Red Flags of Fraud

OVERVIEW

Red Flags of Fraud are warning signs that may indicate a higher fraud risk. They are NOT evidence that fraud is actually occurring. Many employees demonstrate one or more of the flags on the list, and the existence of one or two flags is not likely to cause concern. However, if multiple flags are identified that span the three categories AND accounting irregularities and/or weak internal controls are identified, the risk that fraud is occurring or could occur is significantly higher.

| Common Personality Traits of Fraudsters | Wheeler-dealer attitude  
|                                        | Controlling and unwilling to share duties  
|                                        | Don’t like people reviewing their work  
|                                        | Strong desire for personal gain  
|                                        | Live beyond their means  
|                                        | Often have “too good to be true” work performance  
|                                        | Outwardly, appear to be very trustworthy  
|                                        | Unable to relax  
|                                        | Don’t take vacation or sick time or only take leave in small amounts  
|                                        | Often work excessive overtime  
|                                        | Have a “Beat the System” attitude |

| Common Sources of Pressure | Financial problems  
|                           | Medical problems  
|                           | Divorce  
|                           | Legal problems – criminal or civil  
|                           | Need to maintain a certain lifestyle – pressure to “keep up with” or “out-do” others in regards to material possessions  
|                           | Purchase a new home, second home or major home renovation  
|                           | Unreasonable performance goals  
|                           | Gambling  
|                           | Drug/Alcohol addiction |

| Changes in Behavior | Buys more material items – houses, cars, boats, clothes, jewelry  
|                     | Brags about purchases  
|                     | Starts to carry unusual amounts of cash  
|                     | Creditors/Collectors show up at work or call frequently  
|                     | Borrows money from co-workers  
|                     | Becomes irritable or moody  
|                     | Becomes unreasonably upset when questioned  
|                     | Becomes territorial over area of responsibility  
|                     | Refuses to take vacation or sick leave  
|                     | Starts coming in early or staying late  
|                     | Redo or Rewrite work to “make it neat”  
|                     | Mentions family or financial problems  
|                     | Exhibits signs of addiction – absenteeism, become manipulative, looks ill, inconsistent or illogical behavior, loss of sleep, loss of appetite  
|                     | Exhibits signs of dissatisfaction – decreased productivity, change in attire, irregular schedules, frequent complaining about work issues |
“YOU” Can Prevent Fraud!
SDP Session 7A
May 10, 2011
What can “YOU” do?

- Define - What is Fraud?
- Analyze – Dissect Fraud Elements
- Manage Risk – Internal Control System
- Prevent – Fraud Awareness
What is Fraud?

Webster’s Dictionary defines as:

1
   a : deceit, trickery; specifically : intentional perversion of truth in order to induce another to part with something of value or to surrender a legal right  
   b : an act of deceiving or misrepresenting : trick

2
   a : a person who is not what he or she pretends to be : impostor; also : one who defrauds : cheat  
   b : one that is not what it seems or is represented to be
What is Fraud?

Board of Trustees Policy 350.1 defines as:

...... the intentional, false representation or concealment of a material fact for the purpose of inducing another to act upon it to his or her injury.
What is Fraud?

Ultimately all frauds are

......a violation of trust

For organizations, no trust violation has the potential to be as harmful as those committed by the very group that is relied upon for success

......its employees
What is Fraud?

The Association of Certified Fraud Examiners defines *Occupational Fraud* as

The use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.
Occupational Fraud

- Asset Misappropriation
  - The employee steals or misuses the organization’s resources

- Corruption
  - The employee uses his influence in business transactions in a way that violates his duty to the organization in order to obtain personal gain

- Financial Statement Fraud
  - Intentional misstatement or omission of material information in the organization’s financial report
Study covered 1843 cases of occupational fraud that occurred in more than 100 countries on 6 continents.

Participants in study were anti-fraud specialists with a median of 12 years of experience in the fraud examination field.
Occupational Fraud

Summary of Key Findings

- Median loss caused was $160,000
- Median duration before detection was 18 months
- Initial detection came from tips in 40.2% of the cases, followed by management review at 16.4%
- Small organizations are disproportionately victimized by occupational fraud
Summary of Key Findings

- 85% of fraudsters in the study had never been previously charged or convicted of a fraud-related offense.
- Fraudsters often display warning signs or behavioral red flags that indicate they may be engaged in illicit activity.
- Anti-fraud controls appear to help reduce the cost and duration of occupational fraud schemes.
Fraud Dissected

Fraud Triangle

Pressure

Opportunity  Rationalization
Fraud Dissected

Pressure

What causes a person to commit fraud

- Living beyond means to create a certain lifestyle
- Medical crisis
- Addiction
- Divorce
- Family crisis
Opportunity

The ability to commit fraud. Opportunity is created by:

- Weak or non-functioning internal controls
- Poor management oversight/supervision
- Misuse/abuse of one’s position and authority
- Belief they won’t get caught
Rationalization

The reconciliation of the fraudulent behavior with the commonly accepted ideals of decency and trust

- Stealing justified to save a loved one
- They will lose everything if they don’t steal
- Belief that no outside help is available to them
- Labels stealing as “borrowing” and fully intend to pay back
- Job dissatisfaction creates belief that the organization “owes” them
Fraud Dissected

Fraud Triangle

Pressure

Opportunity

Rationalization
Internal control is broadly defined as a process, effected by the organization's board of trustees, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations
- Safeguarding of assets
Internal Control System

- Monitoring
- Control Activities
- Risk Assessment
- Control Environment
Control Environment

✓ Control consciousness of the organization
✓ Atmosphere in which activities are conducted and staff carries out their control responsibilities
✓ Intangible
✓ Employees understand their responsibilities and limits to their authority

Control Environment Tips:

✓ Develop a leadership philosophy and operating style that promotes internal control
✓ Properly assign authority and responsibility to staff
Internal Control System

Risk Assessment

☑ Relative to achieving goals and objectives
☑ Identifying risks associated with achievement
☑ Identify at both unit and activity level
☑ Consider external and internal factors

Management is responsible for:

☑ Determining the level of acceptable risk the organization can assume
☑ Prioritizing identified risks
☑ Considering qualitative and quantitative costs when developing a management plan
Internal Control System

Control Activities
Actions, supported by policies and procedures, to manage risk

**PREVENTIVE**
Proactive controls to prevent loss
- Segregation of Duties
- Transaction Approvals
- Documentation
- Security of Assets

**DETECTIVE**
Provide evidence a loss has occurred
- Audits
- Reconciliations
- Physical Inventories
- Security of Assets
Internal Control System

Information and Communication

- Sharing information up, down and across organizational units
- From both internal and external sources
- Presented in a form and time frame that is useful

Formal Systems
- Information technology
- Staff meetings
- Reports
- Hotline

Informal Systems
- Casual Conversations with faculty, staff or students
- Vendors and regulators
- May offer clues when combined with other known facts
Internal Control System

Monitoring
Purpose is to determine whether the internal control system is adequately designed, properly executed and effective
✓ Can determine if all 5 components are present and functioning
✓ Important to assess effectiveness over several points in time

Ongoing
- Supervisor activities the evaluate
- Focus on high risk areas
- Spot checks and sampling

Separate Evaluations
- Self-assessments
- Internal Audits
- Peer Reviews
To detect and deter fraud, it is critical that employees:

✓ Understand the importance of a functioning internal control system
✓ Fully understand their role in the internal control system
✓ Are provided training to recognize red flags
✓ Be able to report suspicious activity without fear of reprisal.
Fraud Prevention

Red Flags of Fraud

Warning Signs that may signal fraud risk is higher. They are NOT evidence that fraud is actually occurring.

- Common Personality Traits
- Common Sources of Pressure
- Changes in Behavior
Fraud Prevention

What to do if you suspect fraud

1. Talk to your immediate supervisor and discuss your concerns.

2. Report the activity to the Office of Financial & Management Analysis, ADMN 305, 575-5553 or

3. Call the confidential fraud hotline at 1-866-252-9838
Fraud is a violation of trust
Pressure, Opportunity, Rationalization must all be present for fraud to occur
Organizations have most control over opportunity
An effective Internal Control System limits opportunity
Managers should be aware of Red Flags of Fraud
Report known fraud or suspicious activity
Jean Schook, Associate Vice Chancellor (Retired)