MIS 5208 – Lecture 05 – Recognizing the Symptoms of Fraud

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Learning Objectives

- Fraud symptoms (as we have discussed) help you recognize fraud.
- If fraud symptoms are recognized, frauds can be detected early.
- The text shares many examples of various real-life frauds and how they could have been detected if the fraud symptoms had led someone to investigate.
- We will review some of these cases here.

- Understand how symptoms help in the detection of fraud.
- Identify and understand accounting symptoms of fraud.
- Describe internal controls that help deter and detect fraud.
- Identify and understand analytical symptoms of fraud.
- Explain how lifestyle changes help detect fraud.
- Discuss how behavioral symptoms help detect fraud.
- Recognize the importance of tips and complaints as fraud symptoms.
Elgin Aircraft

- Claims processing and claims payment – adjudicate healthcare claims
- Self-insured company
- Claims processing verifies claim documentation, then forwards document to claims payment.
- Claims payment approves and signs the payment.
- Management has strong faith in their internal controls
  - Various audits – government, defense, internal and outside auditors

- Medical Plans
  - HMO – network of approved doctors – treating employees for a set fee
  - PPO – employees can see the doctor of their choice – compensating the employee for 80% of doctor fees

- Medical Forms and Payments
  - Forms completed by attending doctor and a verification statement of the charges
  - Doctors paid directly – no payments to employee
Claims Department Manager

- Auditor observed Claims Manager arriving at work by Chauffeured Limousine
- One of the company’s “best employees”
- Never missed a day of work for 10 years
Fraud Investigation

- **Outcome**
  - Claims Department Manager
    - Embezzled $12M
    - 22 “dummy” doctors submit claims for employees with little or no medical expenses

Image Source: https://www.private-investigators-uk.com/wp-content/uploads/2015/03/Fraud-Investigation-Service1-e1442901961444.jpg
Symptoms of Fraud

- Accounting anomalies
- Internal control weaknesses
- Analytical anomalies
- Extravagant lifestyle
- Unusual behavior
- Tips and complaints
Accounting Anomalies

- Accounting anomalies result from:
  - Unusual processes or procedures

- Questions to Ask:
  - Are the payments reasonable?
  - Do the endorsements make sense?
  - Why are bills and payments going to the same address?

- Common anomaly frauds involve:
  - Irregularities in source documents
  - Faulty journal entries
  - Inaccuracies in ledgers

Document Anomalies

- Missing documents
- Stale items on bank reconciliation
- Excessive voids or credits
- Common names or addresses – payees and customers
- Increased past due accounts
- Increased reconciling items
- Alterations of documents
- Duplicate payments
- Second endorsements on checks
- Non-sensical document sequences
- Questionable handwriting on documents
- Photocopied documents
Faulty Journal Entries

- Accounting is a language with rules and grammar
  - Debits = Credits
  - Owner’s Equity = Assets - Liabilities
Shareholder equity (value) = Assets - Liabilities
The “Balance Sheet”

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>2011</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>$1,215,561</td>
<td>$1,780,317</td>
</tr>
<tr>
<td>Accounts receivable, net</td>
<td>-</td>
<td>2,874,628</td>
</tr>
<tr>
<td>Accounts receivable, interest</td>
<td>-</td>
<td>51,912</td>
</tr>
<tr>
<td>Prepaid expense</td>
<td>2,396</td>
<td>17,096</td>
</tr>
<tr>
<td>Total current assets</td>
<td>1,217,957</td>
<td>4,723,954</td>
</tr>
</tbody>
</table>

| Property, plant and equipment, net of accumulated depreciation of $181,354 and $93,477 as of December 31, 2011 and 2010, respectively | 169,593 | 257,103 |

<table>
<thead>
<tr>
<th>Other assets:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term investments</td>
<td>2,258,393</td>
<td>1,806,243</td>
</tr>
</tbody>
</table>

**Total assets**

| $3,645,943 | $6,787,306 |

<table>
<thead>
<tr>
<th>LIABILITIES AND STOCKHOLDERS’ EQUITY</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable and accrued expenses</td>
<td>$3,445</td>
<td>$2,821,862</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>3,445</td>
<td>2,821,862</td>
</tr>
</tbody>
</table>

| Commitments and contingencies |              |              |

<table>
<thead>
<tr>
<th>Stockholders’ equity:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Preferred stock: par value $0.01 per share; 25,000,000 shares authorized, none issued and outstanding</td>
<td>949,159</td>
<td>949,159</td>
</tr>
<tr>
<td>Common stock: par value $0.01 per share, 500,000,000 shares authorized, 94,915,855 shares issued and outstanding as of December 31, 2011 and 2010</td>
<td>5,734,036</td>
<td>5,734,036</td>
</tr>
<tr>
<td>Additional paid in capital</td>
<td>5,734,036</td>
<td>5,734,036</td>
</tr>
<tr>
<td>Accumulated deficit</td>
<td>(2,728,308)</td>
<td>(2,723,706)</td>
</tr>
<tr>
<td>Accumulated other comprehensive (loss) income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total stockholders’ equity</td>
<td>3,642,498</td>
<td>3,965,433</td>
</tr>
</tbody>
</table>

**Total liabilities and stockholders’ equity**

| $3,945,943 | $6,787,306 |

Source: http://www.sec.gov/Archives/edgar/data/1276531/000127653112000003/0001276531-12-000003-index.htm
### The “Balance Sheet”

**ADVANCED VENTURES CORP.**

**(A DEVELOPMENT STAGE COMPANY)**

**BALANCE SHEET**

**AS OF DECEMBER 31, 2011 AND 2010**

<table>
<thead>
<tr>
<th></th>
<th>As of December 2011</th>
<th>As of December 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Assets:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and cash equivalents</td>
<td>$9,991</td>
<td>$300</td>
</tr>
<tr>
<td>Deferred offering costs</td>
<td>-</td>
<td>20,000</td>
</tr>
<tr>
<td><strong>Total current assets</strong></td>
<td>9,991</td>
<td>20,300</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td><strong>$9,991</strong></td>
<td><strong>20,300</strong></td>
</tr>
<tr>
<td><strong>LIABILITIES AND STOCKHOLDERS’ (DEFICIT)</strong></td>
<td><strong>$9,991</strong></td>
<td><strong>20,300</strong></td>
</tr>
<tr>
<td>Current Liabilities:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts payable and accrued liabilities</td>
<td>$16,410</td>
<td>$27,253</td>
</tr>
<tr>
<td>Loans from related parties - Directors and stockholders</td>
<td>$28,205</td>
<td>$22,950</td>
</tr>
<tr>
<td><strong>Total current liabilities</strong></td>
<td>44,615</td>
<td>50,203</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>44,615</td>
<td>50,203</td>
</tr>
<tr>
<td><strong>Commitments and Contingencies</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Stockholders’ Equity (Deficit)</strong>:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common stock, par value $0.001 per share, 200,000,000 shares authorized; 5,500,000 and 3,000,000 shares issued and outstanding, respectively</td>
<td>550</td>
<td>300</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>54,750</td>
<td>-</td>
</tr>
<tr>
<td>(Deficit) accumulated during the development stage</td>
<td>(89,923)</td>
<td>(30,203)</td>
</tr>
<tr>
<td><strong>Total stockholders’ Equity (deficit)</strong></td>
<td>(34,622)</td>
<td>(29,903)</td>
</tr>
<tr>
<td><strong>Total Liabilities and Stockholders’ Equity (Deficit)</strong></td>
<td><strong>$9,992</strong></td>
<td><strong>$20,300</strong></td>
</tr>
</tbody>
</table>

Source: [http://www.sec.gov/Archives/edgar/data/1500122/000114420412017437/0001144204-12-017437-index.htm](http://www.sec.gov/Archives/edgar/data/1500122/000114420412017437/0001144204-12-017437-index.htm)
Internal Control Weaknesses

- Internal controls
  - Control environment
  - Accounting System
  - Control Activities

- Weaknesses or Lack of:
  - Segregation and separation of duties (SOD)
  - Physical safeguards
  - Independent checks
  - Proper authorization
  - Proper documents and records
  - Override of existing controls
  - Inadequate accounting system
Analytical Fraud Symptoms

- Analytical Fraud symptoms include:
  - Unexplained inventory shortages or adjustments
  - Deviations from specifications
  - Increased scrap
  - Excess purchases
  - Too many debit or credit memos
  - Significant increases or decreases in account balances, ratios, or relationships
  - Physical Abnormalities
  - Cash shortages and overages
  - Excessive late charges

- Unreasonable financial statement relationships:
  - Increased revenues with decreased inventory
  - Increased revenues with decreased receivables
  - Increased revenues with decreased cash flows
  - Increased revenue with decreased payables
  - Increased volume with increased cost per unit
  - Increased volume with decreased scrap
  - Increased inventory with decreased warehousing costs
Internal Control Weaknesses

- Internal control fraud symptoms include:
  - Lack of segregation of duties
  - Lack of physical safeguards
  - Lack of independent checks
  - Lack of proper authorization
  - Lack of proper documents and records
  - Overriding of existing controls
  - Inadequate accounting system

- Other indicators
  - Forfeited vacation time

- Controls
  - Employee transfers
  - Audits
  - Employee notification of services performed
Unusual Behaviors

Guilt

Fear

Stress

Behavior Changes

- Insomnia
- Increased drinking
- Taking drugs
- Unusual irritability and suspiciousness
- Inability to relax
- Lack of pleasure in things usually enjoyed
- Fear of getting caught
- Inability to look people in the eyes
- Showing embarrassment around friends, coworkers, and family
- Defensiveness or argumentativeness
- Unusual belligerence in stating opinions
- Confessing (either to a religious leader, psychologist, or other professional)
- Obsessively contemplating possible consequences
- Thinking of excuses and finding scapegoats
- Working standing up
- Sweating
- Increased smoking
Thank you