Emerging Fraud Risks

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Introduction

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John Kiss, CPA, CFE

Senior Manager
Baker Tilly

- Twelve years of experience investigating fraud and providing risk and internal audit services
- Diverse background of industry experiences across commercial, not-for-profit, healthcare, and government entities
- Experience with interview techniques and has investigated fraud in the areas of procurement, development, human resources, academics, payroll, finance, and tax
- Knowledge of internal controls and business processes to provide organizations with lasting solutions to address fraud risk

Objectives

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- Understand the concepts related to fraud and global statistics of emerging fraud trends
- Gain an understanding of the relationship between the evolution of fraud and technology
- Learn how to mitigate emerging fraud risks

Agenda

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- Fraud overview
- Evolution of fraud
- Case studies
- Mitigating solutions to emerging fraud risks
- Open discussion and questions

Fraud overview

Fraud overview

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Fraud

Fraud is a knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment.[1]

Fraud against a company can be committed either **internally** by employees, managers, officers, or owners of the company, or **externally** by customers, vendors, and other parties. Other schemes defraud individuals, rather than organizations.

[1] *Bryan Garner, ed., Black's Law Dictionary. 8th Ed. (2004), s.v., "fraud."*

Fraud overview

Opportunity

Opportunities can be created by poor internal controls and/or lack of segregation of duties.

Pressure

Desperate people do desperate things. Pressure comes in many forms, both financial and non-financial.

Rationalization

Rationalization occurs when an employee justifies why he or she commits fraud.

Why does fraud occur?

Need

Poor economic climates can lead companies and therefore individuals to suffer financially. Financial pressures increase the likelihood of an individual committing fraud, as the employee may feel the need to meet financial obligations.

Greed

The more dissatisfied the employee (e.g., inadequate salary, lack of career growth), the more likely he or she may engage in fraudulent behavior. The employee may feel motivated to commit fraud in order to get money he or she feels is “deserved.”

Fraud overview : fraud facts

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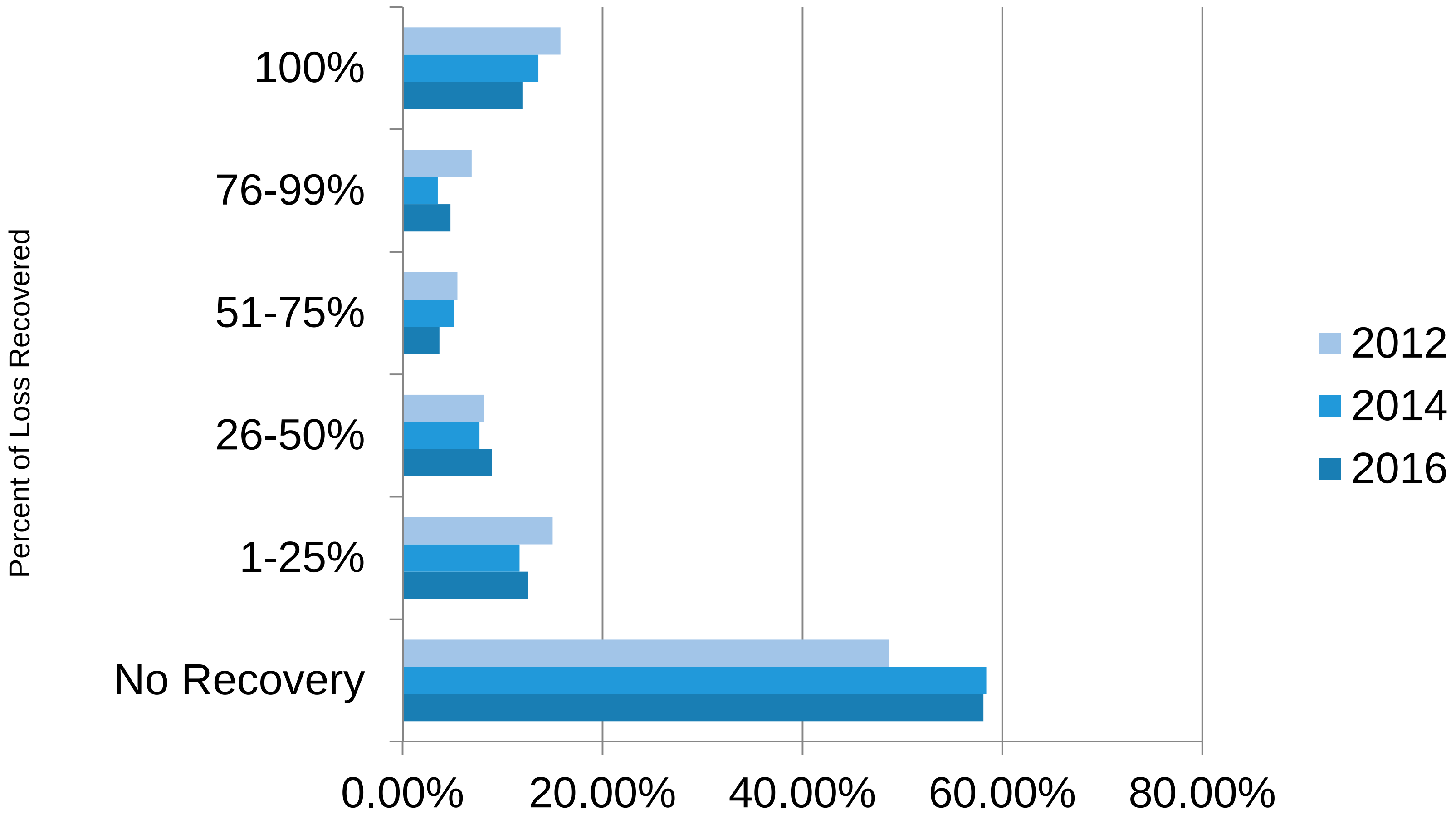
- 58.1% of victim organizations do not recover their loss.



Source : 2016 ACFE Global Fraud Study

Fraud overview : fraud facts

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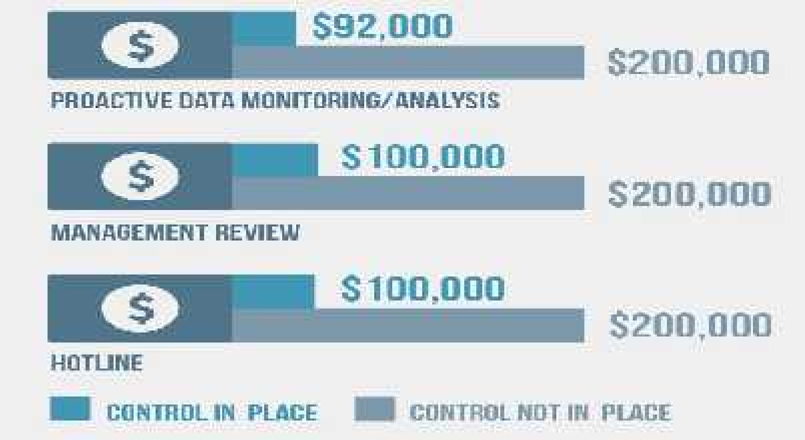
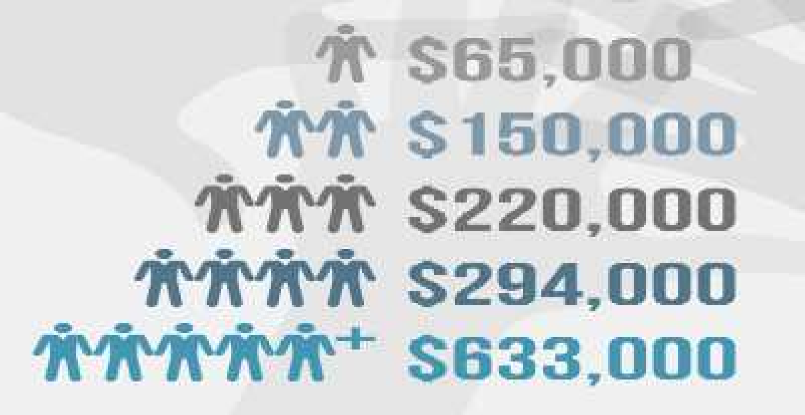
- Victim organizations that lacked anti-fraud controls suffered greater median losses – in fact twice as much.



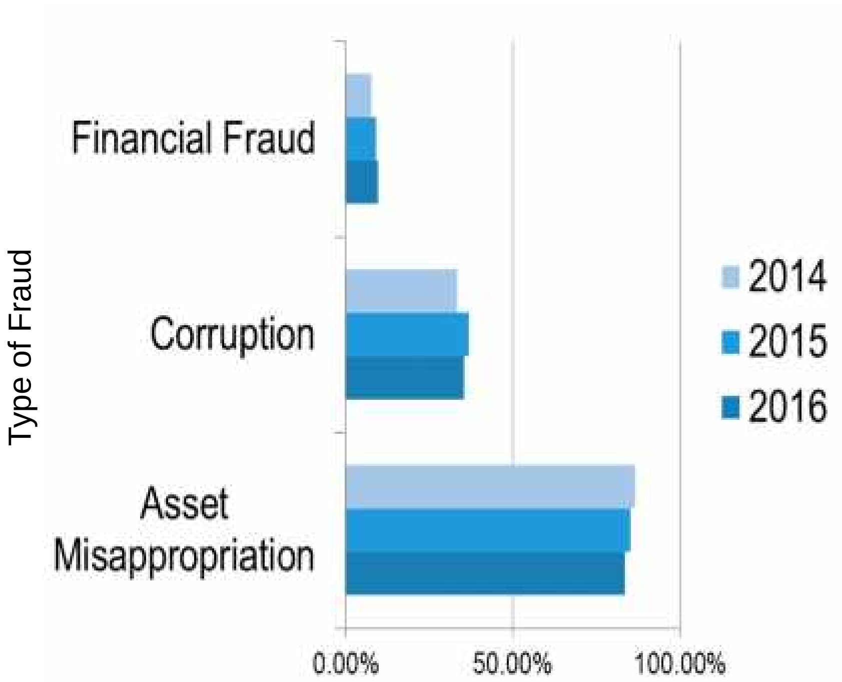
- The more people conspiring in an occupational fraud, the higher losses tend to be.

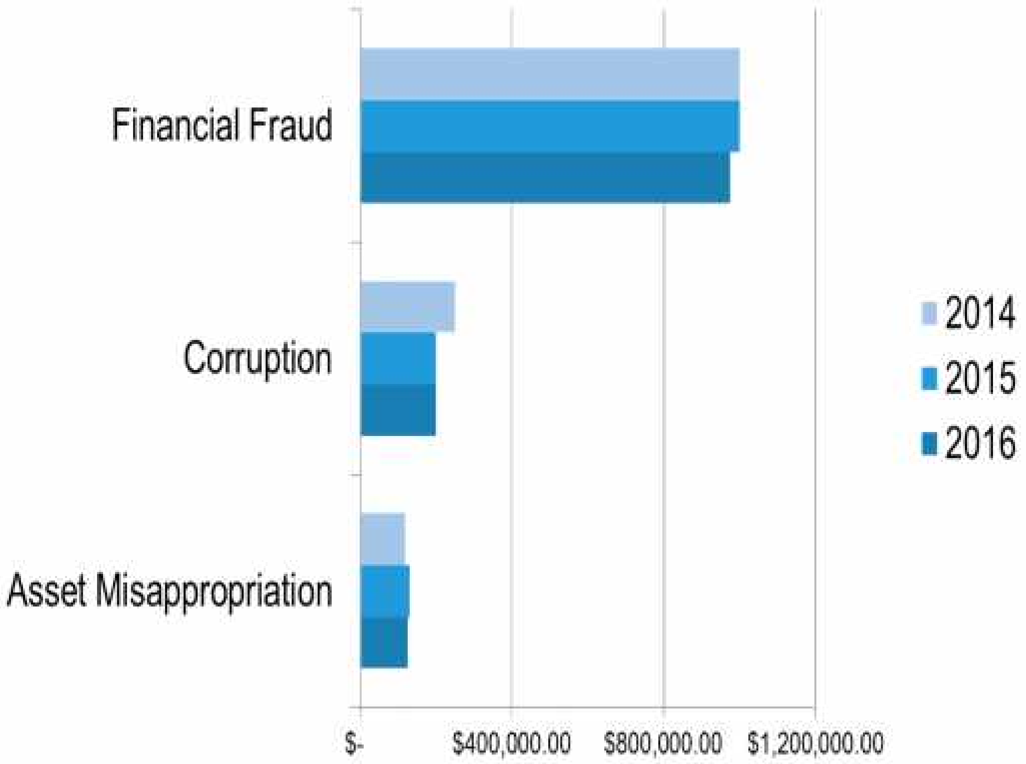


Source : 2016 ACFE Global Fraud Study

Fraud overview: fraud facts

- Asset misappropriation was the most common of the three types of fraud, occurring in 83% of reported cases and costing a median $130,000. The least common type was financial fraud at 9.6%, but these were extensive thefts with a median loss of $1 million. In between, corruption occurred in 37% of cases at a median cost of $250,000.





Source : 2016 ACFE Global Fraud Study

Evolution of fraud

Evolution of fraud

- Many emerging fraud trends can be directly related to technology advancements.
- The new technologies adopted by financial institutions and other organizations are increasing the vulnerability to various risks.

1980's

BANK ONE

This week BANK ONE and 100 pioneering customers are launching the first major test of delivering banking services directly to the home.

[illegible]

BANK ONE

...to this today

Evolution of fraud

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Emerging technologies

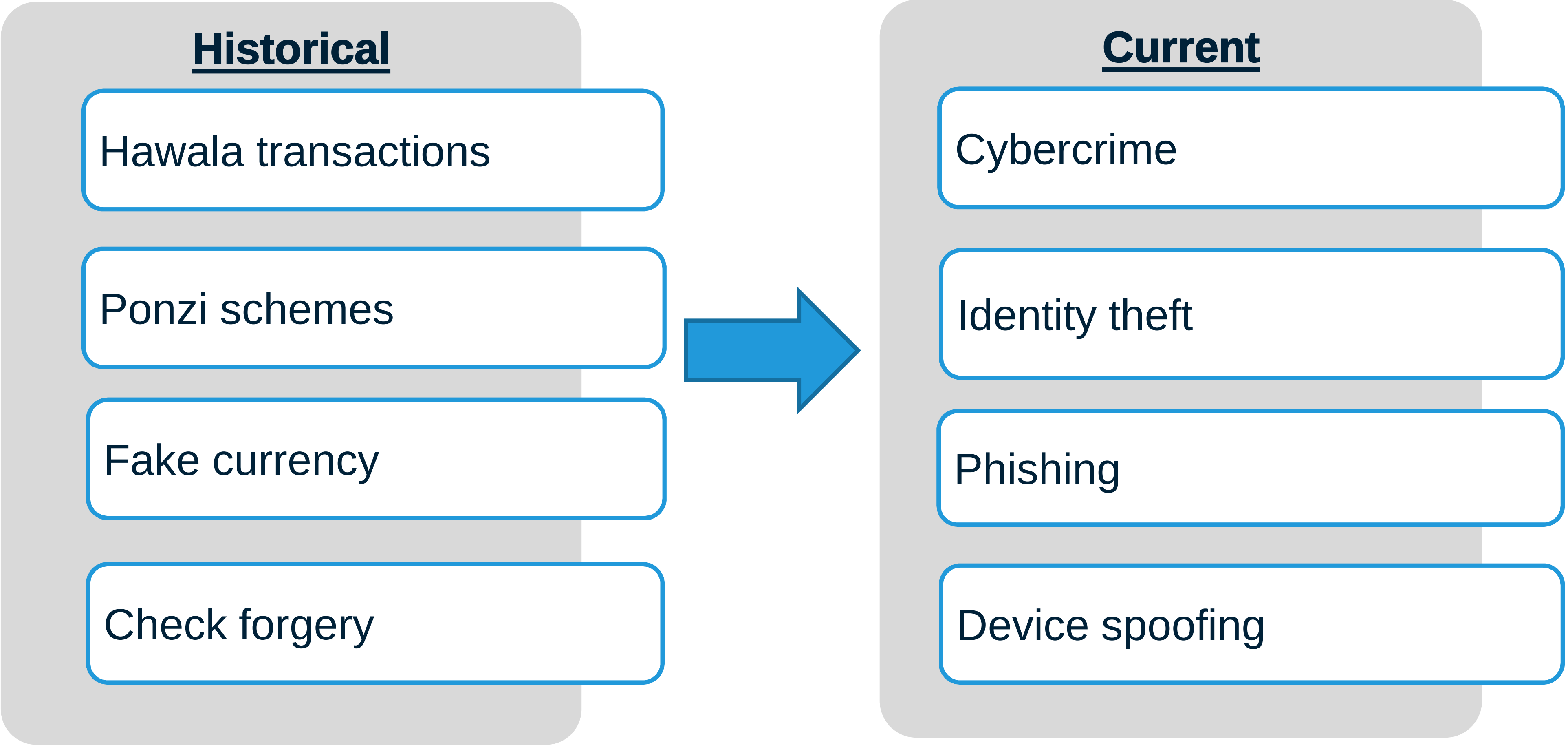
- Quick deposit
- Quick pay
- Cloud processing
- Electronic Funds Transfer (EFT)
- Real-Time Gross Settlement Transactions (RTGS)

Emerging frauds

- Malware
- Wire fraud
- Skimming
- Identity theft
- Cyber stalking
- Phishing
- Social engineering
- Health care or health insurance fraud

Evolution of fraud

- Fraud types and sophistication have grown tremendously in the past few decades.



Historical

- Hawala transactions
- Ponzi schemes
- Fake currency
- Check forgery

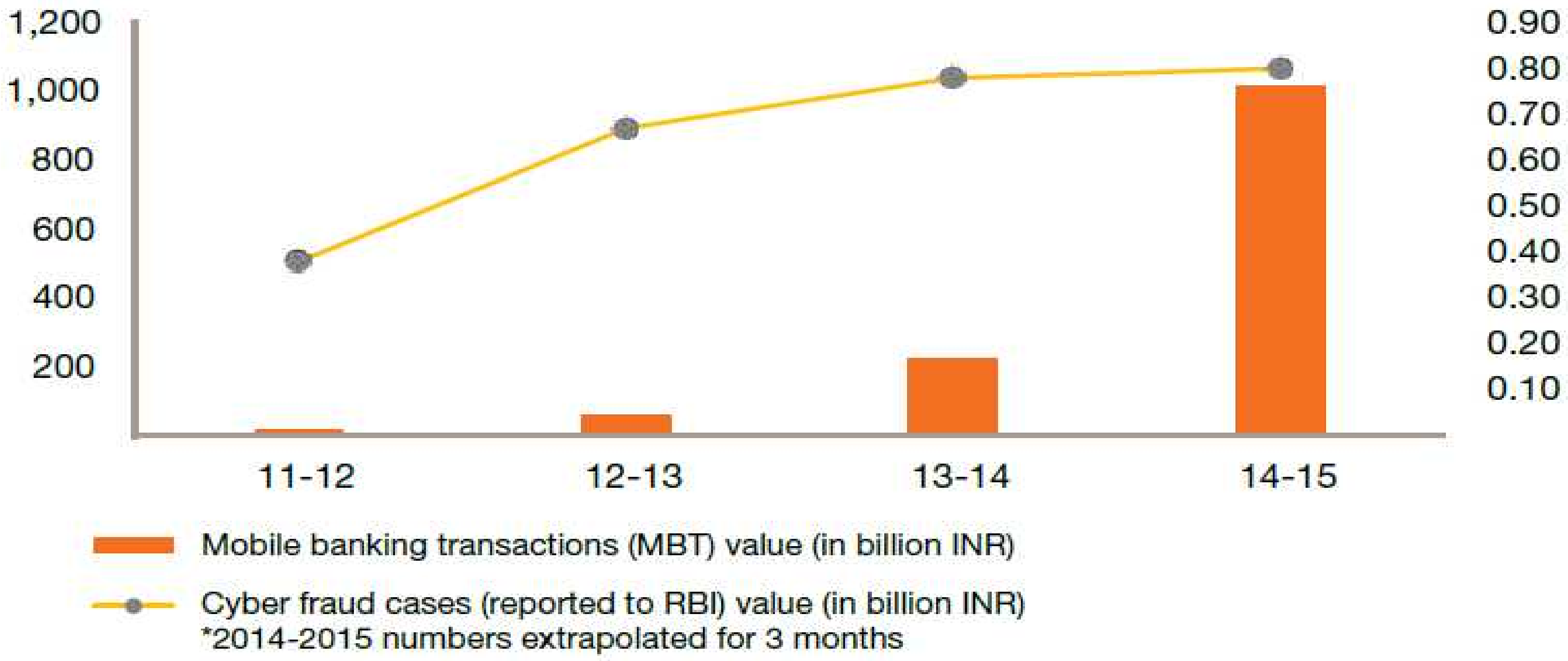
Current

- Cybercrime
- Identity theft
- Phishing
- Device spoofing

Evolution of fraud

Case Study in India

Growing trend of cyber frauds in mobile banking transactions



Source: https://www.rbi.org.in/scripts/NEFTView.aspx

Case studies

Case studies

Case study #1	Malware – Target
Case study #2	Corruption – Johnson & Johnson (J&J)
Case study #3	Payroll scheme – California Patton State Hospital

Case study #1 - Target

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The biggest retail hack in US history

- Up to **40 million** customers' credit and debit card information stolen
- Up to **70 million** addresses, phone numbers, and other pieces of personal information stolen
- Fourth quarter sales in 2013 **decreased by 46%**

How did it happen?

- Thanksgiving 2013, malware was installed in Target's security and payments system designed to steal every credit card used at the company's **1,797** U.S. stores
- At the critical moment - when the Christmas gifts had been scanned and bagged and the cashier asked for a swipe - the malware would step in, capture the shopper's credit card number, and store it on a Target server commandeered by the hackers

Safeguards to prevent malware

- Security awareness training
- Require each machine used for company business have malware, spyware and firewall software installed to help catch and eliminate threats before they become problematic
- Manage email security and validate potential threats
- Enforce strict password policies

Case study #2 – Johnson and Johnson

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J&J settled bribery complaint for $70 Million in fines

- Johnson & Johnson, the world’s second-biggest seller of medical products, paid **$70 million** after admitting that the company bribed doctors in Europe and paid kickbacks in Iraq to win contracts and sell drugs and artificial joints
- J&J was charged under the 1977 Foreign Corrupt Practices Act, which prohibits making improper payments to government official to win or retain business

Case study #2 – Johnson and Johnson

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How did it happen?

- According to the Stock Exchange Corporation (SEC), from 1998 to 2006, J&J earned more than **$24 million** in profits by bribing Greek doctors to buy surgical implants including artificial knees and hips
- The company earned **$4.3 million** in Poland from 2000 to 2006 as a result of bribes and about **$3.5 million** through illegal rewards in Romania from 2000 to 2007

Case study #2 – Johnson and Johnson

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Safeguards to prevent corruption in business

- Understanding the regulatory enforcement environment
- Getting management to understand, commit to, and support anti-fraud and anti-corruption initiatives
- Prioritizing the key risks to the company’s business, brand and reputation
- Educating the workforce about the risks of wrongdoing

Case study #3 – California Patton State Hospital

Employees were overpaid by $900,000

- Former Patton State Hospital employees were arrested in connection with a payroll scheme totaling over **$900,000**
- Auditors noted the hospital disclosed **$900,000** in alleged payroll fraud from 2007 to 2011 by five employees who claimed false work and vacation time

Case study #3 – California Patton State Hospital

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How did it happen?

- Three employees colluded with a payroll transactions unit staff member to falsify payroll records (i.e., misstatements in leave balances, and overpayments and underpayments in overtime compensation) totaling **$800,000**
- An employee falsified attendance records (i.e., several individuals signed in, or out, for two to five other employees in a single work shift) and was paid more than **$100,000** between January 2007 and September 2009

Case study #3 – California Patton State Hospital

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Safeguards to prevent payroll schemes

- Focus on segregation of duties to provide a stronger system of internal control whereby the functions of each employee are subject to the review of another
- Periodic reviews and reconciliation of actual payments to recorded amounts. This duty refers to making comparisons at regular intervals and taking action to resolve differences
- Ensure overtime is pre-authorized by an appropriate official, documented and valid
- Supervisors should always sign timesheets to show they verified the number of hours worked

Mitigating solutions to emerging fraud risks

Mitigating solutions to emerging fraud risks

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> The risk of fraud can never be completely eliminated, but the following steps can help companies significantly reduce fraud risks.

Implement segregation of duties (SOD)

A key concept of internal control is also one of the most effective tools in combatting fraud. The concept of SOD is to separate the responsibilities in each of the following business processes:

> Custody of assets
> Record keeping
> Authorization
> Reconciliations

Mitigating solutions to emerging fraud risks

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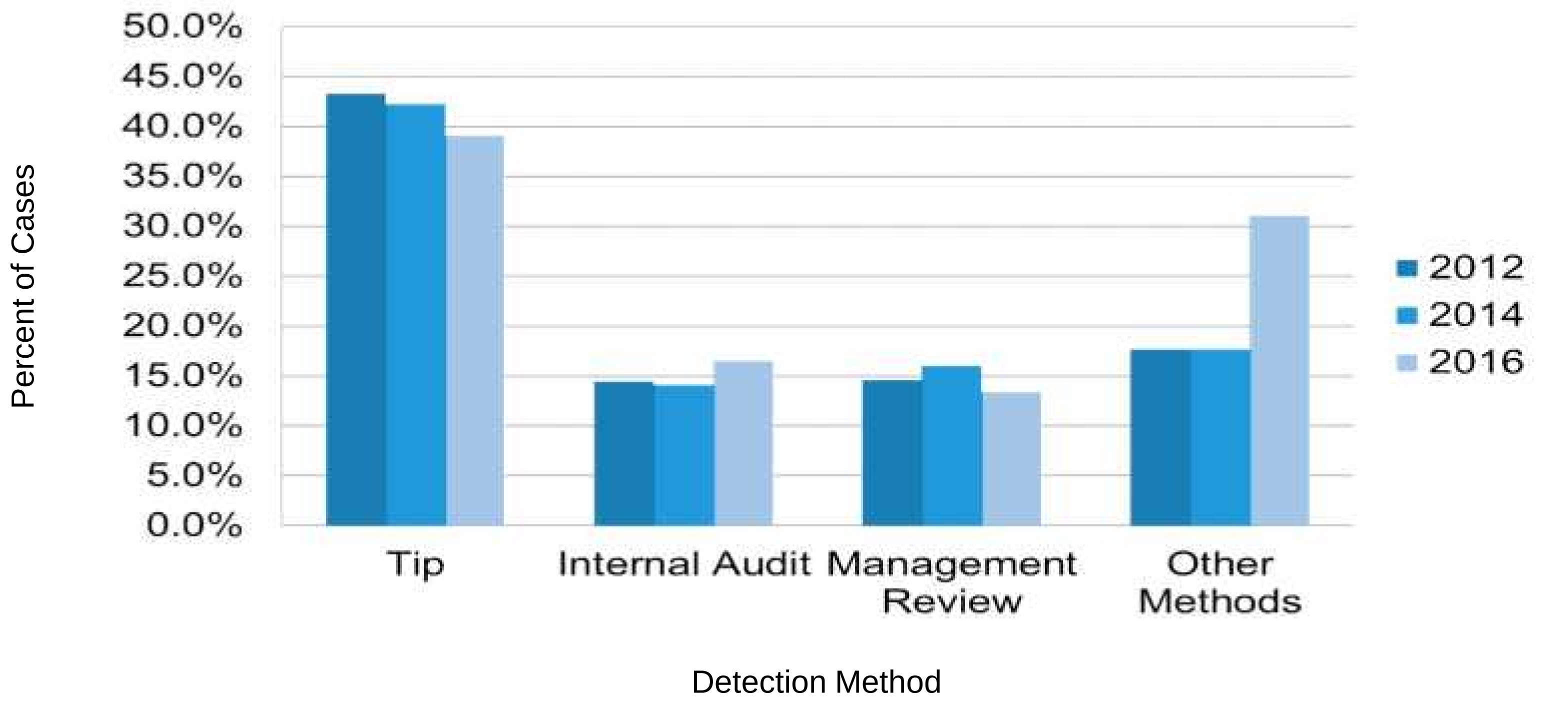
Encourage tips

Fraud is often uncovered through a tip, so a company should create a system for employees to anonymously and easily report information (e.g., a hotline)



Source : 2016 ACFE Global Fraud Study

Mitigating solutions to emerging fraud risks

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Prioritize corporate culture

- Document clear policies and procedures
  - Include repercussions for fraudulent activities
- Establish an open working environment for employees to feel their contribution is welcomed and voice heard

Perform human resource (HR) screening

Fraudsters can often target specific companies, and HR departments can identify fraud risks during the hiring process

Mitigating solutions to emerging fraud risks

Follow the cash

- Accounts can be manipulated, cash can not. If profits are not being transformed into cash, companies should check the balance sheet and understand the reason for the discrepancy
- Fraudsters will use complex balance sheet accounts and reconciliations to hide their actions

Maintain oversight

- Fraud is easier to justify for employees who do not face their victim on a daily basis
- Subsidiaries or branches which are run with no head office oversight can create problems

Mitigating solutions to emerging fraud risks

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Ask questions

- The history of corporate fraud is full of examples of people who took advantage of management unwillingness to dig deeper into issues
- If something does not seem to make sense, keep pressing for an answer and follow up on any explanations which are given

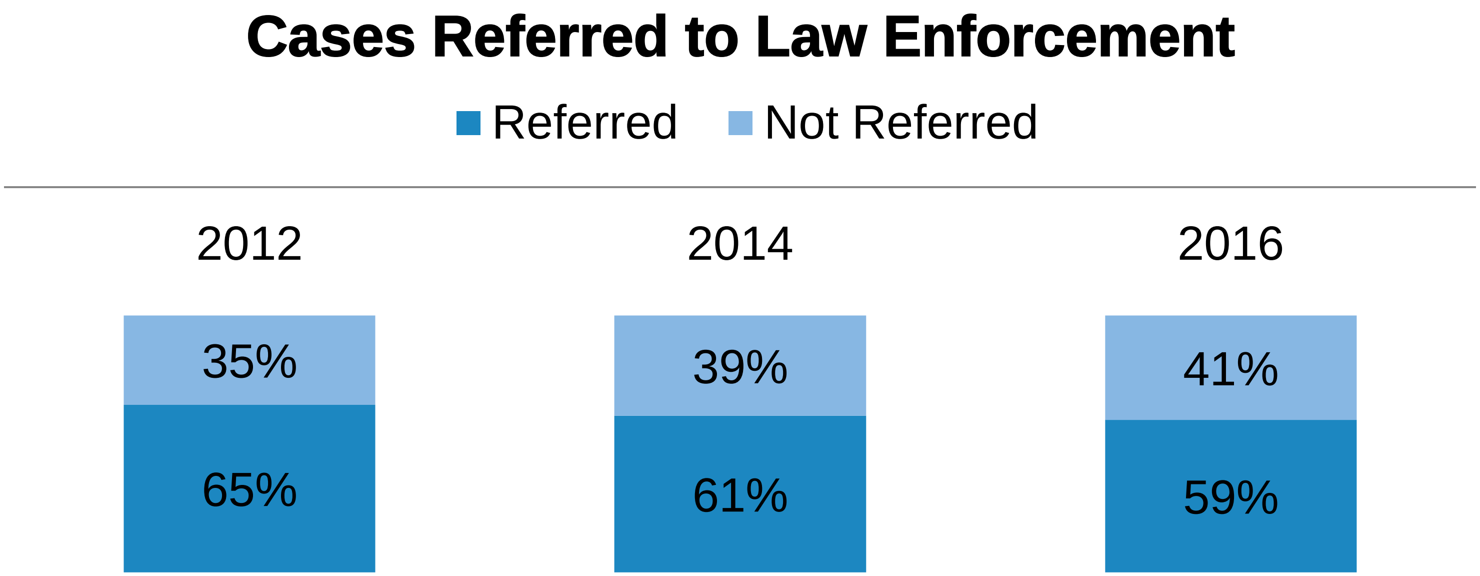
Build in surprise

- Fraudsters like to control and manage their environment; they do not like disruption to their schedules such as holidays, unexpected visits or questions
- Management should build an element of surprise into their work or review

Mitigating solutions to emerging fraud risks

Prosecute

- Even with the best control environment, fraud can still happen. When it does, a company should be in a position to act quickly and decisively
- If the allegation is proven, aggressive prosecution of the individuals involved sends a clear message to all employees that the long-term risk of being caught outweighs any short-term benefits



Source : 2016 ACFE Global Fraud Study

Open discussion and questions

Contact Information

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Required disclosure and Circular 230 Prominent Disclosure

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