan the time reports and note whether one employee clocks significantly more overtime than the others performing the same work.
- Prepare a comparative analysis of commission earned by salesperson, recalculate amounts, and investigate any salesperson who appears to be earning significantly more than the others.

Fraudulent Disbursements - Fraudulent Expense Reports

- Employees sometimes seek reimbursement for fictitious or overstated expenses.

- The employee might
  - seek reimbursement for a nonbusiness expense,
  - put the same item on multiple expense reports, or
  - alter receipts and other supporting documentation to overstate expenses actually incurred.

- Employees usually need their supervisor to approve expense reports before receiving reimbursement, but often managers do not review them closely.

Fraudulent Disbursements
Detection of Fraudulent Expense Reports

- There are two basic methods to detect a fraudulent expense reimbursement fraud:

- Review and analysis of expense accounts—compare employee expense reports with either historical or budgeted amounts.

- Detailed review of expense reimbursements—review employee expense reports *alongside a calendar and a copy of the employee's schedule* to ensure all travel and entertainment expenses appear reasonable.

Asset Misappropriation— Inventory and Other Assets

Non-Cash Larceny

- Non-cash theft occurs when an employee simply takes an asset, usually inventory, from the company premises without attempting to conceal the theft in the books and records.
- Non-cash theft also differs from the billing schemes discussed in the "Fraudulent Disbursements" lesson because the heart of the scheme is the taking of the inventory rather than the purchasing of it.
- An accomplice of the employee-fraudster pretends to buy merchandise, but the employee does not ring up the sale.
- The accomplice takes the merchandise without paying for it or the accomplice hands the employee cash so as not to look suspicious but the employee does not place it in the register.

Inventory and other assets - Purchase and Requisition Schemes

- A common example of an employee abusing the purchasing and receiving functions occurs when a person charged with receiving goods on behalf of the victim company falsifies the records of incoming shipments.

- For example, if 1000 units of an item are received, the perpetrator might indicate that 900 were received and steal the remaining 100.

- One way to detect such schemes is by matching receiving reports with invoices and examining any discrepancies.

Inventory and other assets- False Shipments of Inventory

- To conceal thefts of inventory, employees might *create false shipping and sales documents to make it appear that the inventory they took was sold rather than stolen.*
- This scheme is carried out similarly to the fictitious sales schemes discussed earlier, except the motive is to steal inventory, not to inflate the company's revenue.
- The result is that a fake receivable account goes into the books for the price of the misappropriated inventory.
- This is another reason why close examination of the accounts receivable write-offs is essential to a fraud investigation

Asset Misappropriation— Inventory and Other Assets

Shrinkage

- Shrinkage is a reduction in inventory as a result from theft and is therefore unaccounted for on the company's books.

- Any discrepancies between the physical inventory count and the accounting records indicate potential shrinkage.

Detection of Inventory Misappropriation

- To detect an inventory misappropriation scheme, start by analyzing the perpetual inventory records.
- Perpetual inventory formula : Beginning Inventory (usually from a physical count) + receipts - shipments = Ending Inventory
- Unexplained entries might reveal embezzlement losses.
- **Are all decreases** in the perpetual inventory records explainable by source documents (such as **sales invoices, approvals to remove scrap inventory, or spoilage)?**
- **Are all increases** in perpetual records explainable by source documents such as **receiving reports (GRN)**?

Asset Misappropriation— Inventory and Other Assets

Detection of Inventory Misappropriation

Inventory theft might be uncovered by answers to questions such as:

- Are all sales properly matched with a shipping document?
- Are any shipping documents not associated with a sale?
- Is inventory disappearing from storage?

Detection of Inventory Misappropriation

- Perform some simple analytics based on the general ledger detail you have related to inventory.
- For example, if the cost of goods sold increases by a disproportionate amount relative to sales, and **no changes occur in the purchase prices, quantities purchased, or quality of goods,**
- Then the cause of the disproportionate increase in cost of goods sold might be attributable to fraud.

Asset Misappropriation— Inventory and Other Assets

- Inventory Analytical Review Example

	Yr 1	Yr 2	Percentage change
Sales	500	550	10%
Beginning inventory	100	125	25%
Purchases	200	190	-5%
Good available for sale	300	315	5%
Ending Inventory	175	135	-23%
Cost of Goods	**125**	**180**	**44%**
Gross Margin	375	370	- 1%

Inventory Analytical Review Example

- Note that sales increased 10 percent whereas cost of goods sold increased 44 percent.
- Usually, sales and cost of goods sold typically move in tandem unless there has been a change in the price of goods,
- Which there hasn’t in this case.
- Since cost of goods sold is dependent on the ending inventory figure, this data suggests that there might have been shrinkage in Year 2.

Asset Misappropriation— Inventory and Other Assets

Inventory Analytical Review Example

- An forensic auditor reviewing this data might conclude one of the following:

• Inventory purchases were purposely increased in Year 1 only to be liquidated in Year 2.

• The increased sales in Year 2 were unexpected and the purchase of inventory did not keep pace with the sales.

• There is an inventory fraud scheme.

Prevention of inventory fraud

- There are four basic measures which, if properly installed and implemented, may help prevent inventory fraud.
- They are :
- Proper documentation,
- Segregation of duties (including approvals), independent checks, and
- Physical safeguards

Proper Documentation

- The following items should be pre-numbered and controlled:
- Requisitions
- Receiving reports
- Perpetual records
- Raw materials requisitions
- Shipping documents

Segregation of Duties

- The following duties should be handled by different personnel:

- Requisition of inventory
- Receipt of inventory
- Disbursement of inventory
- Conversion of inventory to scrap
- Receipt of proceeds from disposal of scrap

Independent Checks

- Someone independent of the purchasing or warehousing functions should conduct physical observation of inventory.

- The personnel conducting the physical observations also should be knowledgeable about the inventory.

Physical Safeguards

- All merchandise should be physically guarded and locked
- Access should be limited to authorized personnel only.
- For example, strategic placement of security guards may aid in the detection and deterrence of potential theft schemes.
- Electronic methods may also be used, such as cameras and surveillance devices.
- The effectiveness of any device will, however, depend on the employee's knowledge that physical safeguard controls are adhered to and on the type of inventory available for misappropriation.

DAY ONE

DONE