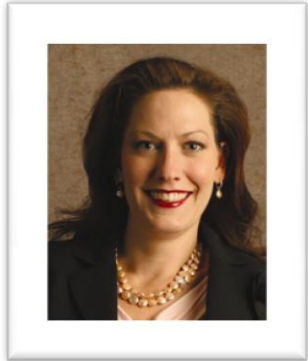




Fraud Risk Assessment

Presented by Alyssa G. Martin





Alyssa G. Martin, CPA

- Partner in Charge of Weaver's Risk Advisory Service
- Has over 22 years experience in public accounting
- Specialize in the areas of:
 - Risk and business management consulting
 - Fraud prevention
 - SOX 404 compliance and monitoring
 - Technology consulting
 - Strategic planning
 - Operational analysis
 - Internal audit
 - IT audit




- **Primary Categories of Fraud**
- **Identifying Fraud Schemes**
- **Fraud Risk Assessment**
- **Anti-Fraud Response**



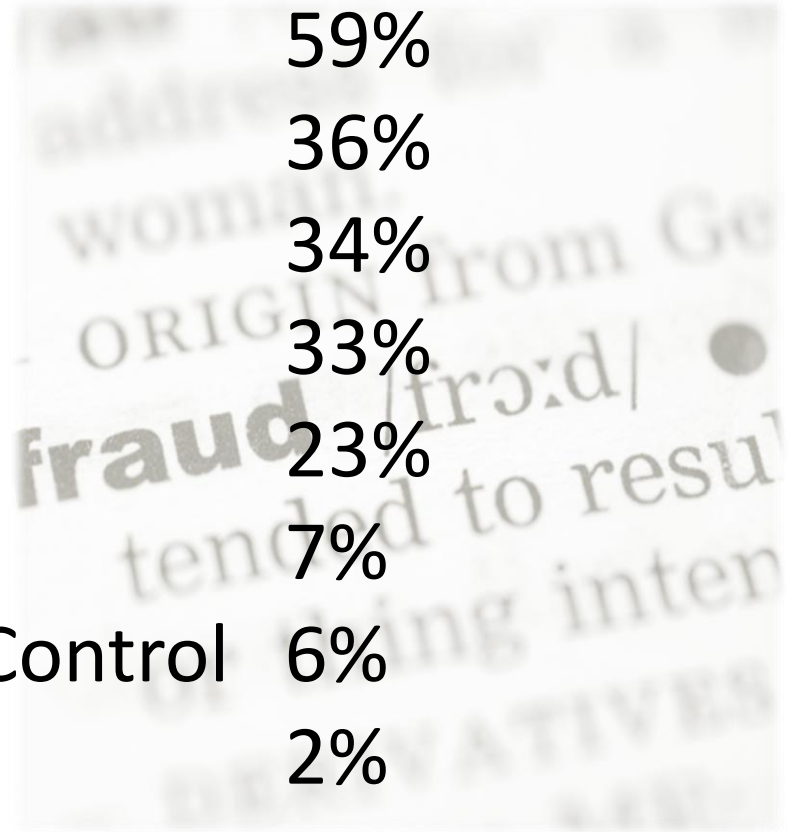
Primary Categories of Fraud

“... any illegal act characterized by **deceit**, concealment, or **violation of trust**. These acts are not dependent upon the threat of violence or physical force. Frauds are **perpetrated by parties** and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure **personal** or business **advantage**.”

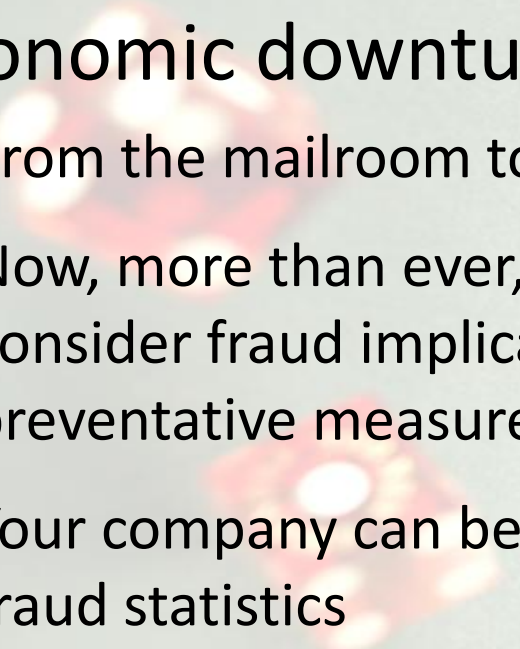
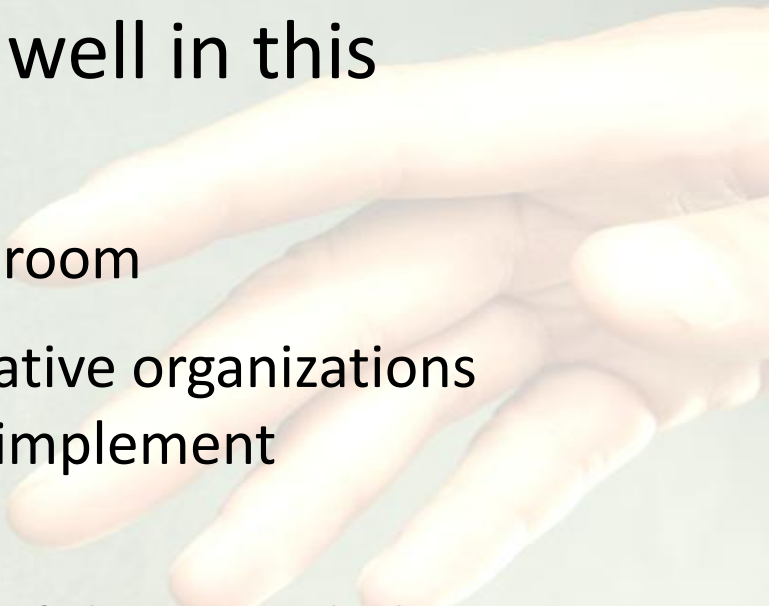
Primary Categories of Fraud

Asset Misappropriation	Corruption / FCPA	Financial Statement Fraud
Theft or misuse of tangible and intangible assets	Utilizing influence in business transactions to obtain a personal benefit	Misstatement or omission of material information in financial statements
Most Common	Less Frequent	Most Rare
		

- Poor Controls 59%
- Management Override 36%
- High Risk Industry 34%
- Third Party Collusion 33%
- Employee Collusion 23%
- No Ethics Policy 7%
- No Board of Directors Control 6%
- Other 2%

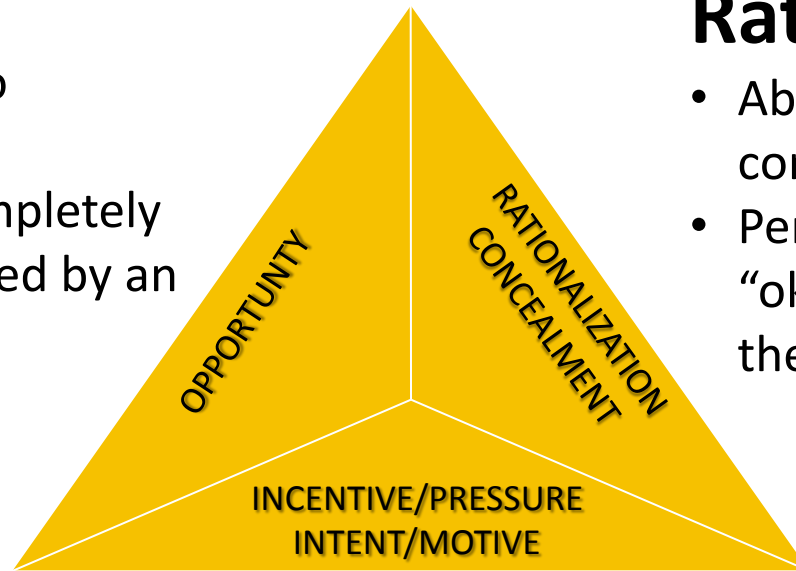


Despite aggressive prosecutions, fraud in the workplace is alive and well in this economic downturn

- From the mailroom to the boardroom
 - Now, more than ever, it is imperative organizations consider fraud implications and implement preventative measures
 - Your company can become part of the overwhelming fraud statistics
 - Don't leave your fraud prevention to chance
- 
- 

Opportunity

- Must gain access to assets/records
- The only factor completely controlled/prevented by an organization



Rationalization

- Ability to follow through and commit the fraud
- Perpetrator has to make it “okay” internally to perform the fraudulent act

Incentive/Pressure

- The more incentive, the easier it is to justify
- Financial or personal problems, financial pressure, mental instability

- Consistent inventory adjustments for defective items or shrinkage
- Compensation tied to operating results
- Consistently meet/exceed analyst expectations
- Operations in countries with history of bribery
- Related party transactions
- Material or frequent adjusting entries
- Missing, altered, late documents
- Lackadaisical oversight combined with friendly employee relations
- Change in personal habits or behavior





Identifying Fraud Schemes



Asset Misappropriation

Scheme	Scenario
Payroll	<ul style="list-style-type: none">• Payment to fictitious employee• Payment to terminated employees• Overpayment to existing employees
Inventory	<ul style="list-style-type: none">• Theft of inventory items• Consistent shrinkage of items• Increased defective/warranty claims
Credit Cards	<ul style="list-style-type: none">• Reimbursement for personal expenses• Use card to circumvent competitive bid requirements
Larceny	<ul style="list-style-type: none">• Theft of materials, supplies, cash
Purchasing	<ul style="list-style-type: none">• Using purchasing authority to purchase raw materials for personal use
Procurement	<ul style="list-style-type: none">• Using procurement card for personal, exorbitant purchases
Reimbursement	<ul style="list-style-type: none">• Reimbursement for undocumented expenses• Reimbursement for luxury accommodations• Reimbursement for travel expenses of family members
Improper Payments	<ul style="list-style-type: none">• Payments to phantom vendors, shell companies

Scheme	Scenario
Kickbacks	<ul style="list-style-type: none"> • Cash or non-cash gifts from vendors for favorable treatment • Awarding contracts based on side agreements
Competitive Bid Rigging	<ul style="list-style-type: none"> • Related party transactions or dealing for personal benefit • Preferential treatment of vendors • Profiteering based on insider knowledge • Establishing criteria that gives select vendors an unfair advantage • Purchasing in smaller increments to avoid the bidding process
Bribery	<ul style="list-style-type: none"> • Domestic or foreign bribes to government officials • Failure to adhere to FCPA
Conflicts of Interest	<ul style="list-style-type: none"> • Awarding contracts to parties related to individuals in involved in the decision making process
Forgery or Falsification of Documents	<ul style="list-style-type: none"> • Falsification of shipping dates, contract terms, operating results • Altering or creating documents with the intent to defraud • Destruction or disappearance of records

Scheme	Scenario
Fictitious Revenue	<ul style="list-style-type: none"> • Improper or early revenue recognition • Falsifying revenue • Earnings manipulation through reserves • Recording pending transactions as completed transactions
Overstating Assets	Improper valuation of securities, inventory, fixed assets
Understating Liabilities and Expenses	<ul style="list-style-type: none"> • Hiding losses in future reporting periods • Understating expense account balances • Reclassifying (capitalizing) expenses as assets • Improper valuation or manipulation of intercompany accounts
Improper Note Disclosure	<ul style="list-style-type: none"> • Omission of material contingencies or subsequent events
Non-financial	<ul style="list-style-type: none"> • Falsifying external documents to suppliers • Internal memorandums give misleading information • Publicly announced information provides unsubstantiated favorable results
Manipulating Management Estimates	<ul style="list-style-type: none"> • Manipulation of management estimates for receivables, goodwill, or depreciation



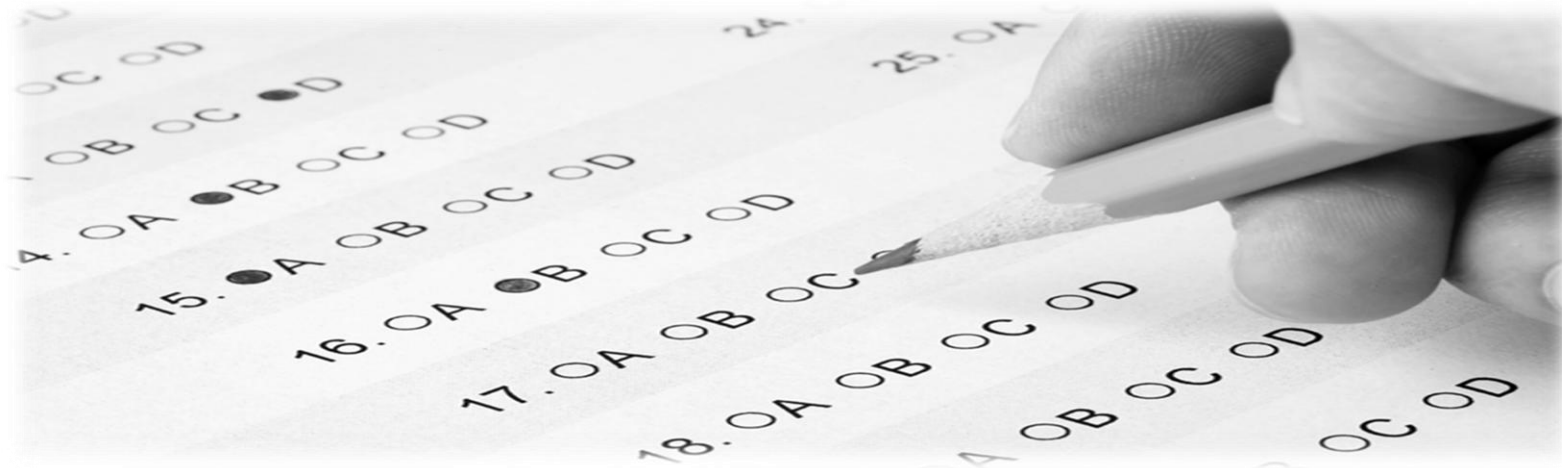
Fraud Risk Assessment

“The **degree of probability** that an **unfavorable event** will significantly impact a functional area’s ability to **meet the organization’s objectives**”



A Fraud Risk Assessment will:

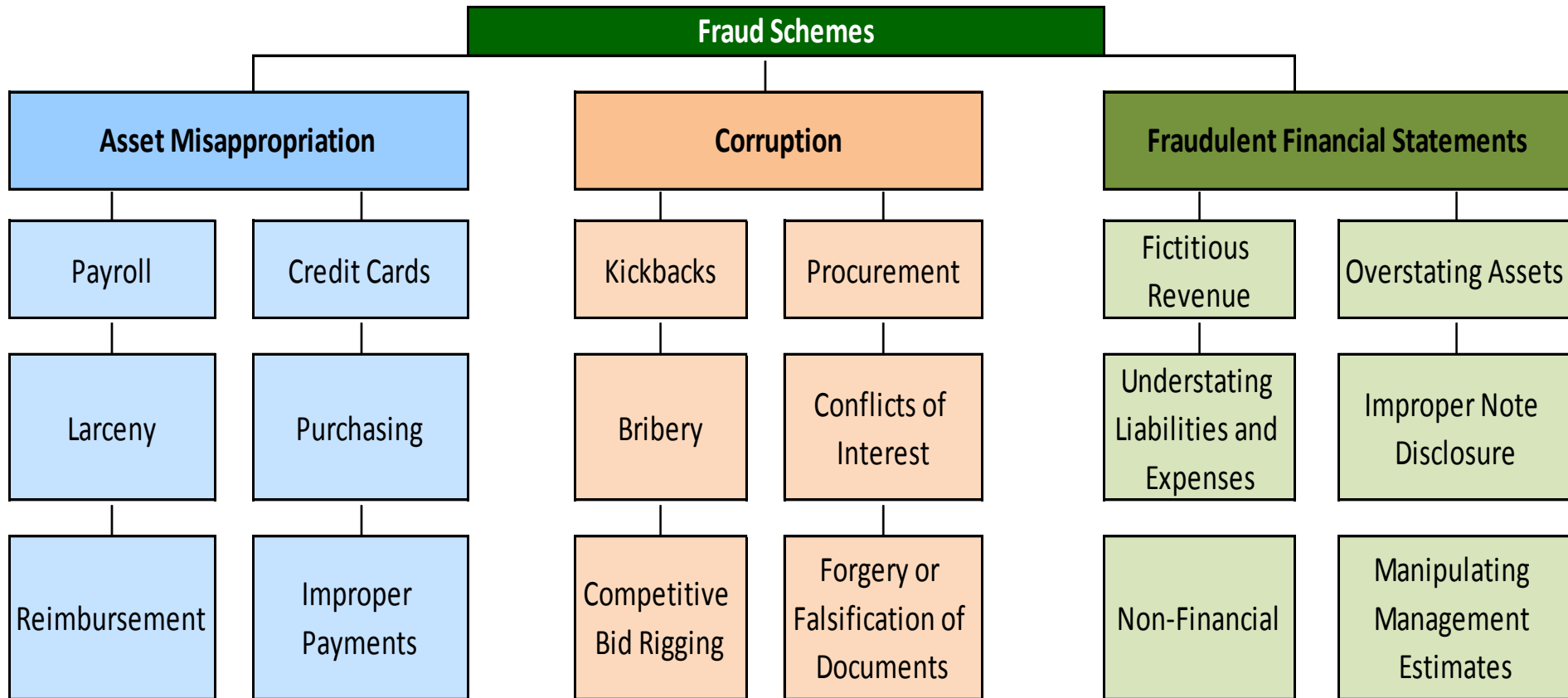
- Identify and recognize fraud risks in the organization
- Determine their likelihood
- Determine how to manage and mitigate fraud risk



Fraud Risk Assessment allows you to:

- Determine critical information
- Identify systems that process, store, or transmit critical information used for red flag identification
- Discover vulnerabilities
- Create new processes, controls and procedures for mitigating fraud risk

Each fraud risk type or scheme is **identified** and assigned a **risk rating**



Develop and implement a comprehensive fraud risk assessment that includes:

- Methods to identify most relevant operational and financial fraud risks
- Profiles for key processes and functional areas, with assigned risk ratings for each
- Schemes and scenarios where fraud could occur in the organization



- Determine significant process areas that should be assessed
 - Financial, operational & compliance activities, that **could** have fraud risk exposure
- Risk rate each activity
 - Consider origin of the risk, current processes and existing controls
 - Include both quantitative and qualitative analysis
- Set rating scale based on risk and tolerance of industry and organization's culture

Example:

Risk Rating	Likelihood	Dollar Threshold
1 = LOW	Very Remote (< 10% Chance)	< \$ 250,000
2 = BELOW AVG	Somewhat Likely (>10% - < 50% Chance)	> \$ 250,000
3 = MODERATE	Likely (>50% - < 70% Chance)	> \$ 500,000
4 = ABOVE AVG	Probable (>70% - < 90% Chance)	> \$ 800,000
5 = HIGH	Highly Probable (> 90% Chance)	> \$ 1,000,000

Results

- Comparing risk ratings by locations illustrates overall threshold and tolerance

ABC Manufacturing Company

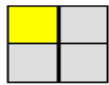
Risk Stmt	Financial / Operational Area	Fraud Scheme & Scenario	Total	Division A	Division B	Division C	Division D
			Average	Average	Average	Average	Average
1	Revenue	Improper/early revenue recognition, Fictitious Revenue	5	4	5	5	5
2	Expenses	Hiding Losses in future reporting periods	4	4	4	4	4
3	Cash and Cash Equivalents	Larceny, defalcation	4	4	4	4	4
4	Occupational Injury	Non-compliance with FMLA, abuse of FMLA	4	3	5	4	2
5	Financial Reporting	Manipulation of management estimates for receivables, goodwill, or depreciation	4	4	4	5	3
6	Improper Note Disclosure	Omission of material contingencies	4	4	5	4	3
7	Hiring Process	Payroll scheme: payment to fictitious employees	4	3	2	5	4
8	Compliance with Contracts	Awarding contracts to parties related to individuals involved in the decision making process	4	3	5	3	3
9	Assets	Improper valuation of securities, inventory, fixed assets	3	3	3	5	1
10	Expense Reimbursement process	Reimbursement for undocumented expenses	3	4	4	1	2
11	Competitive Bid Rigging	Establishing criteria that gives select vendors an unfair advantage	3	3	1	3	4
12	Performance and Compensation Review	Payroll scheme: Overpayment to terminated employees	3	3	3	4	3
13	Credit Card Process	Reimbursement for personal expenses	3	3	3	3	3
14	Non-Financial	Falsifying external documents to suppliers	3	3	4	3	3
15	Document storage	Destruction or disappearance of records	3	3	2	3	3
16	Foreign Operations	Domestic or foreign bribes to government officials	3	3	4	2	1
17	Consolidation Process	Manipulation of intercompany accounts	3	3	4	3	1
18	Non-Financial	Publicly announced information provides unsubstantiated favorable results	2	1	4	2	1
19	Purchasing Process	Using purchasing authority to purchase raw materials for personal use	1	2	1	1	1
20	Accounts Payable	Payments to phantom vendors, shell companies	1	2	1	1	1

- Each process area is plotted onto the risk map to visually illustrate the overall balance
- The risk map can be best evaluated by focusing on those areas in the upper right quadrant and moving diagonally down and to the left



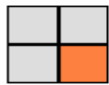
Improve

- Areas of high inherent exposure with a low level of control must be a key priority for controls improvement activity.



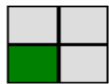
Monitor

- Areas of high inherent risk where controls are deemed adequate should be monitored.



Accept

- Risks with low inherent exposure that also have a low level of control may be consciously accepted by the organization.



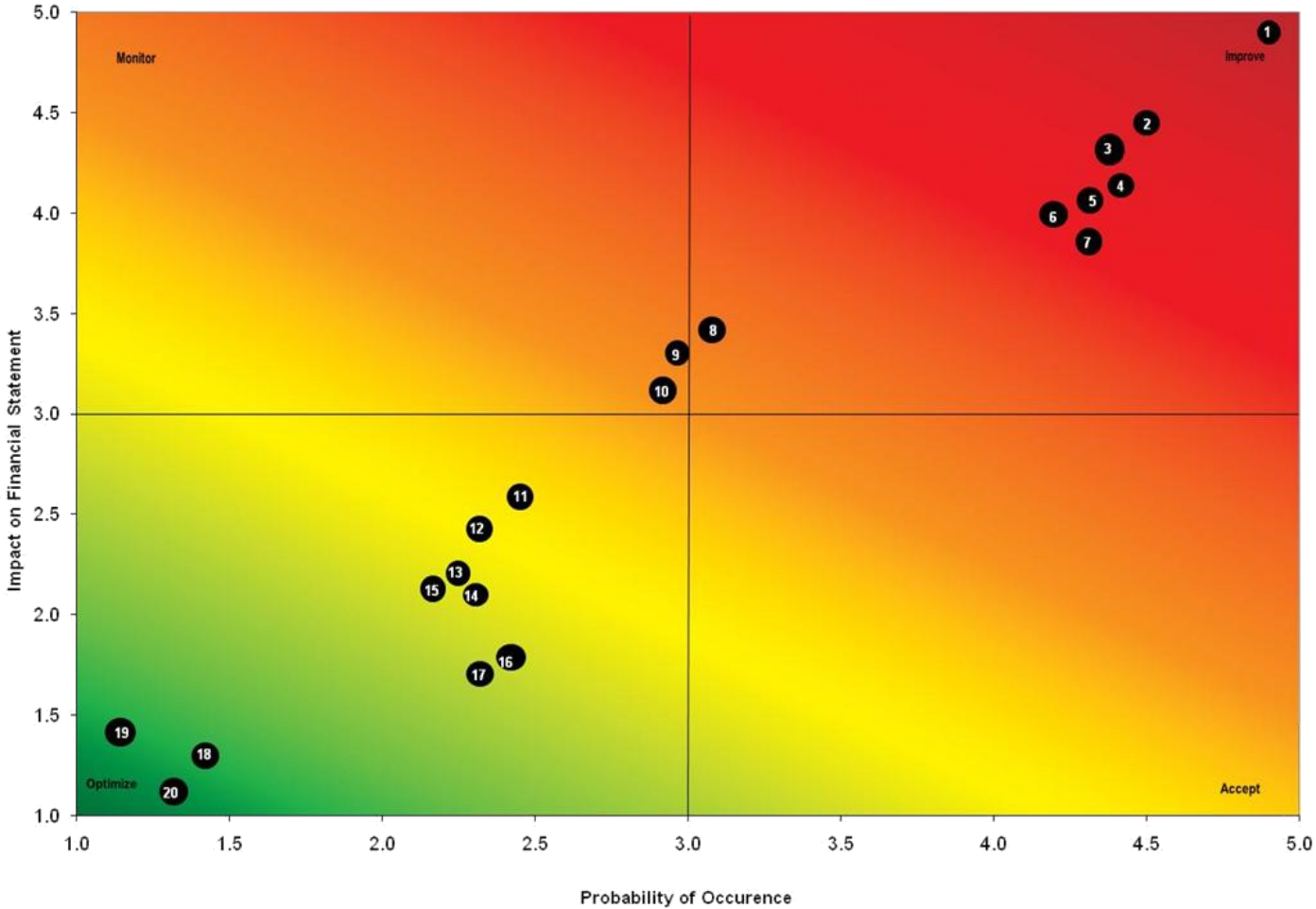
Optimize

- Areas of low inherent exposure with a high level of control may generate opportunities to optimize the process and control for efficiency.



Risk Map Illustrates Top Fraud Risks

ABC Manufacturing Company
Financial and Operational Risk Map Combined



LEGEND	
Risk Stmt	Fraud Scheme & Scenario
1	Improper/early revenue recognition, Fictitious Revenue
2	Hiding Losses in future reporting periods
3	Larceny, defalcation
4	Non-compliance with FMLA, abuse of FMLA
5	Manipulation of management estimates for receivables, goodwill, or depreciation
6	Omission of material contingencies
7	Payroll scheme: payment to fictitious employees
8	Awarding contracts to parties related to individuals involved in the decision making process
9	Improper valuation of securities, inventory, fixed assets
10	Reimbursement for undocumented expenses
11	Establishing criteria that gives select vendors an unfair advantage
12	Payroll scheme: Overpayment to terminated employees
13	Reimbursement for personal expenses
14	Falsifying external documents to supplies
15	Destruction or disappearance of records
16	Domestic or foreign bribes to government officials
17	Improper valuation or manipulation of intercompany accounts
18	Publicly announced information provides unsubstantiated favorable results
19	Using purchasing authority to purchase raw materials for personal use
20	Payments to phantom vendors, shell companies

Anti-Fraud Response

*An increase in any element in the triangle increases the **risks** of fraud. Anti-fraud controls are built to **deter** or **prevent** the ability, incentive, and opportunity to commit fraud.*



Managing key fraud risks

- Identified fraud risks in key operational and financial areas can be mitigated by:
 - Strengthening existing procedures
 - Implementing new procedures and controls

Don't become a statistic!

The typical U.S. organization loses 7% of its annual revenues to fraudulent activity*.



Top Fraud Risks and Responses

Customize response to identified fraud schemes and scenarios

Process	Fraud Scheme	Response
1. Revenue	<ul style="list-style-type: none"> • Improper/early revenue recognition • Fictitious revenue 	<ul style="list-style-type: none"> • Implement month-end review of financial statements • Require review and approval of journal entries
2. Expenses	<ul style="list-style-type: none"> • Hiding losses in future reporting periods 	<ul style="list-style-type: none"> • Implement month-end review of financial statements
3. Cash and Cash Equivalents	<ul style="list-style-type: none"> • Larceny • Defalcation 	<ul style="list-style-type: none"> • Establish ACH deposit into main operating account • Implement lockbox through independent bank
4. Occupational Injury	<ul style="list-style-type: none"> • Non-compliance with FMLA, abuse of FMLA 	<ul style="list-style-type: none"> • Require review and approval of submitted forms
5. Financial Reporting	<ul style="list-style-type: none"> • Manipulation of management estimates for receivables, goodwill, or depreciation 	<ul style="list-style-type: none"> • Review and approval of journal entries • Require supporting documentation for all estimates
6. Improper Note Disclosure	<ul style="list-style-type: none"> • Omission of material contingencies 	<ul style="list-style-type: none"> • Implement month-end checklist reviewed by various members of management
7. Hiring Process	<ul style="list-style-type: none"> • Payment to fictitious employees 	<ul style="list-style-type: none"> • Segregation of duties in the payroll process; outsource payroll
8. Compliance with contracts	<ul style="list-style-type: none"> • Awarding contracts to parties related to individuals involved in the decision making process 	<ul style="list-style-type: none"> • Involve various members of management in contract approval; require two signatures for approval of material contracts
9. Assets	<ul style="list-style-type: none"> • Improper valuation of securities, inventory, fixed assets 	<ul style="list-style-type: none"> • Management review and approval of valuation methods
10. Expense reimbursement process	<ul style="list-style-type: none"> • Reimbursement for undocumented expenses 	<ul style="list-style-type: none"> • Require employee expense reimbursement forms with attached original receipts
11. Competitive Bid Rigging	<ul style="list-style-type: none"> • Establishing criteria that gives select vendors an unfair advantage 	<ul style="list-style-type: none"> • Require independence confirmation for all members involved in negotiations
12. Performance and Compensation Review	<ul style="list-style-type: none"> • Overpayment to existing employees 	<ul style="list-style-type: none"> • Segregation of duties in the payroll process; outsource payroll
13. Credit Card Process	<ul style="list-style-type: none"> • Reimbursement for personal, non-deductible expenses 	<ul style="list-style-type: none"> • Require employee acceptance of Terms of Use and re-payment for personal expenses
14. Non-Financial	<ul style="list-style-type: none"> • Falsifying external documents to suppliers 	<ul style="list-style-type: none"> • Require approved contracts and purchase orders
15. Document Storage	<ul style="list-style-type: none"> • Destruction or disappearance of records 	<ul style="list-style-type: none"> • Establish Code of Conduct that restricts tampering with records; third-party document storage

- Fraud schemes are not static!
- Consider:
 - Economic Environment
 - Organization & Culture
 - Industry
- Addressing strategically provides structure to address new vulnerabilities as they emerge





Apply top-down approach!

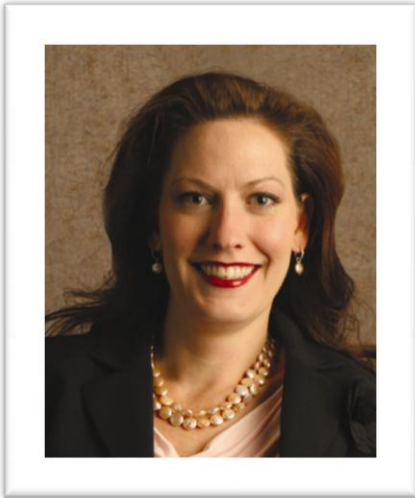
- Involve board & senior management
- Threats posing greatest fraud risk receive most attention
- Mitigate unacceptable vulnerabilities to ensure identified fraud risks do not exceed risk appetite

- Implement a process to regularly identify/respond to fraud risks and address vulnerabilities
- Integrate fraud risk recognition within business strategies
 - Recognize how fraud risks affect different aspects of the organization
 - Make adjustments
 - Avoid operational surprises or unexpected losses





Contact Information



Alyssa G. Martin, CPA

Partner, Risk Advisory Services

alyssa.martin@weaverllp.com

972.448.6975