

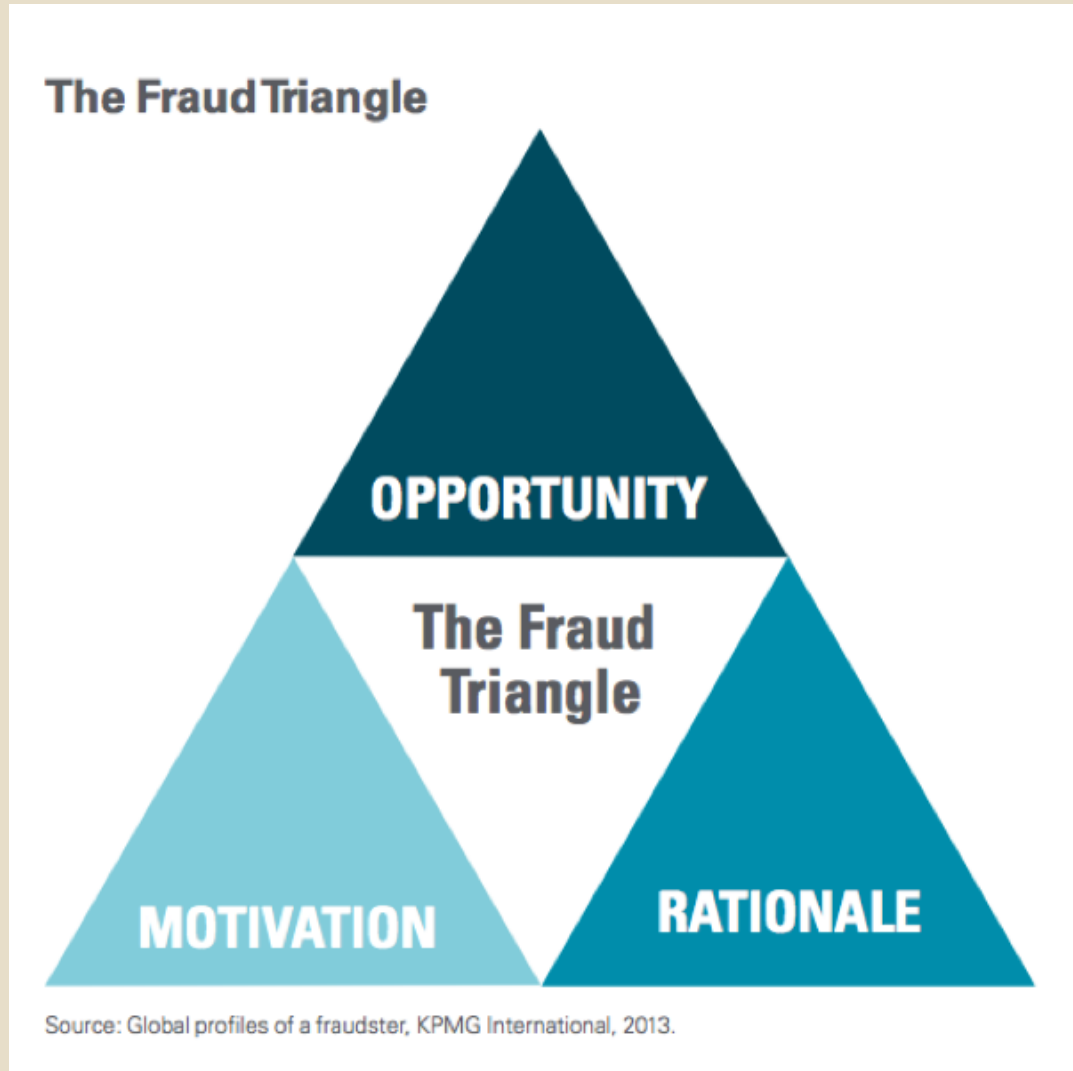
MIS 5208 – Lecture 03 – Why People Commit Fraud

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Learning Objectives

- Know the types of people who commit fraud.
- Explain why people commit fraud.
- Describe the fraud triangle.
- Explain the fraud scale.
- Understand how pressure contributes to fraud.
- Understand why opportunity must be present for fraud to occur.
- Understand why people rationalize.
- Understand how people are recruited to participate in fraud schemes.

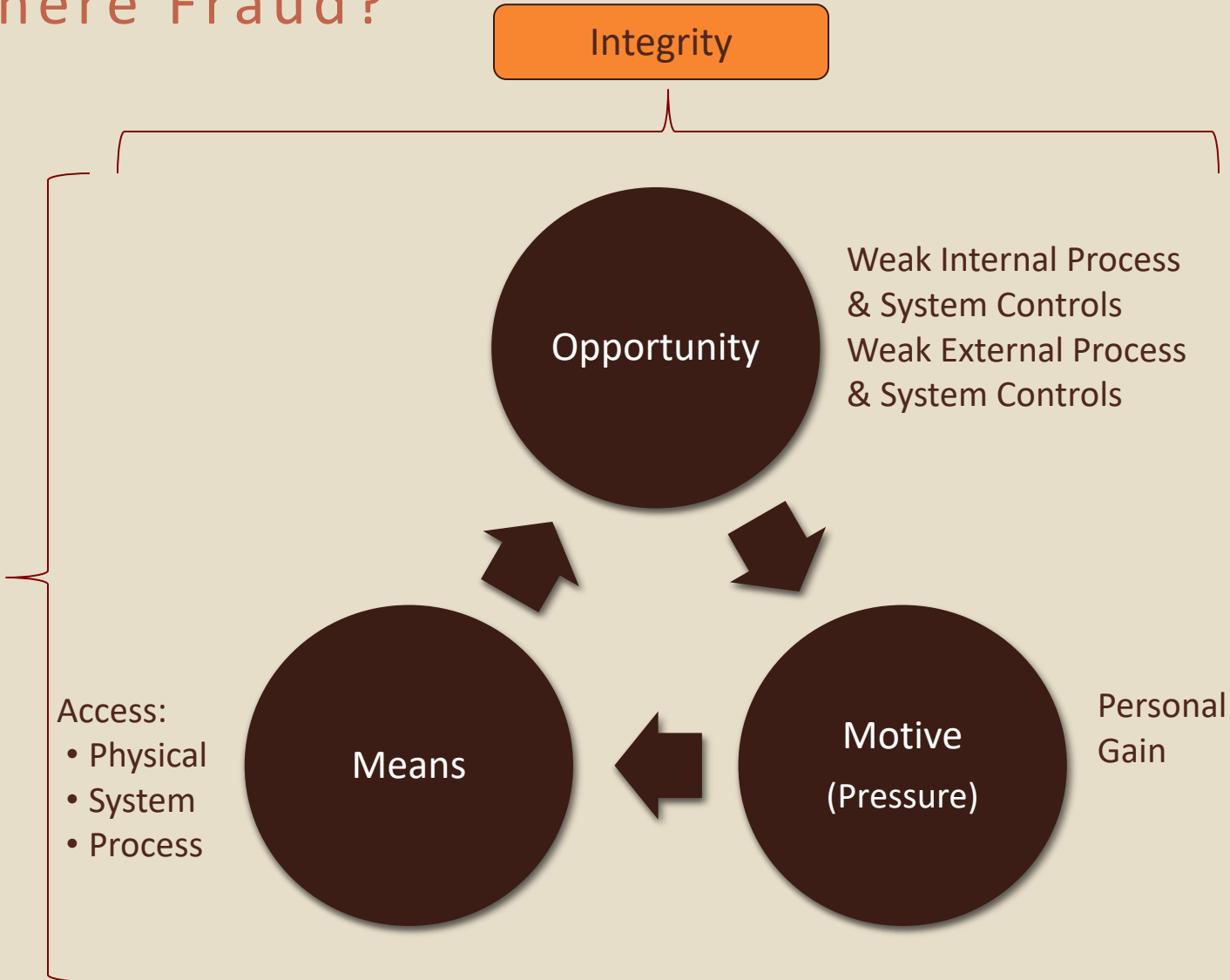
The Fraud Triangle



Why Is There Fraud?

Rationalization:

- I am simply borrowing the money...
- Everyone else is doing it...
- We are just meeting our numbers...
- It's not really illegal...
- I have to do this for my family...
- If I don't they will break my legs...



Classic Criminal & Fraudulent Activity

Responsibility for Fraud Detection (RACI)

Responsible	Accountable	Consulted	Informed
Internal Audit External Audit	Executive Management	Legal Counsel Enterprise Risk Line Management	Interested parties (e.g. shareholders, governmental regulators, etc.)

Concept	Definition
Responsible	The person or group that does the work
Accountable	The person or group that gets fired if something goes wrong
Consulted	The person or group that is asked for their opinion and guidance
Informed	The person or group that is informed of the issue

Cyber Fraud – Financial Service Company

Rationalization	Opportunity	Motive (Pressure)	Means
If I don't do this they are going to break my legs or worse.	Custodian had physical access to the bank funds transfer room.	Gambling indebtedness to organized crime	Poor physical, process and system controls

How Do Criminals Think About Money?

- A large percentage of your money (wealth) is illegal
- The government will seize this money (wealth) if detected and caught
- Therefore criminals need to:
 - Hide their wealth
 - Transport / Transfer in order to hide
 - Transform the wealth from illegally sourced funds to legally sourced funds
 - Enjoy



Fraud vs. Money Laundering

Fraud

- Secure cash or property under false pretenses
- Companies or individuals that are victims of fraud incur financial losses.

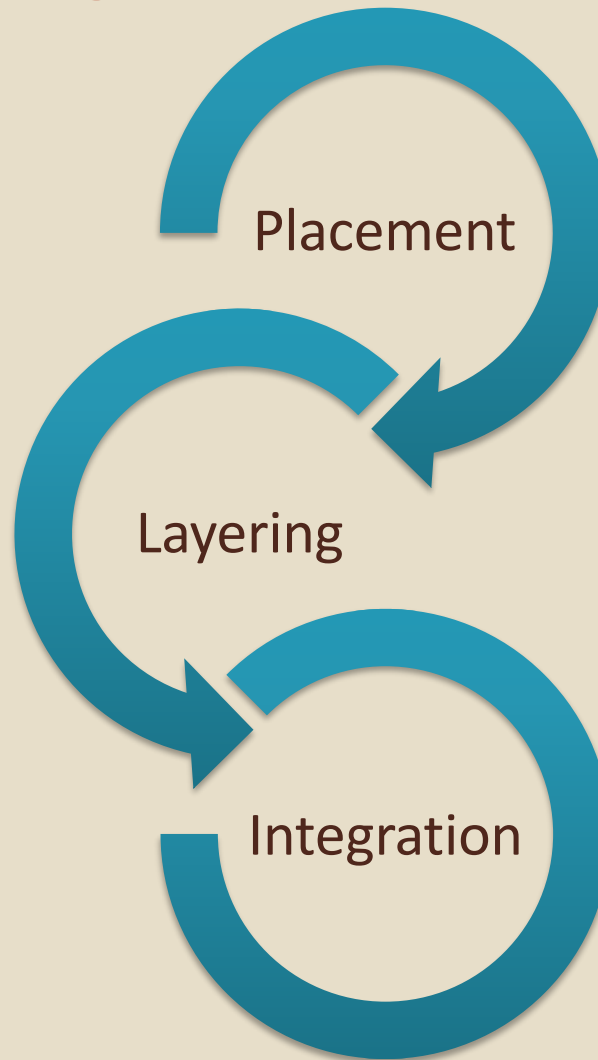
Money Laundering

- Companies or individuals that launder money do not incur financial losses
- Money laundering separates the source of the cash
- Loss is only experienced if the government seizes funds due to illegal activity

Money Laundering

An estimated 900 billion to 1 trillion US dollars of illicit funds circulating worldwide Approximately 500 to 600 billion US dollars associated with the drug trade About 300 billion US dollars associated with United States drug sales.

Aggregate money laundering is estimated to be 2% to 5% of the world's gross domestic product (GDP)



Placement

Physical introduction of bulk cash into the financial system – cash deposits, and cash equivalent purchases – currency smuggling

Layering

Separating the proceeds of criminal activity for their source through complex layers of transactions – using more than one financial institution – obscuring the audit trail

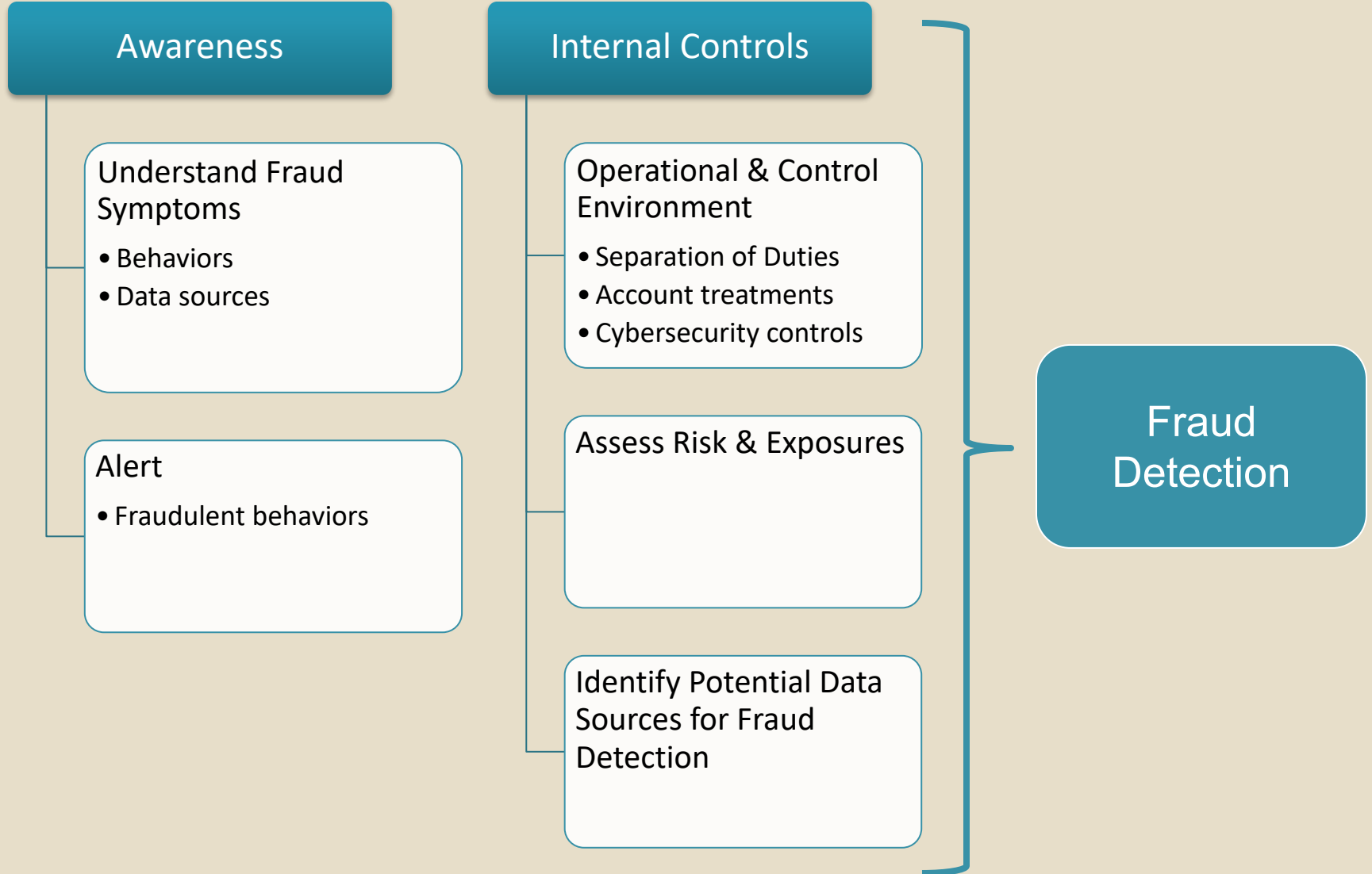
Integration

Placing the laundered funds back into the economy – entering as apparently legitimate funds. Accomplished through real-estate purchases, shell companies, and securities investments.

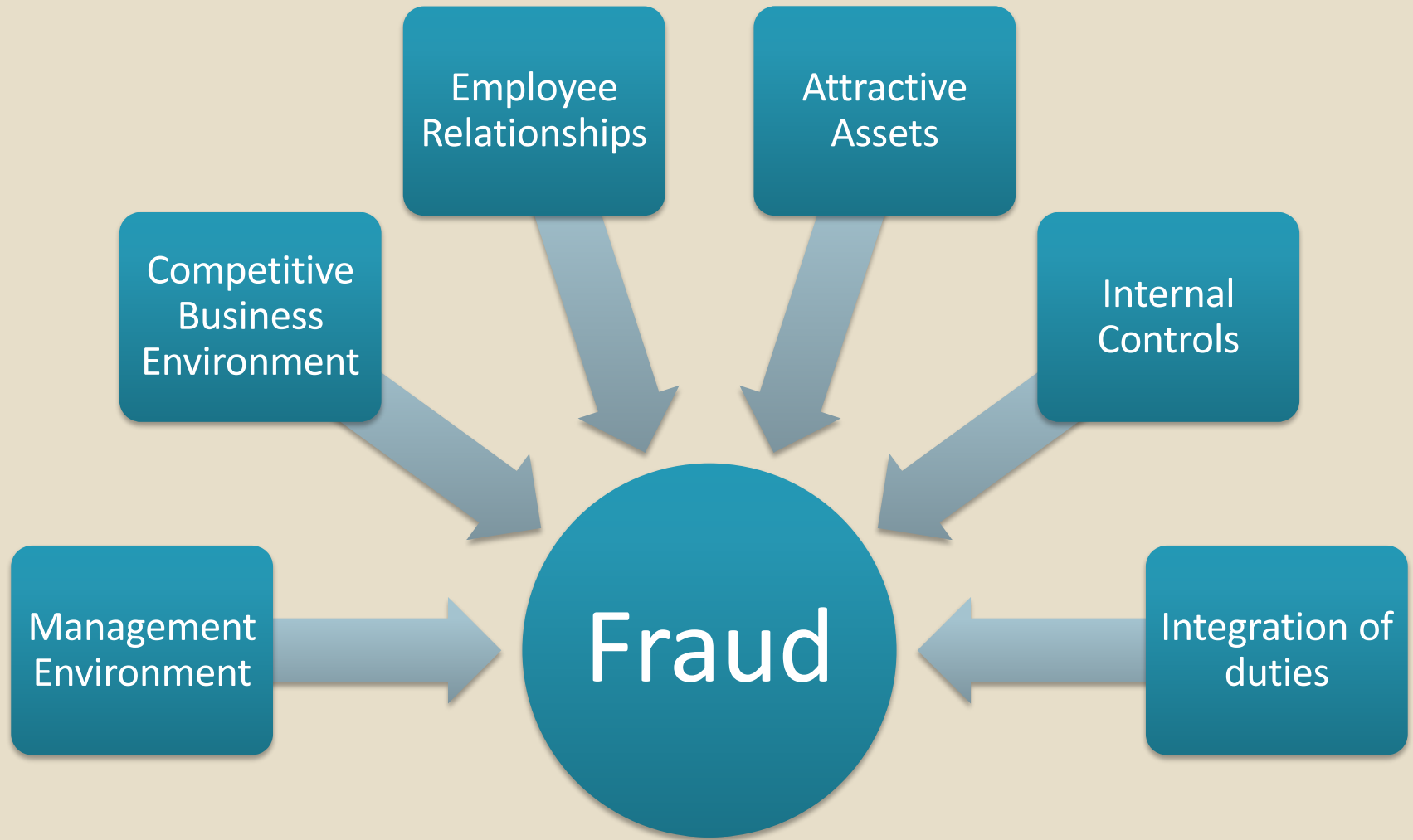
Next Week

Fraud Detection & Prevention

Fraud Awareness & Internal Controls



Risk Factors For Fraud



Fraud Exposure

Fraud Risk Assessment

- Risk assessment is a sometimes and controversial issue
- We will have an entire section on risk assessment
- Examine the risks and exposures to identify process and system weakness

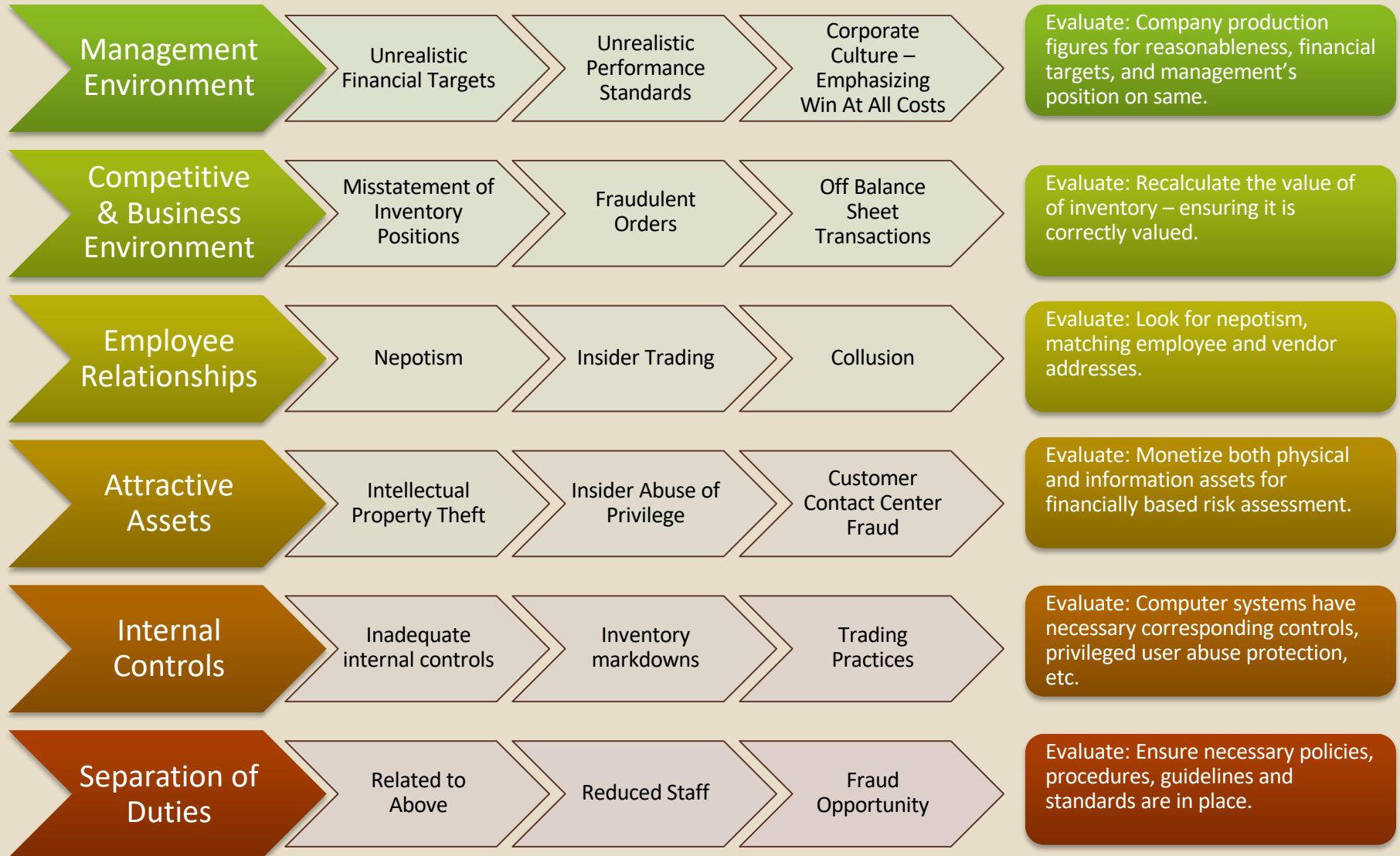
Develop Categories of Risk

- External environment
- Legal
- Regulatory
- Governance
- Strategy
- Operational
- Information
- Human resources
- Financial
- Technology

Determining Fraud Exposure

- Sources of risk
- Review existing risk assessments
- Review risk assessment process
- Business Impact Analysts
- Types and sources of fraud
 - External environment
 - Governance
 - Legal
 - Regulatory
 - Operational
 - Strategy

Risk Factors for Fraud



Fraud Schemes – A Data Driven Approach

Control Weaknesses Approach

- Examine key controls
- Determine vulnerabilities
 - System
 - Process

Key Fields

- Focus on data entry
- Which data can be changed?
- What is the impact?



Control Weakness

- Internal / External parties
- Example: Received quantity less than ordered quantity – but payment made for full amount

Key Fields

- Data manipulation
- Privileged user abuse
- Example: Create fictitious vendors, changing address and bank account.

Case Study - Sunbeam

The New York Times

S.E.C. Accuses Former Sunbeam Official of Fraud

By FLOYD NORRIS
Published: May 16, 2001

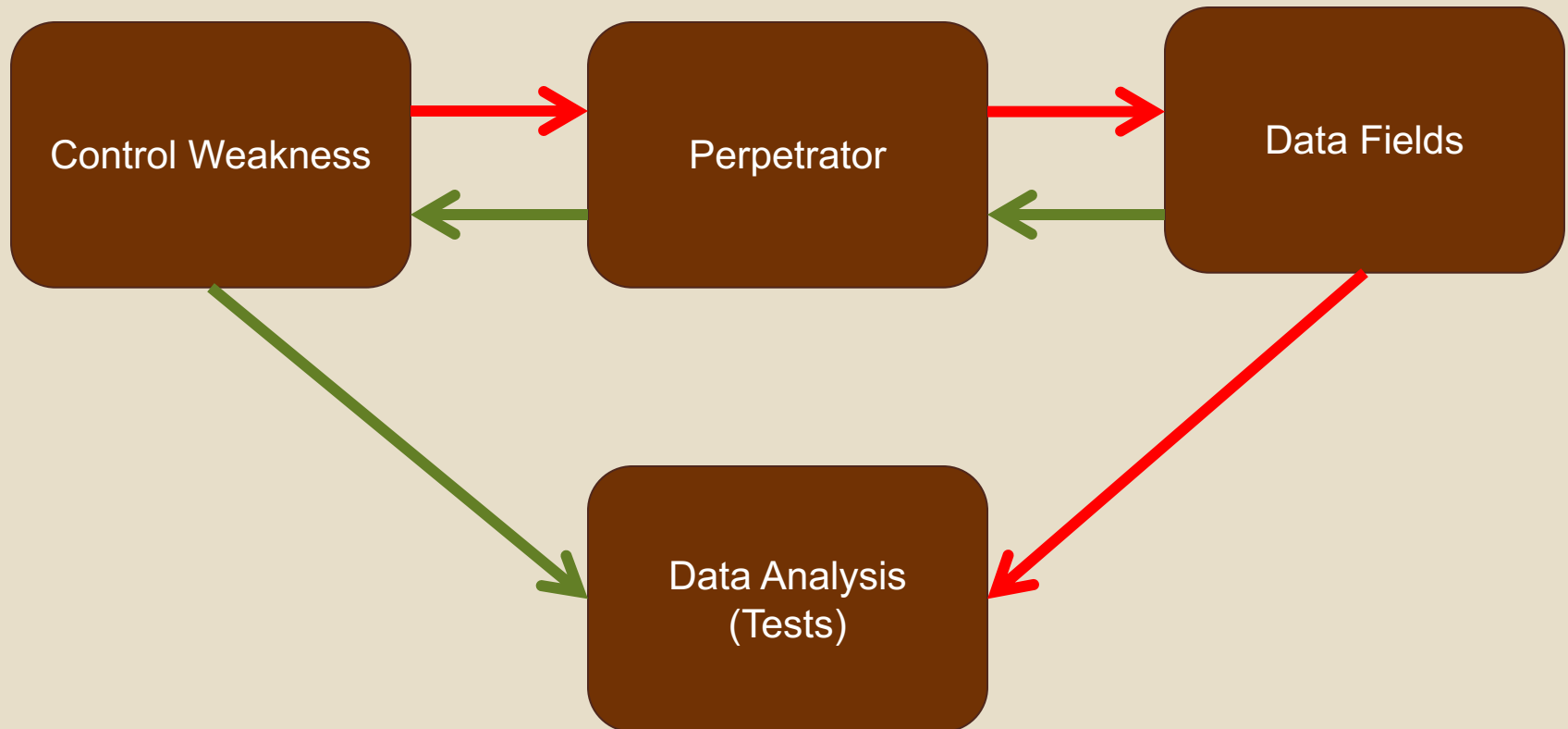
Albert J. Dunlap directed a huge accounting fraud as chief executive of the Sunbeam Corporation and was aided by a partner of Arthur Andersen, the firm that audited Sunbeam's books, the Securities and Exchange Commission contends in a civil case filed yesterday.

Mr. Dunlap, who embraced the nickname Chainsaw Al, became a corporate star in the 1990's, making tens of millions for himself as he laid off thousands of employees in the name of efficiency. Sunbeam's stock leaped nearly 50 percent the day he was hired to run the company in 1996, and his memoirs became a best seller. But the S.E.C. suit, filed in federal court in Miami, said the Sunbeam turnaround directed by Mr. Dunlap was a sham.


The executives "orchestrated a fraudulent scheme to create the illusion of a successful restructuring of Sunbeam and facilitate the sale of the company at an inflated price," the S.E.C. said.

"This case is the latest in our ongoing fight against fraudulent earnings-management practices" that have cost investors billions of dollars, said Richard H. Walker, the commission's director of enforcement.

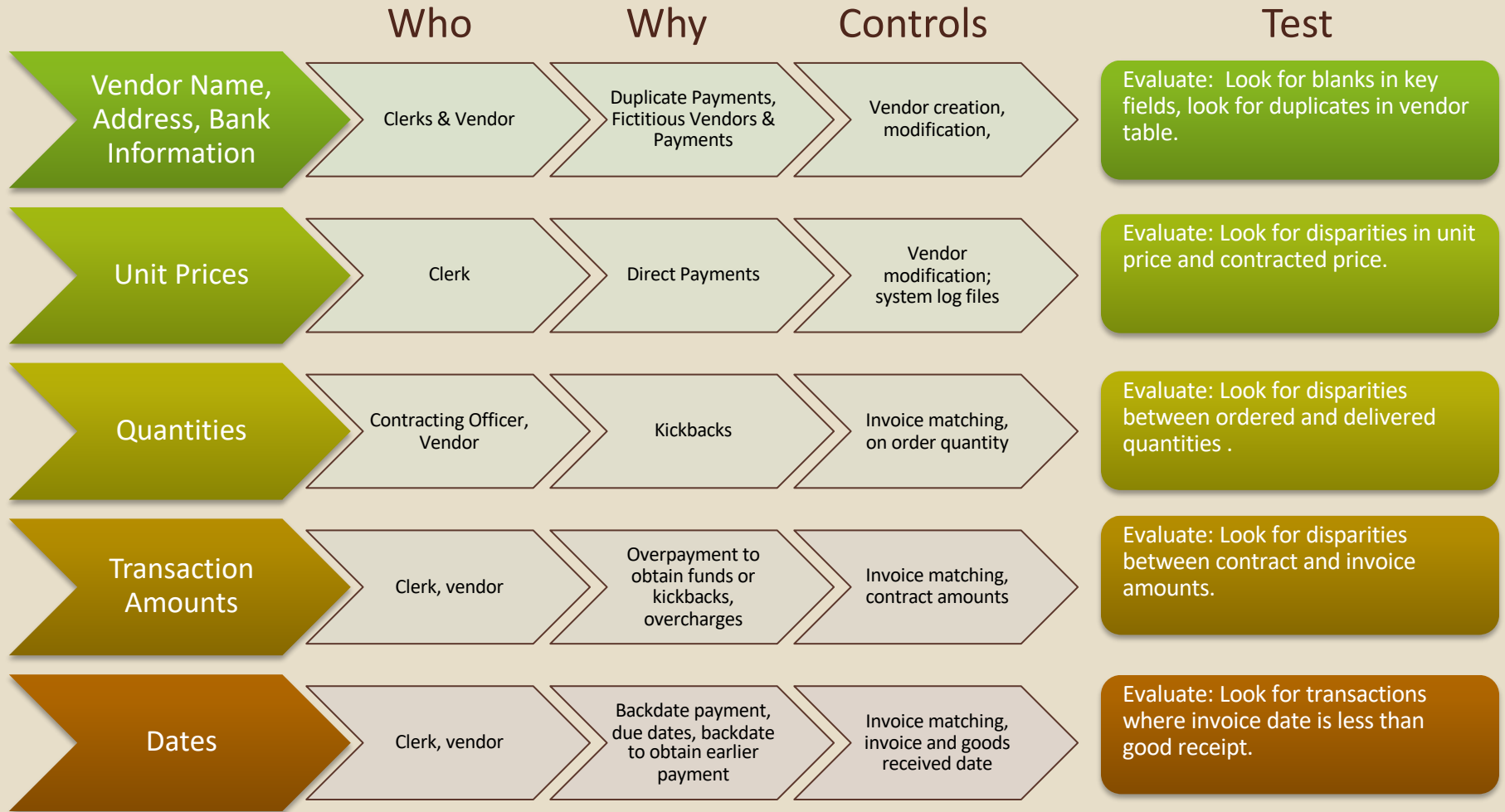
Fraud Exposure Identification



 Control Weakness

 Data of Interest

Key Data



Case Study – Conde Nast

TARCO 4/03/2011 @ 3:27PM | 223,040 views

Conde Nast Paid \$8 Million To Scammer Who Sent One Email

The account holding the larger sum was in the name of Quad Graph. If that seems vaguely familiar, it's maybe because it's very similar to [Quad/Graphics Inc.](#), a publicly traded company that prints famous magazines like the Condé Nast titles and, for that matter, Forbes. The account with the smaller sum was in the name of one Andy Surface, whose picture also adorns this post. You'll learn a little more about him; the feds say both accounts were in his *Portfolio*.

The really scary part is that this deal went down as easily as a stroll through the *Golf World*. We can't summarize it any better than the lawsuit:

“ In early November, Condé Nast received an “Electronic Payment Authorization” form by email at its offices in ... New York. The form appeared to have been sent by Quad/Graphics. The form requested that Condé Nast direct payments for Quad Graphics to the Quad Graph Account, and provided account information. Condé Nast filled out the form and returned it by facsimile from its offices in ... New York to the facsimile number provided in the form. Following Condé Nast's receipt of the “Electronic Payment Authorization” form, Condé Nast started making payments for Quad/Graphics bills by ACH transfer from a Condé Nast account with [JPMorgan Chase Bank](#) in New York to the Quad Graph Account.



Andy Surface

<http://www.forbes.com/sites/williamparrett/2011/04/03/conde-nast-paid-8-million-to-scammer-who-sent-one-email/print/>

Fraud Standards

Investigating Fraud

Which of these is true?

An audit will:

Detect all material errors and irregularities in the financial statements



Discover all illegal acts committed by the client



Ensure the financial health of the entity

Auditors Responsibilities

- **Errors - Unintentional misstatements**

- Mistakes in gathering or processing accounting data
- Incorrect accounting estimates
- Mistakes in the application of accounting principles

- **Irregularities - Intentional misstatements, manipulation, falsification, or alteration of accounting records & supporting documents**

- Misrepresentation or intentional omission of events, transactions, or other significant information
- Intentional misapplication of accounting principles

Software Accounting Standards

SAS 1 and 22

- Plan and perform the audit to provide reasonable assurance that financial statements are free of material misstatements caused by error or fraud.

SAS 47

- Audit risk, materiality and misstatements in financial statements

SAS 54

- Detection of illegal acts (AU Section 317)

Section 301 of the Private Securities Litigation Reform Act

- Private Securities Litigation Reform Act of 1995

Section 10(a) of the Exchange Act

- Requires the inclusion of certain procedures in accordance with generally accepted accounting standards (GAAS).
- Audit procedures provide reasonable assurance of detecting illegal acts
- Audit procedures will identify related party transactions material to financial statements
- Evaluate if there is substantial doubt about the ability of the company to stay in business.

SAS 82

- Auditor's responsibility related to fraud in a financial statement
- Provides guidance on what auditors should do to meet these responsibilities
- Describes:
 - Fraudulent Financial Reporting
 - Misappropriation of Assets

SAS 82 Requirements

- **Consider the presence of fraud risk factors.** - SAS No. 82 provides examples (detailed below) of risk factors an auditor may consider for fraud related to a) fraudulent financial reporting, and b) misappropriation of assets misstatements. An auditor should become familiar with these risk factors and be alert for their presence at the client's.
- **Assess the risk of material misstatement of the financial statements due to fraud.** SAS No. 82 requires an assessment as to the risk of material misstatement due to fraud. This assessment is separate from but may be performed in conjunction with other risk assessments (for example, control or inherent risk) made during the audit. SAS No. 82 also requires reevaluation of assessments if other conditions are identified during fieldwork.
- **Develop a response.** Based on assessments of risk, SAS No. 82 requires development of appropriate audit response. In some circumstances, an auditor's response may be that existing audit procedures are sufficient to obtain reasonable assurance that the financial statements are free of material misstatement due to fraud. In other circumstances, auditors may decide to extend planned audit procedures.
- **Document certain items in work papers.** SAS No. 82 requires auditors to document evidence of the performance of their assessment of risk of material misstatement due to fraud. Documentation should include risk factors identified as being present as well as the auditor's response to these risk factors.
- **Communicate to management.** If it is determined that there is evidence that a fraud may exist, an auditor should apprise the appropriate level of management, even if the matter may be considered inconsequential. SAS No. 82 also requires an auditor to communicate directly with the audit committee (or equivalent) if the matter involves fraud that would materially misstate the financial statements or fraud committed by senior management

Fraud Investigation

Fraud Types

- Billing
- Cash Larceny
- Cash on Hand
- Check Tampering
- Corruption
- Financial Statement Fraud
- Non-Cash
- Payroll
- Register Disbursements
- Skimming

Thank you.