

# **FORENSIC ACCOUNTING**

## **What's in it for me?**

**Albany, NY**

**June 14, 2011**

**Presented by**

**Gary J. Cassiello, CPA, ABV, CFF**

**garyc@jgspc.com**

**845-692-9500**

# Today's Outline

- Why is Forensic Accounting important?
- Executive Summary - “2010 Report to the Nations”
- How is Fraud Committed?
  - Common Fraud Schemes
  - Some Statistics on Fraud
  - Profile of a perpetrator
  - Some more Statistics
- What can you do?
- Anatomy of a Fraud - Two Case Studies
  - The Trusted Bookkeeper
  - Pizza Man
- CPA, CFF, CFE - What does it all mean?

# Why is Forensic Accounting Important?

- It is “Auditing on Steroids”
- It responds to what we will call an “epidemic” of recent fraudulent activities which have come to light.
- Provides unbiased, detailed view of financial information.
- Used in mergers and acquisitions, divorce and dissenting shareholder actions.
- Can be used proactively to avoid fraudulent transactions.
- Adds value to our client services.

# Source of Data

- A great deal of the data presented is from “The Association of Certified Fraud Examiner’s (ACFE) 2010 Report to The Nations on Occupational Fraud and Abuse.” This bi-annual report estimates the total amount lost in employee fraudulent transactions at \$2.9 trillion per year (5% of GWP).

# 2010 Report to the Nations Executive Summary

- Survey participants estimated that the typical organization loses 5% of its annual revenue to fraud. Applied to the estimated 2009 Gross World Product, this figure translates to a potential total fraud loss of more than \$2.9 trillion.
- The median loss caused by the occupational fraud cases in this study was \$160,000.

# 2010 Report to the Nations Executive Summary (Con't)

- The frauds lasted a median of 18 months before being detected.
- Occupational frauds are much more likely to be detected by tip than by any other means.
- Small organizations are disproportionately victimized by occupational fraud.
- The industries most commonly victimized in this study were the banking/financial services, manufacturing and government/public administration sectors.

# 2010 Report to the Nations Executive Summary (Con't)

- More than 85% of fraudsters in this study had never been previously charged or convicted for a fraud-related offense. This finding is consistent with prior studies.
- The most common behavioral red flags displayed by the perpetrators in this study were living beyond their means (43% of cases) and experiencing financial difficulties (36% of cases).

# How Fraud is Committed

- Asset Misappropriations - which involve the theft or misuse of an organization's assets. (Common examples include skimming revenues, stealing inventory, and payroll fraud.)

# How Fraud is Committed

- Corruption - in which fraudsters wrongfully use their influence in a business transaction in order to procure some benefit for themselves or another person, contrary to their duty to their employer or the rights of another. (Common examples include accepting kickbacks, and engaging in conflicts of interest.)

# How Fraud is Committed

- Fraudulent Statements - which generally involve falsification of an organization's financial statements. (Common examples include overstating revenues and understating liabilities or expenses.)

## Asset Misappropriation Sub-Categories

Category	Description	Examples	Cases Reported	Percent of all cases <sup>5</sup>	Median Loss
<b>Schemes Involving Theft of Cash Receipts</b>					
Skimming	Any scheme in which cash is stolen from an organization <i>before</i> it is recorded on the organization's books and records	<ul style="list-style-type: none"> <li>Employee accepts payment from a customer, but does not record the sale, and instead pockets the money</li> </ul>	267	14.5%	\$60,000
Cash Larceny	Any scheme in which cash is stolen from an organization <i>after</i> it has been recorded on the organization's books and records	<ul style="list-style-type: none"> <li>Employee steals cash and checks from daily receipts before they can be deposited in the bank</li> </ul>	181	9.8%	\$100,000

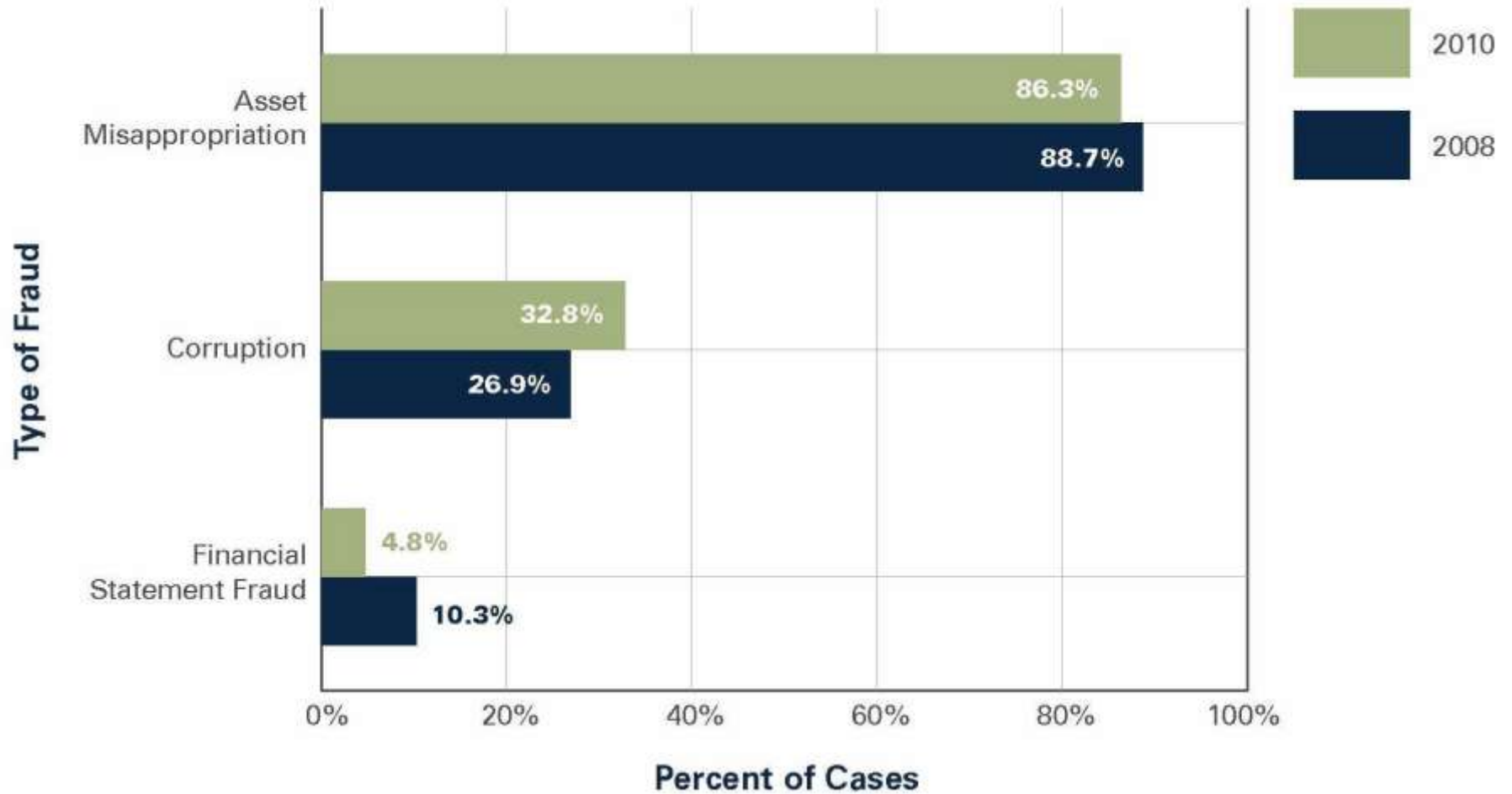
### Schemes Involving Fraudulent Disbursements of Cash

Billing	Any scheme in which a person causes his employer to issue a payment by submitting invoices for fictitious goods or services, inflated invoices or invoices for personal purchases	<ul style="list-style-type: none"> <li>Employee creates a shell company and bills employer for services not actually rendered</li> <li>Employee purchases personal items and submits invoice to employer for payment</li> </ul>	479	26.0%	\$128,000
Expense Reimbursements	Any scheme in which an employee makes a claim for reimbursement of fictitious or inflated business expenses	<ul style="list-style-type: none"> <li>Employee files fraudulent expense report, claiming personal travel, nonexistent meals, etc.</li> </ul>	278	15.1%	\$33,000
Check Tampering	Any scheme in which a person steals his employer's funds by intercepting, forging or altering a check drawn on one of the organization's bank accounts	<ul style="list-style-type: none"> <li>Employee steals blank company checks, makes them out to himself or an accomplice</li> <li>Employee steals outgoing check to a vendor, deposits it into his own bank account</li> </ul>	274	13.4%	\$131,000
Payroll	Any scheme in which an employee causes his employer to issue a payment by making false claims for compensation	<ul style="list-style-type: none"> <li>Employee claims overtime for hours not worked</li> <li>Employee adds ghost employees to the payroll</li> </ul>	157	8.5%	\$72,000
Cash Register Disbursements	Any scheme in which an employee makes false entries on a cash register to conceal the fraudulent removal of cash	<ul style="list-style-type: none"> <li>Employee fraudulently voids a sale on his cash register and steals the cash</li> </ul>	55	3.0%	\$23,000

### Other Asset Misappropriation Schemes

Cash on Hand Misappropriations	Any scheme in which the perpetrator misappropriates cash kept on hand at the victim organization's premises	<ul style="list-style-type: none"><li>Employee steals cash from a company vault</li></ul>	121	12.6%	\$23,000
Non-Cash Misappropriations	Any scheme in which an employee steals or misuses non-cash assets of the victim organization	<ul style="list-style-type: none"><li>Employee steals inventory from a warehouse or storeroom</li><li>Employee steals or misuses confidential customer financial information</li></ul>	156	16.3%	\$90,000

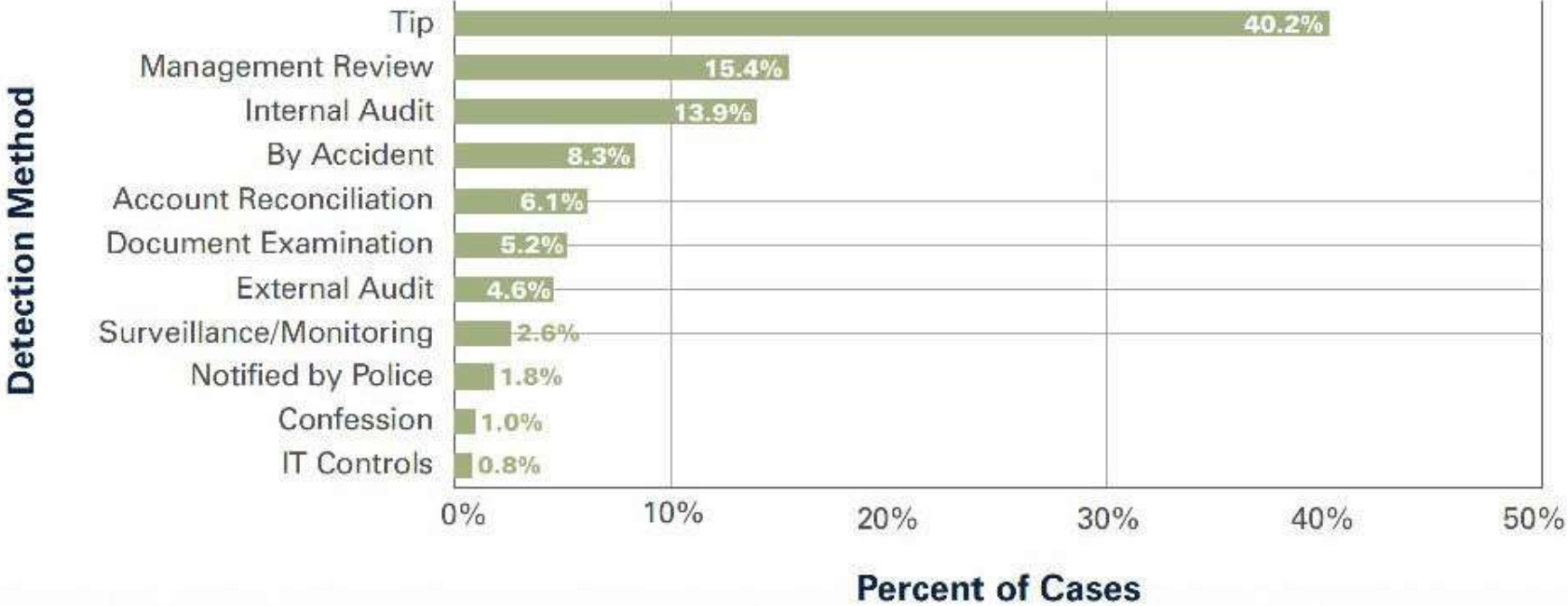
## Occupational Frauds by Category — Frequency<sup>3</sup>



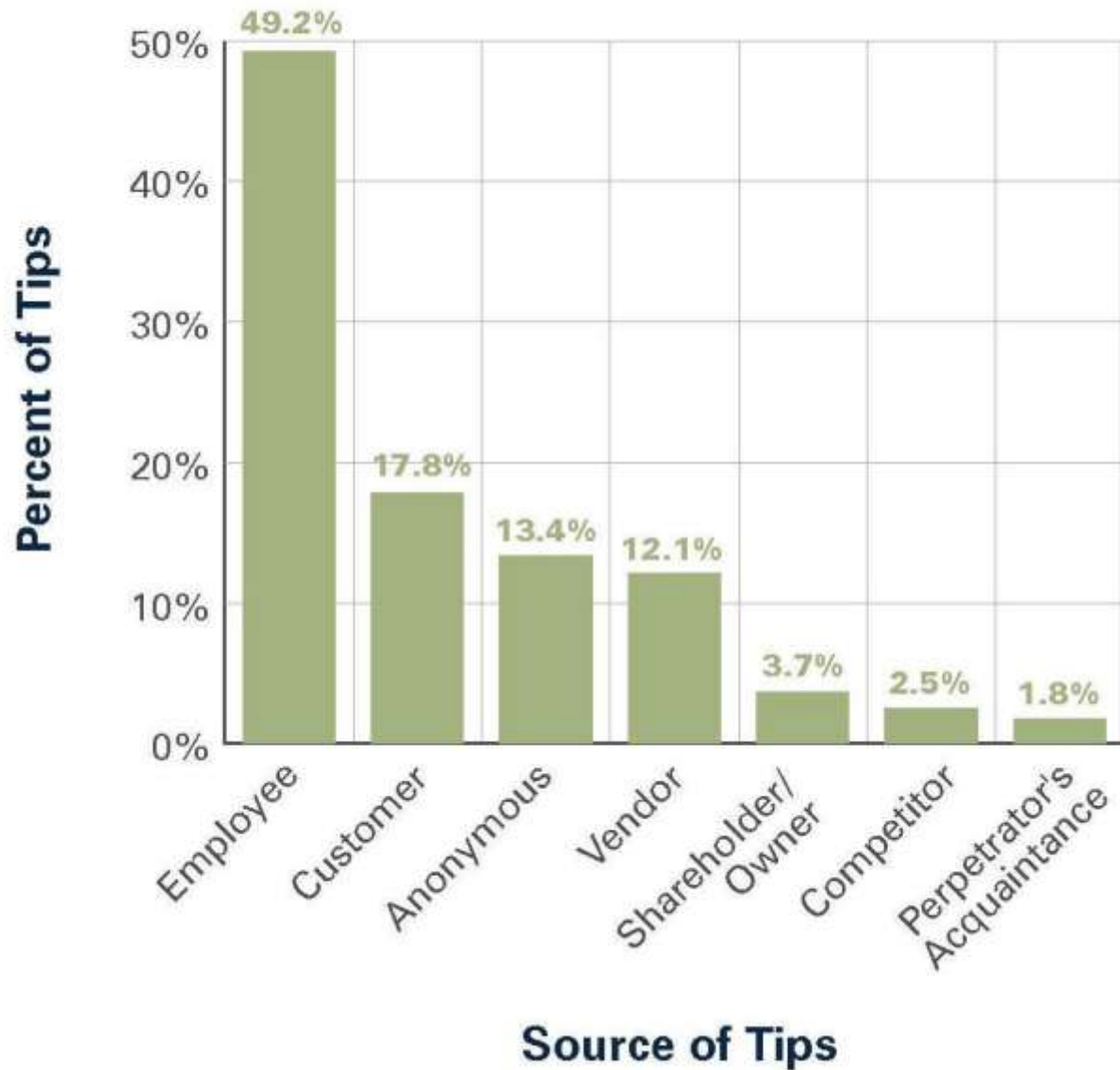
## Occupational Frauds by Category — Median Loss



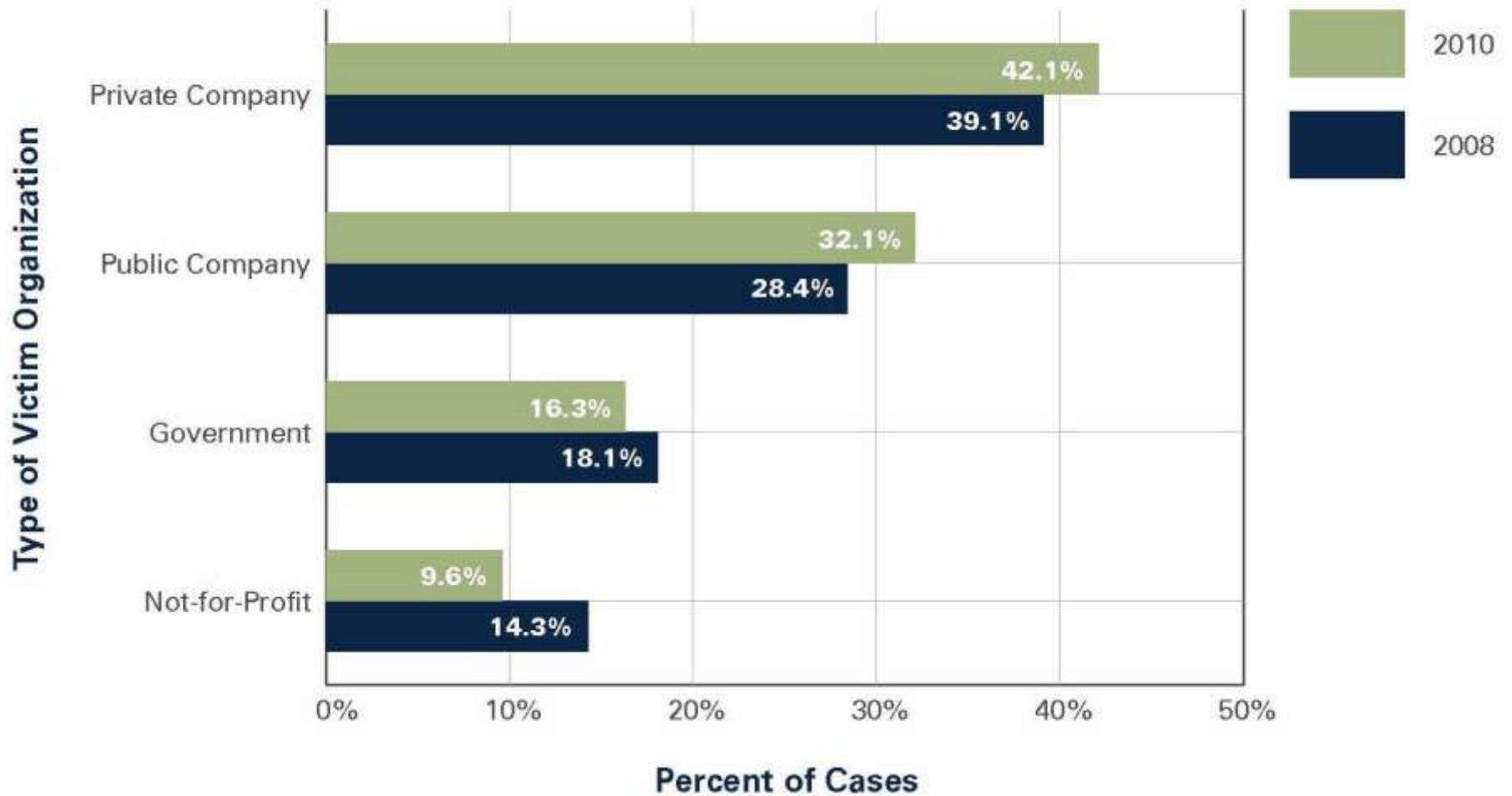
### Initial Detection of Occupational Frauds



## Source of Tips



## Organization Type of Victim — Frequency



## Organization Type of Victim — Median Loss



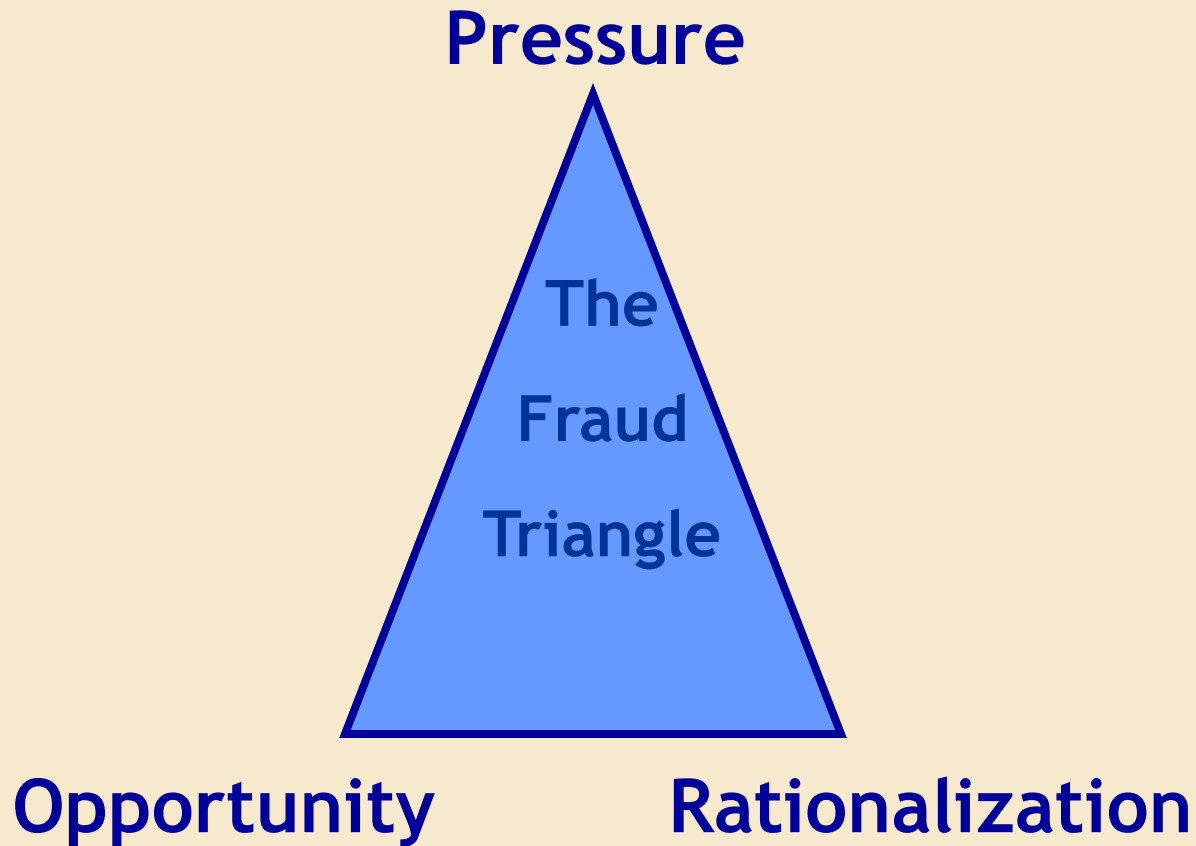
## Size of Victim Organization — Median Loss



## Industry of Victim Organizations (sorted by Median Loss)

Industry	Number of Cases	Percent of Cases	Median Loss
Mining	12	0.7%	\$1,000,000
Wholesale Trade	42	2.3%	\$513,000
Oil and Gas	57	3.2%	\$478,000
Real Estate	57	3.2%	\$475,000
Agriculture, Forestry, Fishing and Hunting	27	1.5%	\$320,000
Manufacturing	193	10.7%	\$300,000
Transportation and Warehousing	62	3.4%	\$300,000
Technology	65	3.6%	\$250,000
Construction	77	4.3%	\$200,000
Insurance	91	5.1%	\$197,000
Arts, Entertainment and Recreation	49	2.7%	\$180,000
Banking/Financial Services	298	16.6%	\$175,000
Healthcare	107	5.9%	\$150,000
Telecommunications	37	2.1%	\$131,000
Utilities	45	2.5%	\$120,000
Services (professional)	51	2.8%	\$110,000
Communications/Publishing	16	0.9%	\$110,000
Services (other)	88	4.9%	\$109,000
Retail	119	6.6%	\$85,000
Government and Public Administration	176	9.8%	\$81,000
Religious, Charitable or Social Services	41	2.3%	\$75,000
Education	90	5.0%	\$71,000

# Profile of a Perpetrator



# The Fraud Triangle

- Pressure: What causes a person to commit fraud -Significant financial need or problem
  - Divorce
  - Drug or Alcohol Addiction
  - Excessive Gambling
  - Maintain a Certain Life Style

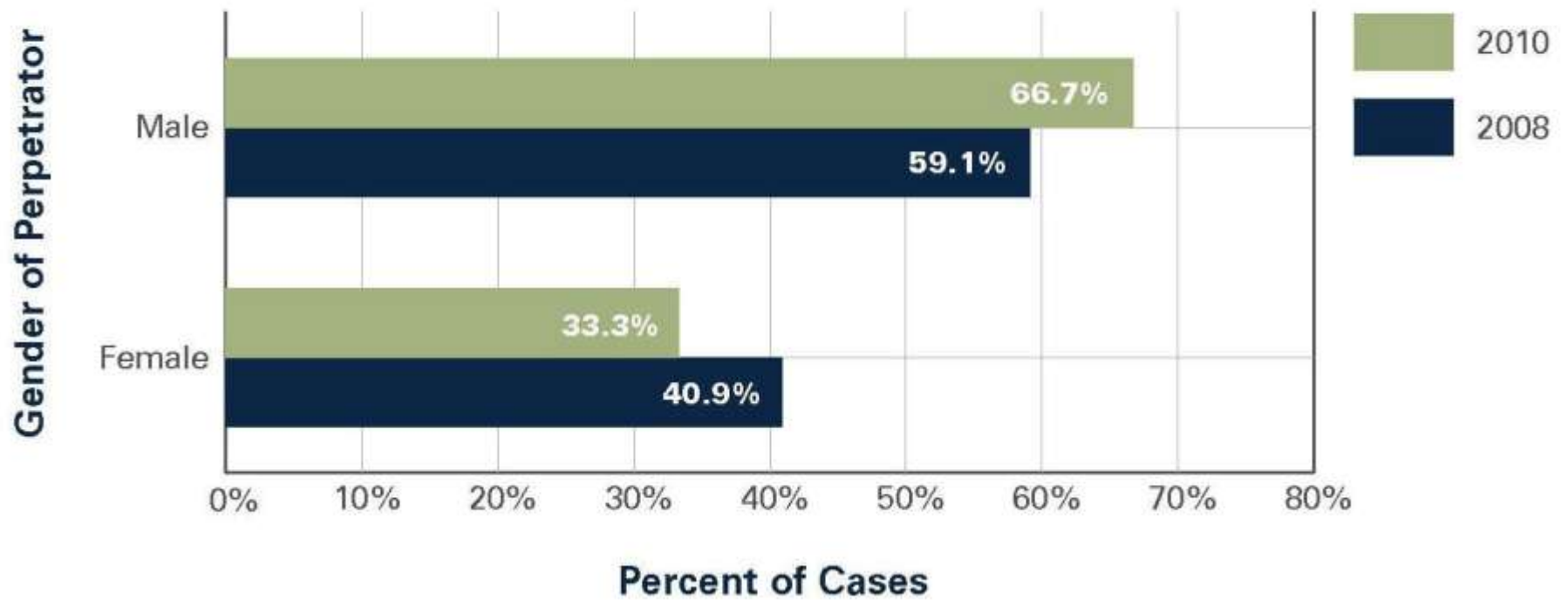
# The Fraud Triangle

- Opportunity: The ability to commit fraud and not be detected
  - Weak Internal Controls
  - Poor Management Oversight

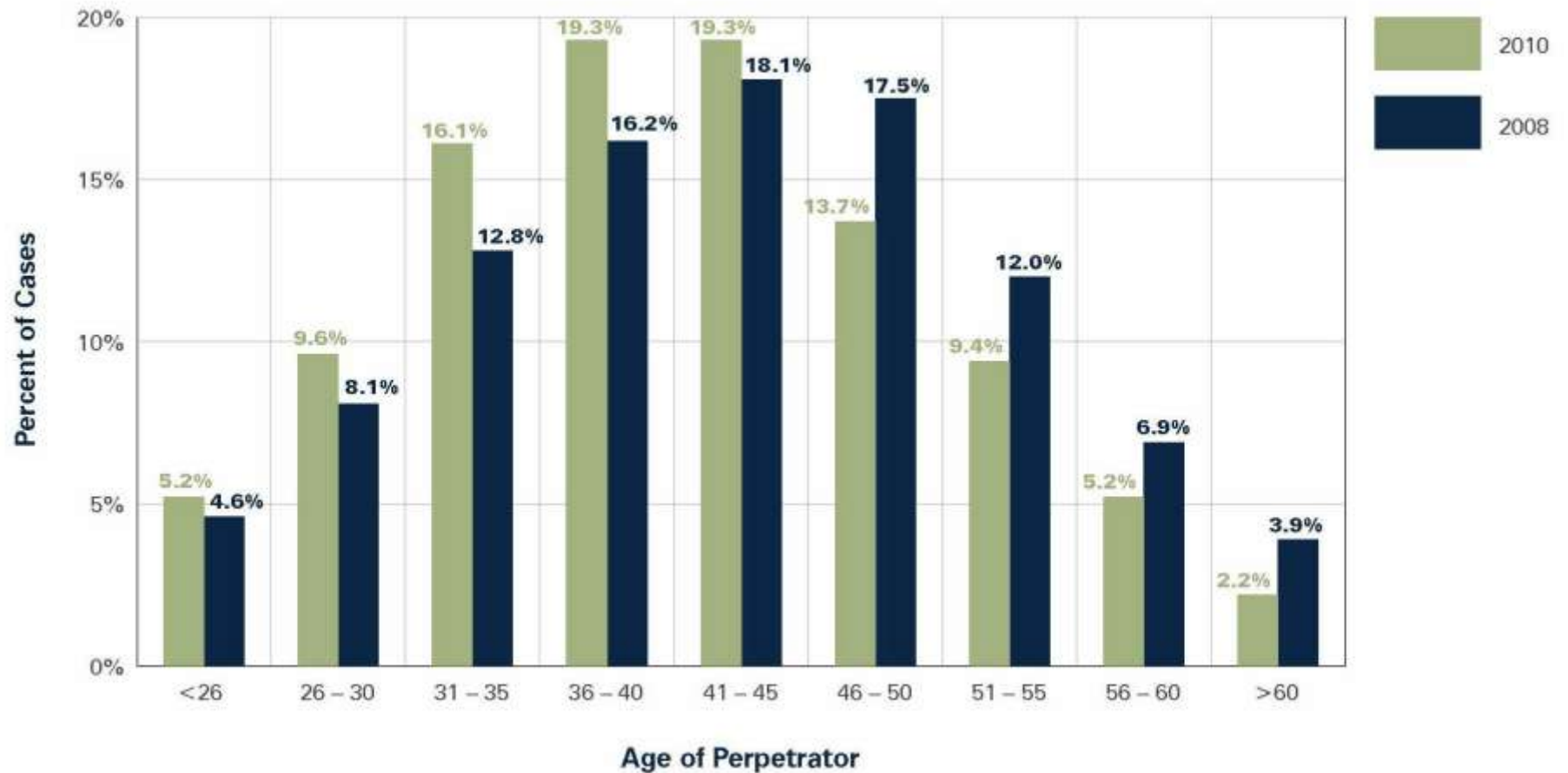
# The Fraud Triangle

- Rationalization: Convincing oneself that its ok or justified.
  - I'm just borrowing the money
  - I'm owed this for all the work I do
  - I'm underpaid/employer cheated me
  - My employer is dishonest and they deserve to be fleeced

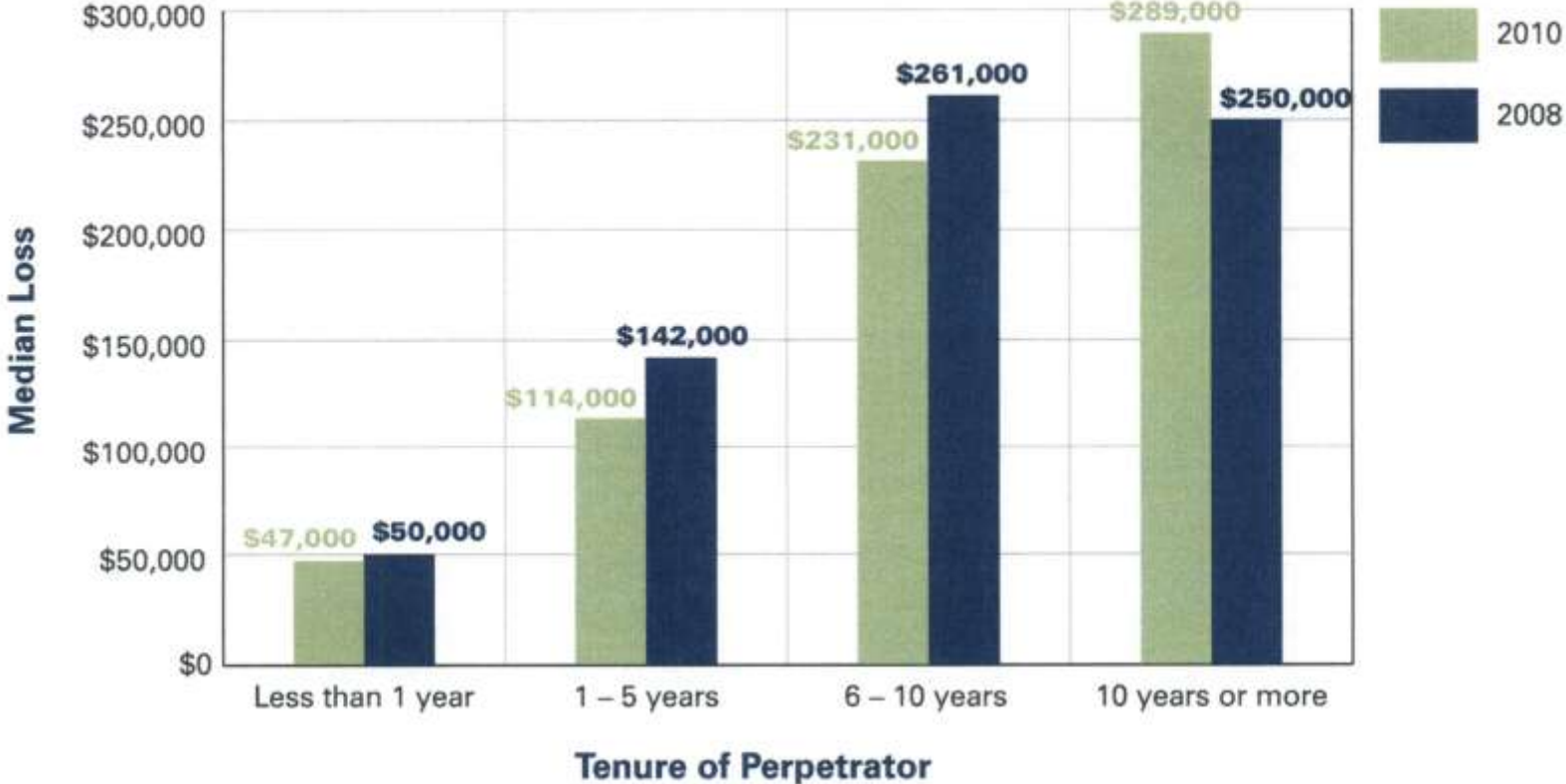
## Gender of Perpetrator — Frequency



## Age of Perpetrator — Frequency



### Tenure of Perpetrator — Median Loss



## Education of Perpetrator — Frequency

Education Level of Perpetrator



## Education of Perpetrator — Median Loss



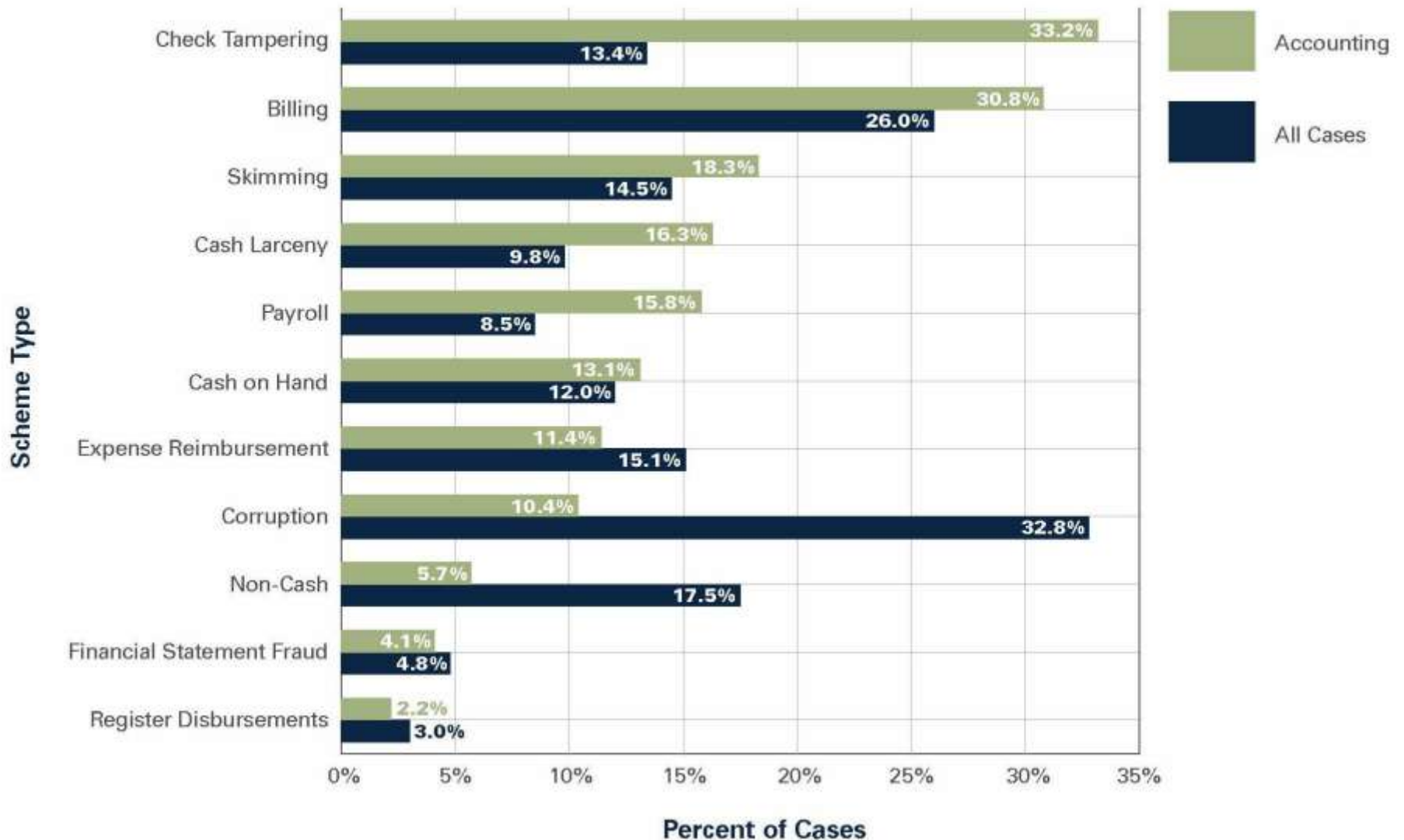
## Median Loss Based on Perpetrator's Department

Department	Number of Cases	Percentage	Median Loss
Executive/Upper Management	224	13.5%	\$829,000
Board of Directors	24	1.4%	\$800,000
Legal	8	0.5%	\$566,000
Purchasing	103	6.2%	\$500,000
Finance	70	4.2%	\$450,000
Marketing/Public Relations	34	2.0%	\$248,000
Warehousing/Inventory	78	4.7%	\$239,000
Human Resources	22	1.3%	\$200,000
Accounting	367	22.0%	\$180,000
Manufacturing and Production	28	1.7%	\$150,000
Operations	299	18.0%	\$105,000
Research and Development	13	0.8%	\$100,000
Sales	225	13.5%	\$95,000
Information Technology	47	2.8%	\$71,400
Customer Service	120	7.2%	\$46,000
Internal Audit	3	0.2%	\$13,000

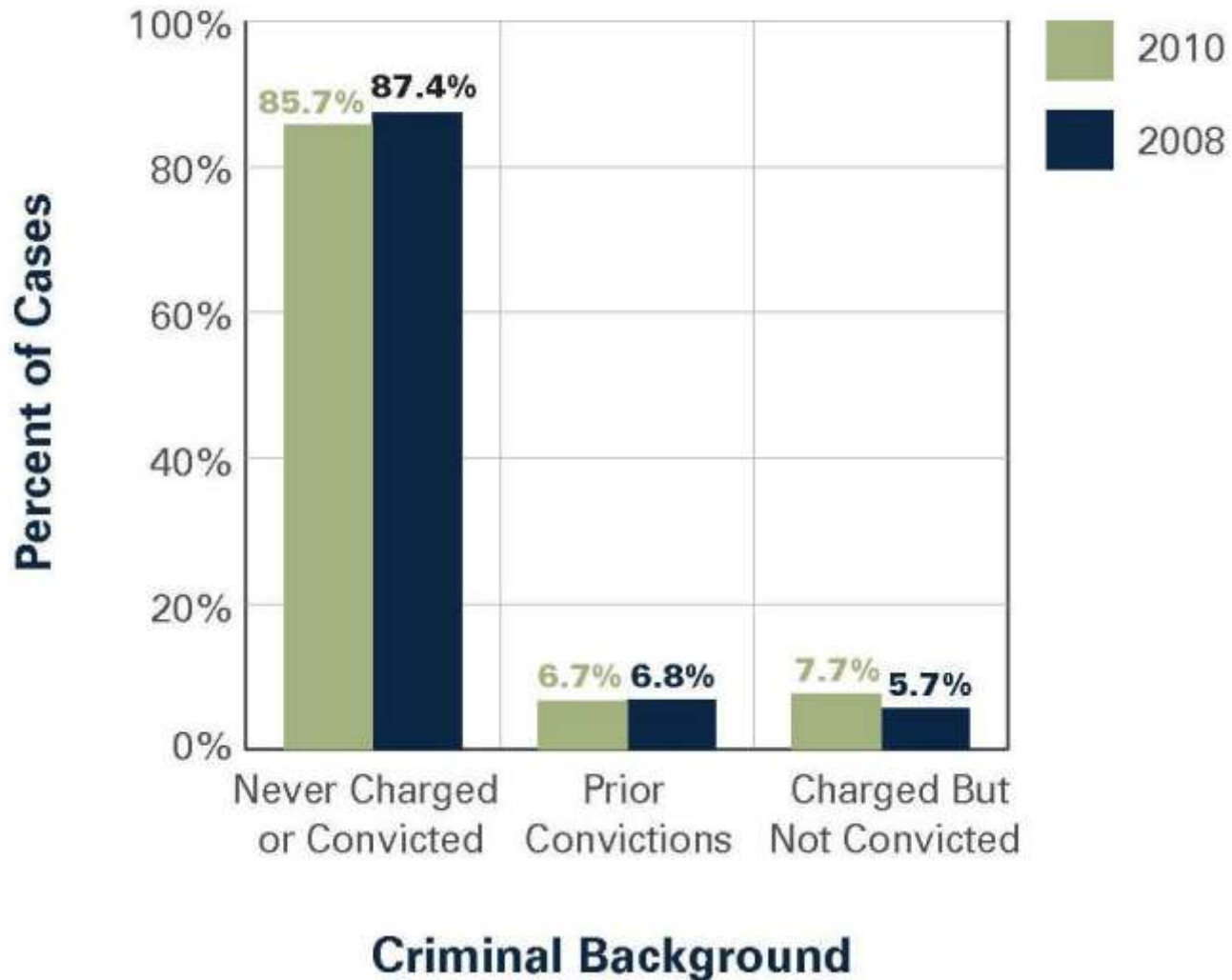
# Other Losses due to Fraud

- Loss of an employee
- Loss of a vendor or supplier
- Loss of a customer
- Loss of productivity
- Loss of reputation
- Loss of morale
- Loss of innocence

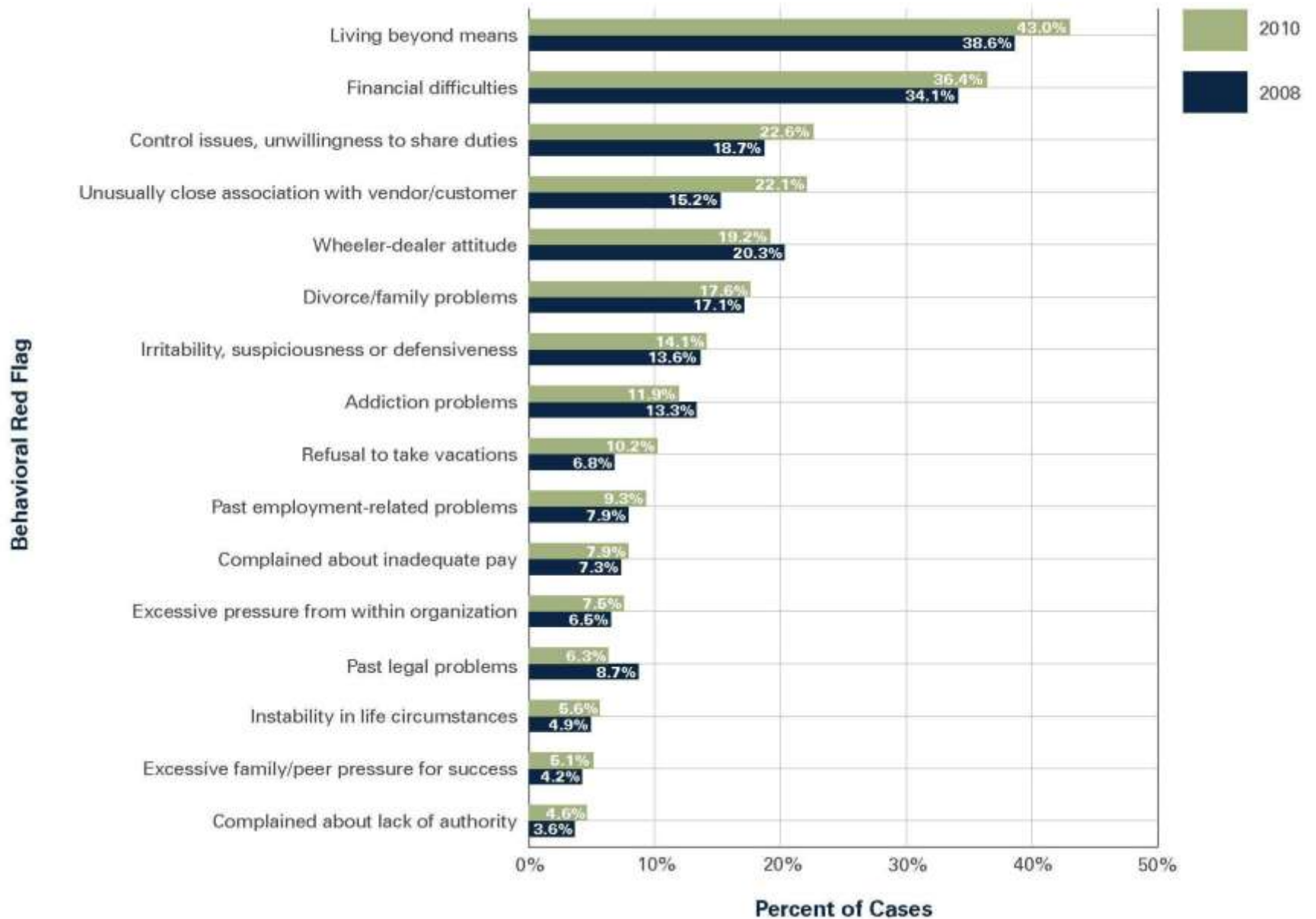
## Schemes Committed by Perpetrators in the Accounting Department — 367 Cases<sup>23</sup>



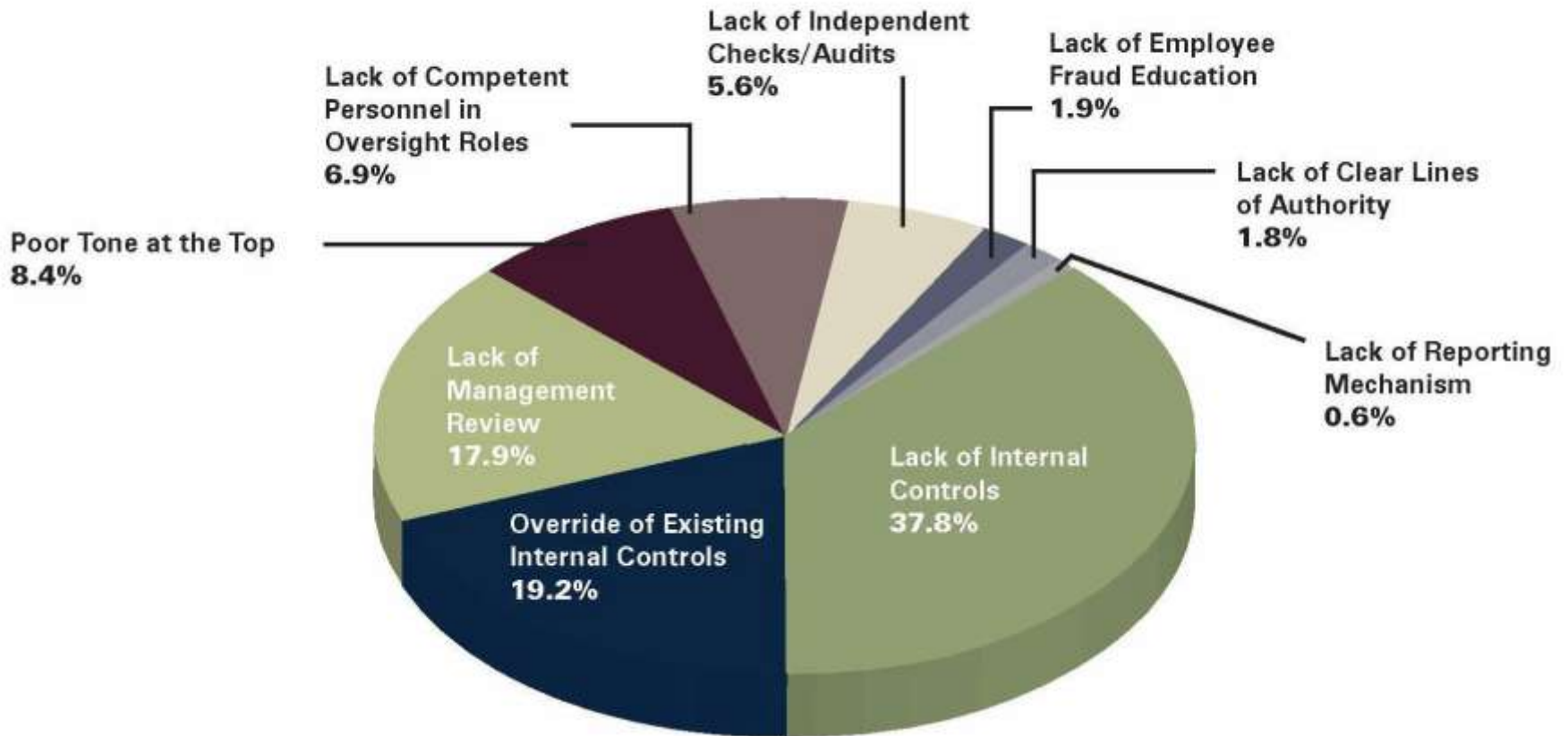
## Perpetrator's Criminal Background



## Behavioral Red Flags of Perpetrators<sup>29</sup>



## Primary Internal Control Weakness Observed by CFEs



# What can you do?

- Set the “tone at the top”.
- Owners should open the bank statement and thumb through it.
- Follow through on company’s fraud policy.
- Review internal controls.
  - No one person should have unrestricted access to cash.
- Change passwords.
- Use monitoring equipment where needed.
- Be sure physical security is up to date.
- Look for professional guidance on how to deter fraud.
- Prescreen employees.
- Review changes in employees work habits and attitudes.
- Establish an anonymous hotline for fraud reporting.
- Reward whistleblowers.
- Schedule surprise procedures and reviews.
- Mandatory job rotation and vacations.

**The most cost-effective way to limit fraud losses is to prevent fraud from occurring. This checklist is designed to help organizations test the effectiveness of their fraud prevention measures.**

**1. Is ongoing anti-fraud training provided to all employees of the organization?**

- Do employees understand what constitutes fraud?
- Have the costs of fraud to the company and everyone in it — including lost profits, adverse publicity, job loss and decreased morale and productivity — been made clear to employees?
- Do employees know where to seek advice when faced with uncertain ethical decisions, and do they believe that they can speak freely?
- Has a policy of zero-tolerance for fraud been communicated to employees through words and actions?

**2. Is an effective fraud reporting mechanism in place?**

- Have employees been taught how to communicate concerns about known or potential wrongdoing?
- Is there an anonymous reporting channel available to employees, such as a third-party hotline?
- Do employees trust that they can report suspicious activity anonymously and/or confidentially and without fear of reprisal?
- Has it been made clear to employees that reports of suspicious activity will be promptly and thoroughly evaluated?

**3. To increase employees' perception of detection, are the following proactive measures taken and publicized to employees?**

- Is possible fraudulent conduct aggressively sought out, rather than dealt with passively?
- Does the organization send the message that it actively seeks out fraudulent conduct through fraud assessment questioning by auditors?
- Are surprise fraud audits performed in addition to regularly scheduled fraud audits?
- Is continuous auditing software used to detect fraud and, if so, has the use of such software been made known throughout the organization?

**4. Is the management climate/tone at the top one of honesty and integrity?**

- Are employees surveyed to determine the extent to which they believe management acts with honesty and integrity?
- Are performance goals realistic?
- Have fraud prevention goals been incorporated into the performance measures against which managers are evaluated and which are used to determine performance-related compensation?
- Has the organization established, implemented and tested a process for oversight of fraud risks by the board of directors or others charged with governance (e.g., the audit committee)?

- 5. Are fraud risk assessments performed to proactively identify and mitigate the company's vulnerabilities to internal and external fraud?**
  
- 6. Are strong anti-fraud controls in place and operating effectively, including the following?**
  - Proper separation of duties
  - Use of authorizations
  - Physical safeguards
  - Job rotations
  - Mandatory vacations
  
- 7. Does the internal audit department, if one exists, have adequate resources and authority to operate effectively and without undue influence from senior management?**

**8. Does the hiring policy include the following?**

- Past employment verification
- Criminal and civil background checks
- Credit checks
- Drug screening
- Education verification
- References check

**9. Are employee support programs in place to assist employees struggling with addictions, mental/emotional health, family or financial problems?**

**10. Is an open-door policy in place that allows employees to speak freely about pressures, providing management the opportunity to alleviate such pressures before they become acute?**

**11. Are anonymous surveys conducted to assess employee morale?**

# Anatomy of a Fraud

- Co-worker calls CPA firm and tells us (sobbing) she saw a company check on the bookkeeper's desk with the bookkeeper's son's business landlord as payee.
- The next day was a regularly scheduled quarterly visit from the CPA firm to the company.

- Engagement partner has several conversations that day with the bookkeeper who reveals:
  - Her son is in a business which is having financial difficulties.
  - Her husband (not the boy's father) has made it clear the boy must “sink or swim” on his own.
  - Engagement partner offers the bookkeeper to help her son with business consulting.

- During the company visit, the engagement partner solicits the co-worker to point out names of vendors who might be the bookkeeper's son vendors and not the company's.
- Engagement partner sees multiple entries each month for these “bogus” vendors and speaks to the owners. He suggests engaging a CFE (a member of his firm). Owners agree, however, they ask that the investigation be done after business hours as not to tip off the bookkeeper and agitate the staff. It seems the bookkeeper was a 25 year employee and was well liked by the owners and staff.

- The CFE, engagement partner, co-worker and owners meet the next evening and review the cash disbursements, general ledger and bank statements for bogus vendors. Quickly they find over \$50,000 in fraudulent transactions over the past 18 months. The pattern is escalating. In the first 6 months the loss is a few thousand. In the next 12 months it is averaging \$3-5,000 per month.

- The CFE collects evidence of invoices (with the name of buyer purposely covered when copied and put in the file), cancelled checks and copies of the cash disbursement journals for use in prosecution.

- Significant discussions are held with the owners on the course of action. Both owners are shocked by the discovery of the fraud. They decide, for business reasons, not to prosecute and to terminate the bookkeeper. Grasping for one last hope she is innocent, they ask the engagement partner to speak with her and find out if this was “just a mistake” or, if not, why she did this.

- The engagement partner comes to the company the next day unannounced and asks the bookkeeper to come into the vacant conference room (neutral site) as there are some “numbers” he does not understand.
- The bookkeeper asks what it is about and when they get to the conference room, the engagement partner says there are some irregularities in the books and asks if she knows what was going on.

- She indicates no knowledge of irregularities whereupon the engagement partner tells her he knows she is paying her son's business vendors from the company checkbook.
- She indicates that these checks were authorized by the owners. He indicates that the owners have seen the transactions and say no, it is not true. He tells her she has to tell the truth as the police will be called if she keeps quiet (a bluff).

- She breaks down and (crying) tells the engagement partner that she had to do this as her husband would not help her son. She is sorry and wants to know if she will go to jail. She wants to give back a \$7,000 Rolex watch she was given by the company for her 25 years of service. She offers it in restitution.

- The owners are asked into the conference room, tell her of their disappointment with her actions and ask her to clean out her desk. By pre-arrangement, the IT people froze her out of the network when she was asked into the conference room. The bank was also notified that she was to be removed as check signer on the petty cash account.

- While she admitted to the \$50,000 theft, it was later discovered the amount was \$70,000 from the company and another \$10,000 from the 91 year old father of the owner. It was also discovered she was in the process of attempting to loot another \$10,000 from a real estate partnership account.

# Useful Websites

[www.acfe.com](http://www.acfe.com)

[www.411.com](http://www.411.com)

[www.dos.state.ny.us](http://www.dos.state.ny.us)

[www.osc.state.ny.us](http://www.osc.state.ny.us)

[www.freetranslation.com](http://www.freetranslation.com)

[www.irs.gov](http://www.irs.gov)

[www.orangecountygov.com](http://www.orangecountygov.com)

[www.aicpa.org](http://www.aicpa.org)

[www.mylife.com](http://www.mylife.com)

[www.brandyourself.com](http://www.brandyourself.com)

# **CASE STUDY**

**Pizza Dough or the case of the  
Pilfering Pizza Man**

# JUST THE FACTS MA'AM

- Owner of a Pizza/Italian Restaurant (with Bar) is getting divorced
- The soon to be ex-wife believes that “Pizza Man” has not been reporting the true amount of income for his business

Your task (should you choose to accept it Ethan) is to find if “Pizza Man” has been pilfering and how much

# Preliminary Procedures

- Obtain the tax returns for the past 5 years and investigate any significant fluctuations
- Obtain cash receipt and cash disbursement records to look for unusual or suspicious items
- Obtain a list of vendors for the following:
  - Verify Vendor is not a related party or actual entity
  - Get vendor statements and compare to records
  - Look for vendors who are not related to the business activity e.g. jewelry store, sporting goods, etc.
  - Contact vendors to see how much in goods or services were purchased e.g. pizza boxes
  - Contact vendors and ask if any payments were made in cash
  - Contact vendors and find out where the goods were delivered

# Preliminary Procedures (Con't)

- Obtain the guest checks (or MICROS records) and compare to income recorded and numerical sequence for the guest checks
- Obtain sales tax returns and compare to income reported on the income tax return
- Obtain bank statements to see amounts actually deposited
- Look at deposit slips to see if the cash deposited is reasonable
- Stake out
- Count the coasters and straws used for beverage sales
- Look at the garbage bills. Do they vary with the amount of volume?

# Preliminary Procedures (Con't)

- Interview former and current employees
- Examine payroll tax returns for number of employees paid
- Examine names of employees and addresses to determine they are not fictitious
- Compare to industry standards and, if available, similar businesses in the same locality
- Look at loan applications for hidden assets
- Does “Pizza Man” have a safe
- Lifestyle Audit
- Trojan Horse (Buyer)

**C**ertified

**F**raud

**E**xaminer

# How Do I Become a Certified Fraud Examiner (CFE)

1. Be an associate member of the Association of Certified Fraud Examiners (ACFE) in good standing.
2. Meet minimum academic and professional requirements.
  - Minimum of a bachelors degree (or equivalent) from an institute of higher learning. No specific field of study is required. Also, two years of fraud related professional experience may be substituted if you do not have a bachelors degree.
  - Must have at least two years of professional experience in a field either directly or indirectly related to the detection or deterrence of fraud. i.e. - Accounting and Auditing, Criminology and Sociology, Fraud Investigation, Loss Prevention, and Law.
3. Pass the four part CFE exam.
  - Criminology and ethics
  - Financial transactions
  - Fraud investigation
  - Legal elements of fraud
4. Get final approval from the certification committee.

**C**ertified

in

**F**inancial

**F**orensics

# How Do I Become Certified in Financial Forensics (CFF)

1. Available from American Institute of Certified Public Accountants (AICPA) only
2. Exclusively for CPA's
3. To become a CFF
  - Member in good standing of AICPA
  - Hold valid CPA license
  - Pass CFF examination
  - Agree to comply with requirements of CFF re-certification
4. CFF Exam
  - Profession Responsibilities and Practice Management
  - Fundamental Forensic knowledge including Knowledge of Law, Courts, Engagement Preparation, Information Gathering, Reports and Testimony
  - Specialized Forensic Knowledge in Bankruptcy, Computer Forensics, Economic Damages, Family Law, Financial Statements, Fraud Prevention and Valuation

**Questions?**

**Any stories to share?**

**Thank you!**