RED FLAGS OF FRAUD
MAY 13, 2014
IIA AUSTIN CHAPTER

ACFE℠

Association of Certified Fraud Examiners

Association of Certified Fraud Examiners

WORLD HEADQUARTERS, THE GREGOR BUILDING
716 WEST AVENUE • AUSTIN, TX 78701-2727 • USA
TEL: (800) 245-3321 • +1 (512) 478-9000
FAX: +1 (512) 478-9297
WWW.ACFE.COM

DISCLAIMER

Every effort has been made to ensure that the contents of this publication are accurate and free from error. However, it is possible that errors exist, both typographical and in content. Therefore, the information provided herein should be used only as a guide and not as the only source of reference.

The author, advisors, and publishers shall have neither liability nor responsibility to any person or entity with respect to any loss, damage, or injury caused or alleged to be caused directly or indirectly by any information contained in or omitted from this publication.

Printed in the United States of America.

JAMES D. RATLEY, CFE
President and CEO
Association of Certified Fraud Examiners
Austin, TX

James D. Ratley graduated from the University of Texas at Dallas, with a Bachelor's Degree in Business Administration. In 1971, he joined the Dallas Police Department as a police officer.

Mr. Ratley was assigned to several police department divisions, including vice, child abuse, and internal affairs. He was a member of numerous department task forces which concentrated on major fraud cases.

In 1986, Mr. Ratley left the police department to join Wells & Associates, a forensic accounting practice, where he was in charge of fraud investigations. He handled investigations regarding internal frauds, conflicts of interest, and litigation support. In 1988, he was named Program Director for the Association of Certified Fraud Examiners and oversaw all aspects of the ACFE's training and education programs.

In 2005, Mr. Ratley was awarded the Association of Certified Fraud Examiners' Cressey Award. The Cressey Award is the ACFE's highest honor. It is bestowed annually for a lifetime of achievement in the detection and deterrence of fraud.

In 2006, Mr. Ratley was named President of the ACFE. In this role, he works to promote the ACFE to the public and other professional organizations and continues to assist in the development of anti-fraud products and services to meet the needs of the ACFE's members. In addition to his executive duties, Mr. Ratley serves as a member of the ACFE's faculty, and teaches regularly at workshops and conferences on a variety of fraud-related subjects.

Mr. Ratley was named One of the Top 100 Most Influential People in Accounting by *Accounting Today* in 2012, with the magazine praising his leadership in a "changing, growing and evolving" accounting landscape. He was also selected as one of *Security* magazine's Most Influential Security Executives for 2010. This honor is bestowed each year to the top security executives who positively impact the security industry, their organizations, their colleagues and their peers.

Mr. Ratley is a member of the Association of Certified Fraud Examiners, Austin Chapter, and a member of the Board of Advisors for the Institute for Bank Director Education. He was also a Visiting Scholar at the University of Nebraska in Lincoln. In addition, he has been certified as a Master Peace Officer by the Texas Commission on Law Enforcement Standards and Education.

NOTES

The Detection of Fraud

Fraud is generally detected by one of four means:

- Tips or complaints
- Internal controls
- The perpetrator turning himself/herself in
- Assessment of "red flags"

Tips or Complaints

Tips or complaints have been known to be some of the best means of fraud detection and should be taken seriously. In fact, research consistently shows that tips from employees, customers, vendors, and other sources are the method by which the most frauds are detected. Although occasionally the motives of the complainant may be suspect, the allegations usually have merit and warrant further investigation.

Internal Controls

Certain internal controls, such as management review, surveillance and monitoring activities, account reconciliations, and document examinations, are designed to detect errors and fraud. Likewise, internal and external audits serve as important controls in uncovering potential fraudulent acts.

Perpetrator Turning Himself/Herself In

Committing a fraud and keeping the crime hidden takes a continuing effort on the part of the fraudster. Because of the increased likelihood of detection, fraudsters aren't able to take vacations or sick time. Although it may not be a common occurrence, some fraudsters find that they cannot deal with the emotional expense of the fraud and may eventually turn themselves in, choosing to face the consequences of fraud over continuing the effort of concealment.

NOTES

Assessment of Red Flags

A *red flag* is a circumstance, or set of circumstances, that is unusual in nature or varies from the normal activity. It is a signal that something is out of the ordinary and should be further investigated.

If you analyze a fraud case, you will usually uncover the presence of red flags, which, had employees or auditors noticed or reported, might have resulted in the fraud being detected earlier. Frauds committed by employees and management frequently involve obvious signs of fraud—if those around the perpetrator know what to look for.

General Red Flags

Typically, the fraud will result in symptoms that can signal other employees or auditors to the crime. Warning signs relating to potential fraud can be broken down into several categories. These categories are:

- ❑ Accounting anomalies
- ❑ Internal control weaknesses
- ❑ Analytical anomalies
- ❑ Operational anomalies
- ❑ Behavioral anomalies

Accounting Anomalies

Accounting anomalies are unusual deviations from the standard accounting practice. They involve irregularities in the accounting system, such as:

- Missing, altered, or photocopied documents
- Stale items on reconciliations
- Increased or excessive past due accounts
- Unexplained or confusing journal entries
- Inaccuracies in the ledger accounts
- Unexplained changes in financial statements

NOTES

Internal Control Weaknesses

Common internal control weaknesses that can serve as red flags of fraud are:

- Lack of segregation of duties
- Lack of physical safeguards
- Lack of independent checks
- Lack of proper authorization on documents and records
- Overrides of existing controls
- Inadequate accounting system

Analytical Anomalies

Analytical anomalies are relationships, procedures, and events that don't make sense—either common or business—or that appear to be unreasonable. These include transactions that happen at odd times or places, transactions that involve people who would not normally be a part of the event, transactions that involve amounts that are too small or too big, and transactions that occur too often or too rarely. Examples of analytical anomalies include:

- Company assets sold under market value
- Excessive number of checking accounts
- Frequent changes in banking accounts
- Use of several different banks
- Significant downsizing in a healthy market
- Unexpected overdrafts or declines in cash balance

Operational Anomalies

Operational anomalies are unusual events concerning the company's operations. Such circumstances may or may not be within the control of management, but they do merit consideration as a red flag for possible fraud. Some of these anomalies are:

NOTES

- Operating on a crisis basis
- Insufficient capital
- Dependence on only one or two products
- Frequent changes in legal counsel
- Frequent changes in executive management and directors
- High employee turnover, especially in areas that are more vulnerable to fraud
- Continuous rollover of loans
- A compensation program that is out of proportion to profits
- Unusual organizational structure (e.g., having the internal audit department report to the finance department)
- Severe obsolescence of assets
- Problems with government regulators

Behavioral Anomalies

The vast majority of fraudsters display some sort of behavioral symptoms of their scheme—symptoms that co-workers or supervisors might have picked up on without realizing that they were connected to fraudulent actions.

The ACFE's 2014 *Report to the Nations on Occupational Fraud and Abuse* examines 1,483 cases of occupational fraud in an effort to identify common threads and trends in white-collar crimes. According to the Report, at the time of their frauds:

- 44% of perpetrators were living beyond their means.
- 33% of perpetrators were experiencing financial difficulties.
- 22% of perpetrators had an unusually close association with a vendor or customer.

NOTES

- 21% of perpetrators displayed control issues or an unwillingness to share duties.
- 17% of perpetrators had experienced a recent divorce or family problems.
- 15% of perpetrators displayed unusual irritability, suspiciousness, or defensiveness.
- 12% of perpetrators had addiction problems.

Red Flags in Specific Transactions and Functions

Certain business functions are particularly susceptible to fraudulent acts. It is therefore vital to review these functions with specific red flags of fraud in mind.

Red Flags in Cash /Accounts Receivable

Since cash is the asset most often misappropriated, fraud examiners should pay close attention to warning signs of cash theft, including:

- Excessive number of voids, discounts, and returns
- Unauthorized bank account in a company name
- Sudden activity in a dormant banking account
- Customer complaints that they are receiving notices for non-payment on account
- Discrepancies between bank deposits and deposits posted to the company books
- Abnormal number of expense items or reimbursements by employee
- Presence of employee checks in petty cash for the employee who oversees petty cash
- Excessive or unjustified cash transactions
- Large number of write-offs of accounts receivable
- Bank accounts that are not reconciled on a timely basis

NOTES

Red Flags in Payroll

Red flags that show up in a payroll are generally worthy of examination. Payroll is usually an automated function, but it is a vulnerable area, especially if collusion is involved. Red flags in this area include:

- Inconsistent overtime hours for a cost center
- Overtime charged during a slack period
- Overtime charged for employees who normally would not have overtime wages
- Budget variations for payroll by cost center
- Employees with duplicate Social Security numbers, names, and addresses
- Employees with few or no payroll deductions

Red Flags in Purchasing/Inventory

Because purchasing is the major source of cash outflows within most companies, this area is extremely vulnerable to fraud. Likewise, an organization's inventory can be very susceptible to misappropriation by dishonest employees. Warning signs that the purchasing and inventory functions are being manipulated include:

- Increase in number of complaints about products or service
- Increase in purchasing inventory but no increase in sales
- Abnormal inventory shrinkage
- Increase in scrap materials and then reorders for the same items
- Lack of physical security over assets/inventory
- Sales without shipping documents
- Payments to vendors who aren't on an approved vendor list
- High volume of purchases from new vendors shortly after they attain vendor status

- Purchases that bypass the normal procedures
- Vendors without physical addresses
- Vendor addresses that match employee addresses
- Excess inventory and inventory that is slow to turn over
- Purchasing agents that pick up vendor payments rather than having them mailed

Red Flags in Financial Reporting

The motivations for manipulating the financial reporting function are quite different than those for stealing company assets. However, red flags are often present in financial statement frauds, just as they are in asset misappropriation schemes. The following are some of the warning signs of financial statement fraud:

- Unusual or large and profitable transactions near the ends of accounting periods
- Recurring negative cash flows while reporting earnings or earnings growth
- Expenses increasing faster than revenues
- Urgent need to report favorable earnings
- Significant transactions with related parties
- Reluctance to provide auditors with corporate data needed for their audits
- Frequent changes in external auditors

How to Evaluate Red Flags

In many cases, conducting a post-mortem after a fraud examination will show that red flags were present. If the auditor or employees in the affected area had recognized these warning signs, then a loss might not have occurred or would, at least, have been substantially reduced.

NOTES

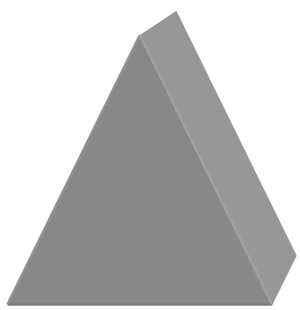
NOTES

Cressey's Hypothesis: The Fraud Triangle

Donald Cressey published what remains the classic model for occupational offenders in *Other People's Money: A Study in the Social Psychology of Embezzlement*. In subsequent years, Cressey's work has come to be associated with a term called the *fraud triangle,* which explains the nature of fraud.

While the specific components of the fraud triangle may vary, it is basically set up as follows:

Non-sharable Financial Problem



Rationalization **Opportunity**

The *non-sharable financial problem*, or *pressure*, may be anything from gambling debts to the desire for a new sports car. *Rationalization* is a crucial component of most frauds because most people have a need to reconcile their behavior with commonly accepted notions of decency and trust. The *opportunity* to commit and conceal the fraud, of course, is the only element over which the fraud examiner has significant control. Many believe that if one of the three legs of the triangle is taken away, fraud will not be committed.

The fraud triangle forms a foundational framework that can be used to evaluate and understand the red flags of

NOTES

fraud: most red flags are directly traceable to one of the three legs of the triangle.

Analyzing and Responding to Red Flags

Being aware of red flags isn't enough for the fraud examiner. Once a red flag has been identified, action must be taken to determine its effect: is there fraud, do errors result, or is there no effect on the business?

Evaluating the red flag may involve financial analysis or observation. Once the analysis is complete, action must be taken to correct the situation and educate the parties in the responsible area about the warning signs that were missed.

PERFORM FINANCIAL ANALYSIS

Financial analysis can be used to determine the full financial impact the situation has on the business. For example, how much has already been lost as a result of the red flag? What is the potential future loss related to the red flag? What is the cost to prevent a potential loss from occurring? What will it cost to recoup the loss identified?

OBSERVE THE EFFECT OF THE RED FLAG

Direct observation is the method of choice to determine the effect a red flag has on an organization. For example, if analysis of overtime for an area suggests that one person is falsifying timecards, observing the person's start and stop times is important.

Observation may prove useful when employee lifestyle changes are noted, or to get an understanding of how an area works. Does the

NOTES

employee in fact drive a new Jaguar on a salary that clearly wouldn't support it? Are there lax security procedures and physical safeguards?

CORRECT THE SITUATION

Whether it is fraud or an error, action should generally be taken to prevent the act from occurring again. That is, unless the cost of prevention is more than the loss suffered; in such a situation, the decision may be to not to take action at all.

EDUCATE THE RESPONSIBLE AREA

In any case, educating the affected area is a prudent thing to do. If people don't know how to spot a potential red flag, then it may never be caught. This is true for both the internal audit staff and employees in the user area. Education involves all levels, from the lowest level to the highest level.

Two Cautionary Notes

- Do not ignore a red flag
- Sometimes an error is just an error

Do Not Ignore a Red Flag

Studies of fraud cases consistently show that red flags were present, but either were not recognized or were recognized but not acted upon by anyone. Once a red flag has been noted, management should take action to investigate the situation to determine if a fraud has been committed.

Sometimes an Error is Just an Error

As discussed above, red flags should lead to appropriate action. However, sometimes an error is just an error and no fraud has occurred. Just as action is important, so is

NOTES

avoiding overreaction. Respect for employees—which is itself a vital part of detecting and deterring fraud—demands avoiding assumptions that fraud has taken place in the absence of evidence. It further requires that investigations not be conducted unprofessionally or with unwarranted hostility. Responsibility for follow-up investigation of a red flag should be placed in the hands of a measured and responsible person.

Conclusion

Red flags are warnings that something could be or is wrong. Fraud examiners, employees, and management need to be aware these warning signs of fraud in order to, at the very least, monitor the situation, and to correct it as needed. Employees who notice that red flags are ignored may mistakenly believe that it is okay to game the system or that they won't get caught. A small fraud soon becomes a large fraud if left to grow.