

The Threat From Within: Counter Internal Fraud Risks to Safeguard Your Organization

September 19, 2023



Agenda

- **Introduction**
- **ACFE 2022 Report to the Nations**
 - Why do people commit fraud?
 - Types of Fraud Schemes & Statistics
- **Enterprise Risk Management**
 - Enterprise Risk Management Approach
 - Control Environment
 - Fraud Risk Assessment
- **Ripped from the Headlines**
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Introduction

Presenter Bio

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- **Education & Certifications**

- Bachelor of Science in Public Accounting, Fordham University
- Certified Fraud Examiner (CFE)
- Certified Insolvency & Restructuring Advisor (CIRA)
- Certified Financial Crime Specialist (CFCS)
- Certified Cryptocurrency Expert (CCE)
- Certified Cryptocurrency Auditor (CCA)
- Certified Artificial Intelligence & Investigations Expert (CAIIE)

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Career Journey

- **Background**
- **External Audit**
- **Corporate Bankruptcies and the Ponzi Years**
- **Working with the Feds...**
- **Bringing it all together and Crypto**

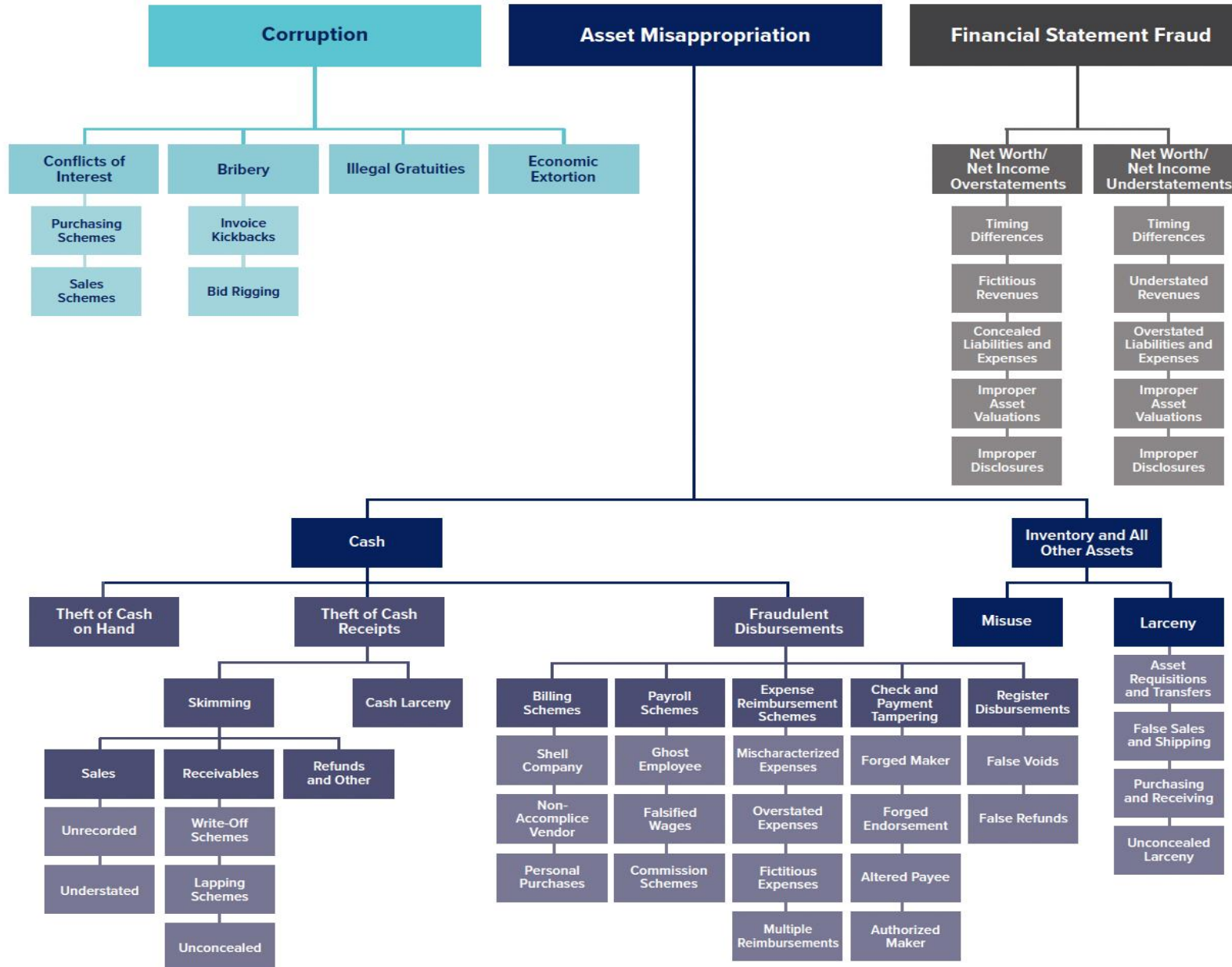
ACFE 2022 Report to the Nations

WHY DO PEOPLE COMMIT FRAUD?

- The Fraud Triangle is a model that outlines the three conditions generally present when fraud occurs: **Financial Pressure**, **Rationalization**, and **Opportunity**
 - Financial Pressure
 - An individual may be facing significant liabilities (medical bills, loans, credit card bills) or might be dealing with an expensive habit/compulsion. The individual may feel like they have no other choice.
 - Rationalization
 - An individual needs to make a rationalization that the fraud is acceptable. This can often take the form of “It won’t hurt anyone” or “it’s just a small amount of money” or “it’s temporary; I’ll pay it back.”
 - Opportunity
 - A person must have an opportunity to commit fraud. This can be due to weak or non-existent internal controls.



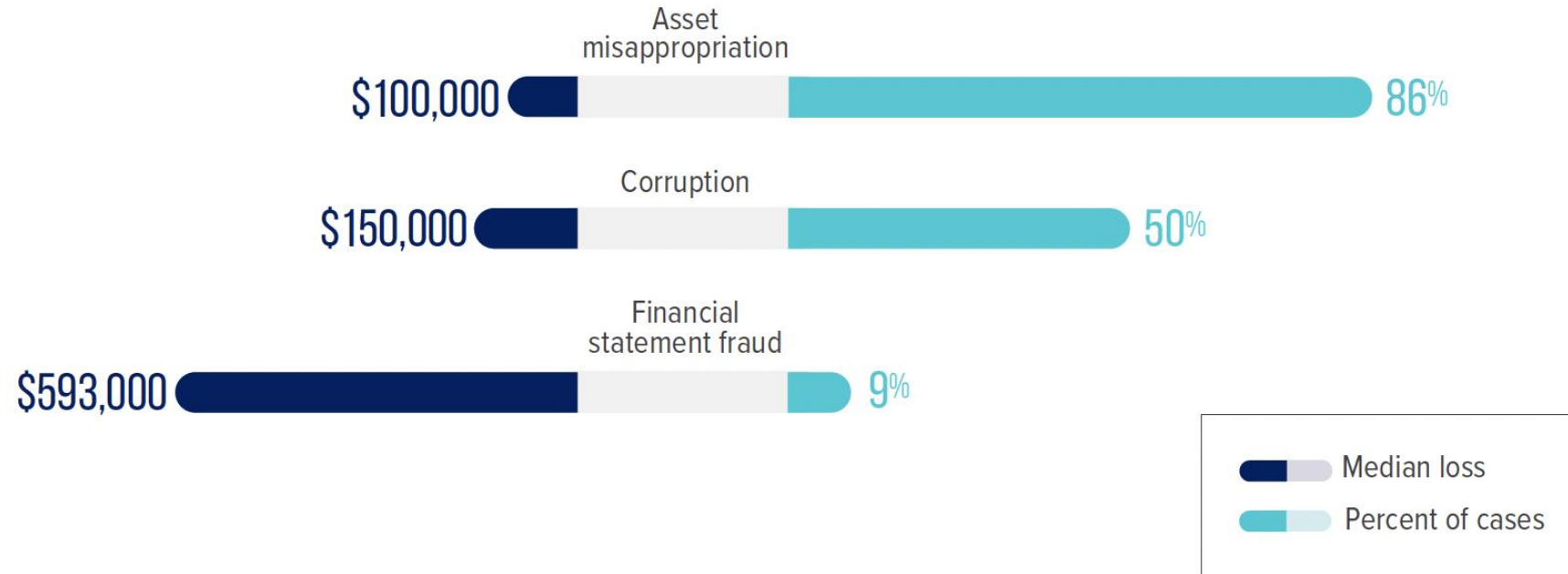
OCCUPATIONAL FRAUD AND ABUSE CLASSIFICATION SYSTEM (THE FRAUD TREE)



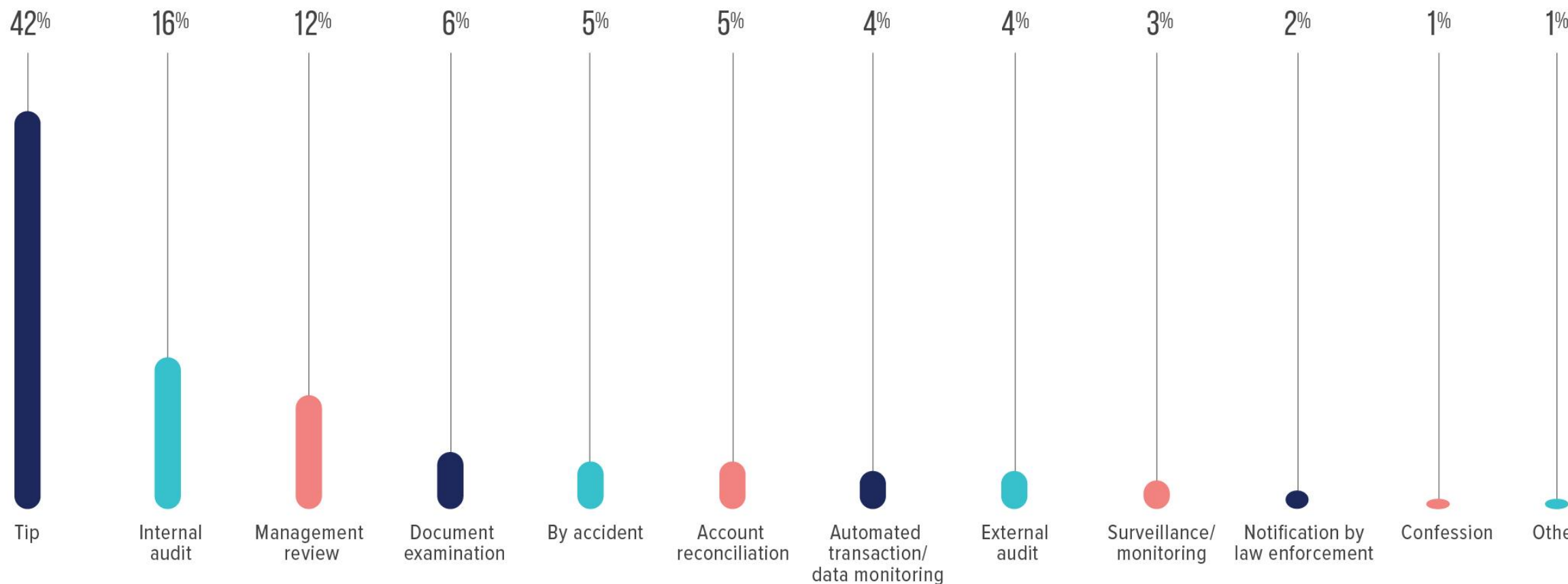
TYPES OF FRAUD

- **Occupational fraud refers to fraudulent activities committed by employees against their employers and can be categorized into three main types.**
 - Corruption
 - Bribery: Illicit payments to influence decisions or actions
 - Kickbacks: Receiving or providing unauthorized benefits in exchange for something of value
 - Conflicts of interest: Engaging in activities that conflict with the individual's responsibilities to the organization.
 - Asset Misappropriation
 - Embezzlement: Unauthorized taking of funds or assets
 - Theft of cash or goods: Stealing money or physical assets from an organization
 - Financial Statement Fraud
 - Earnings manipulation: Deliberately altering financial data to present a more favorable picture of a company's financial position.
 - Assets/Liabilities
 - Overstating assets: Inflating the value of assets to improve balance sheet health.
 - Understating liabilities: Reducing the amount of recorded liabilities to present a less risky financial position.

HOW IS OCCUPATIONAL FRAUD COMMITTED?

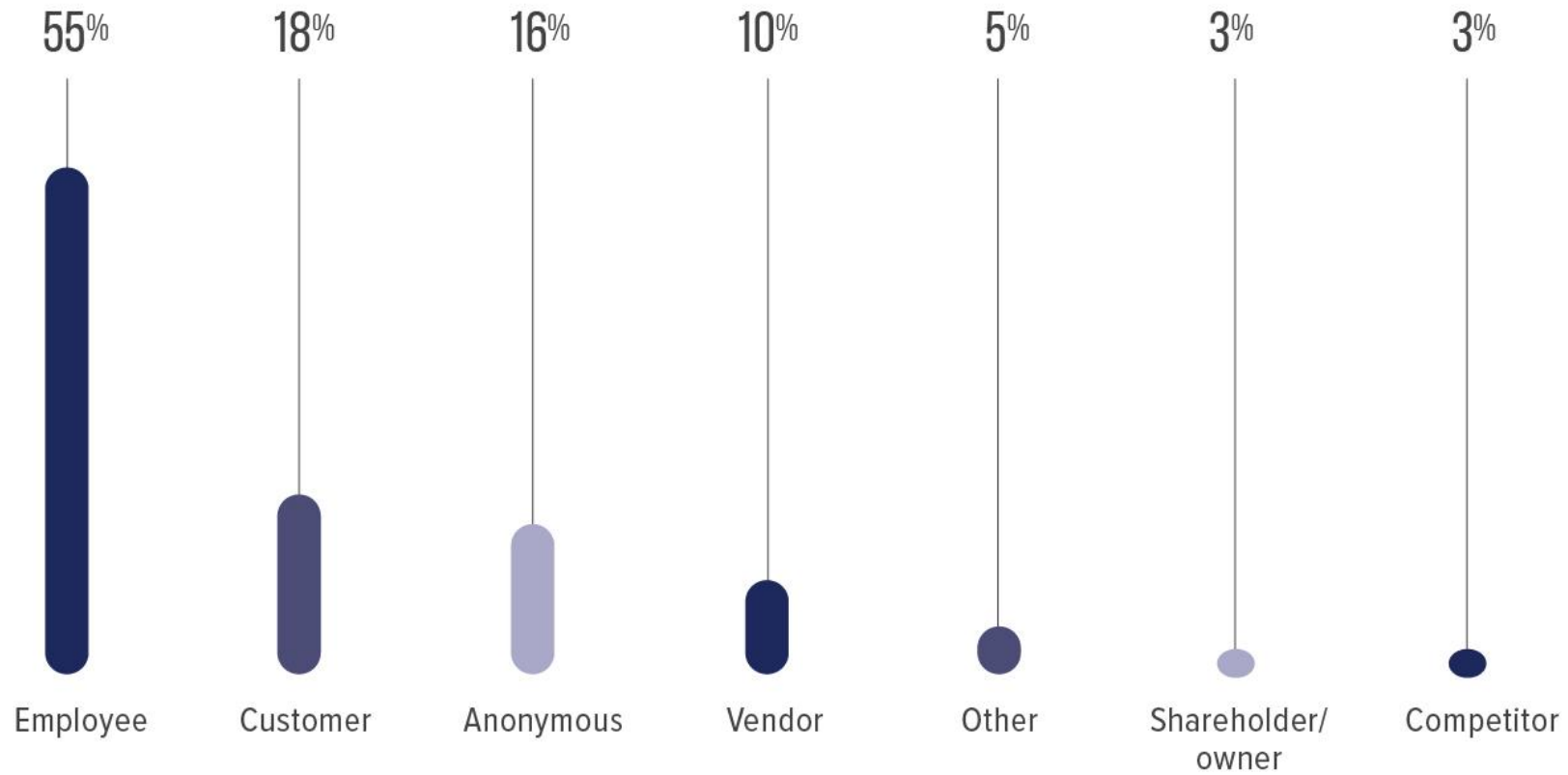


HOW IS OCCUPATIONAL FRAUD INITIALLY DETECTED?

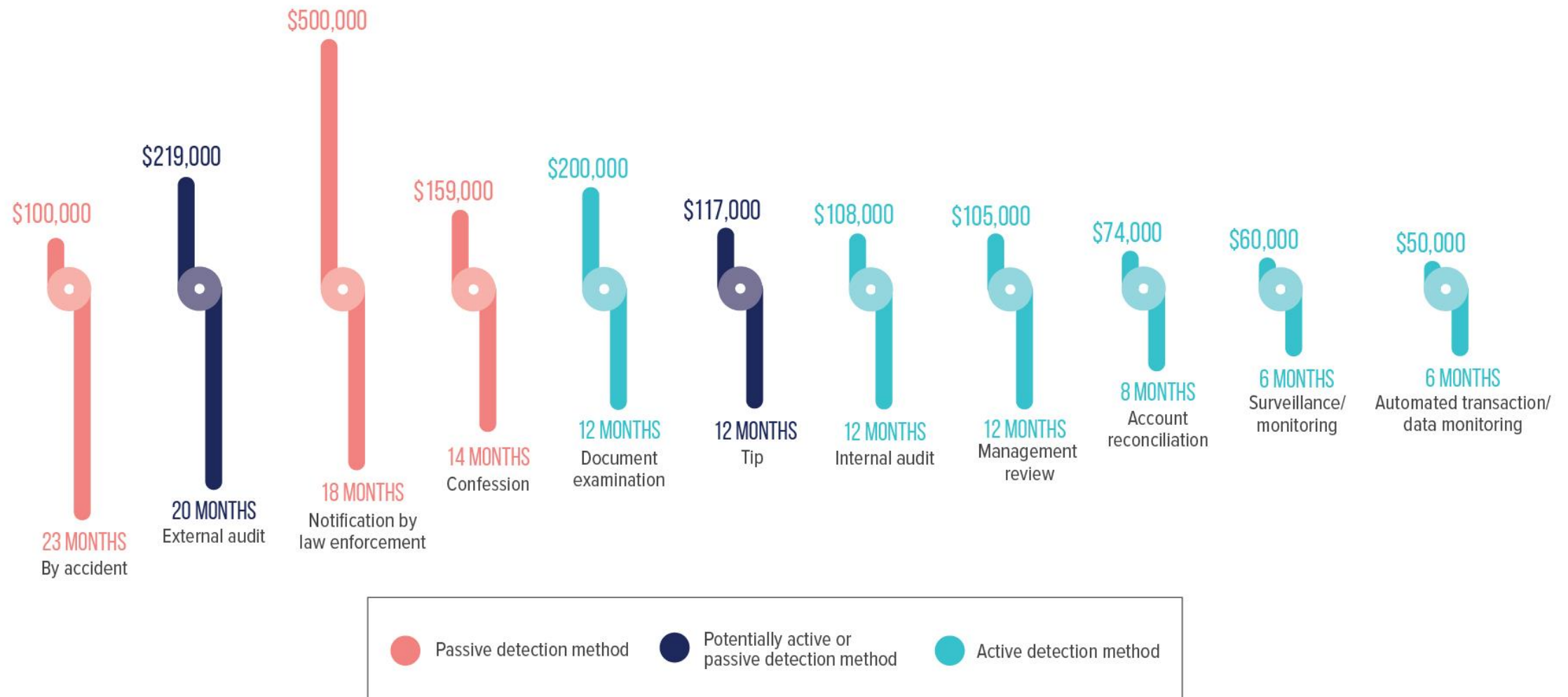


Source: ACFE – Occupational Fraud 2022: A Report to the Nations

WHO REPORTS OCCUPATIONAL FRAUD?



HOW DOES DETECTION METHOD RELATE TO FRAUD LOSS AND DURATION?



Enterprise Risk Management

ENTERPRISE RISK MANAGEMENT APPROACH

- **Enterprise Risk Management seeks to identify and prevent major risks that can stop an organization from completing its mission.**
- **Identify**
 - Focus on Big Risks: Financial, operational, reputational
 - Be creative: Identify risks that are not immediately obvious
- **Prepare**
 - Build Capacity: Develop systems to identify and monitor risk areas
 - Empower Employees: Encourage employees to report concerns
 - Early identification: The earlier a risk is identified, the easier it is to address.
 - Future Planning: Develop strategies to address long-term risks
- **Response**
 - Governance Structure: Establish a framework for how risks are managed and who is responsible
 - Key Business Functions: Identify the critical areas of the business and assign risk management ownership
 - Practice: Test risk management procedures through drills, simulations, etc.

ENTERPRISE RISK MANAGEMENT GUIDANCE

- **COSO Framework Components and Principles:**



CONTROL ENVIRONMENT

- **Control Environment**

- The control environment serves as the foundation for all other components of internal control and fraud risk management. It includes the actions and attitudes of management (executives, board members, etc.) toward the internal control system and commitment to ethical behavior.
- Factors Influencing Control Environment:
 - Management Communication
 - Management Actions
 - Engaged Board of Directors/Audit Committee
 - Well-designed Organizational Structure
 - Commitment to a Code of Ethics/Conduct
 - HR Policies
 - Fostering a Speak-Up Culture

WHAT IS A FRAUD RISK ASSESSMENT?

- **What is a fraud risk assessment?**
 - A fraud risk assessment is designed to proactively identify vulnerabilities to both external and internal fraud risks, thereby enabling organizations to implement effective controls and mitigation strategies.
- **Types of Fraud Risks**
 - External fraud risks: These include check and credit card fraud, shoplifting, vendor and telemarketing fraud, and fraud perpetuated by ID theft.
 - Internal fraud risks: These include schemes covering embezzlement, fraudulent payments, and data theft.
- **What are the key elements of a fraud risk assessment?**
 - Identify & Assess Fraud Risks
 - Control Evaluation & Risk Mitigation
 - Monitoring and Review
 - Stakeholder Involvement

IDENTIFY FRAUD RISKS

Scope and Objectives

- **Define the Areas:** Clearly outline the areas that will be covered in the assessment.
- **Set Clear Objectives:** Establish specific goals that the assessment aims to achieve.

Types of Fraud

- **Asset Misappropriation**
- **Corruption**
- **Financial Statement Fraud**

Risk Factors

- **Lack of Internal Controls**
- **Complex Organizational Structure**
- **High Employee Turnover**

ASSESS FRAUD RISKS

Likelihood

- **Evaluate Probability:** Assess the likelihood of each type of fraud occurring within the organization.

Impact

- **Financial and Reputational Assessment:** Evaluate the potential financial loss and reputational damage that could result from each type of fraud.

Inherent Risk

- **Calculate Risk:** Combine the assessed likelihood and impact to calculate the inherent risk for each type of fraud.

Vulnerability

- **Organizational Assessment:** Evaluate how vulnerable the organization is to each identified risk, considering existing controls and organizational culture.

CONTROL EVALUATION AND RISK MITIGATION

Existing Controls

- **Identify Controls:** List the current controls in place, such as Segregation of Duties, Audits, Mandatory Vacations, etc.

Control Effectiveness

- **Performance Evaluation:** Assess how well existing controls are working, based on metrics like the number of incidents, audit results, etc.

Residual Risk

- **Risk Assessment:** Calculate the remaining risk after taking into account existing controls. This can be on a High/Medium/Low scale or a numerical value.

Additional Controls Needed

- **Identify Gaps:** Determine where current controls are insufficient and propose additional measures, such as extra monitoring, new software, or a whistleblower hotline.
- **Implementation Strategy:** Outline who is responsible for implementing new controls, as well as the budget, resources, and timeline required.

MONITORING AND REVIEW

Ongoing Monitoring

- **Oversight Mechanisms:** Outline the continuous oversight methods in place, such as:
 - Real-time Alerts: Immediate notifications for suspicious activities.
 - Monthly Audits: Regular monthly reviews to assess control effectiveness.
 - Employee Engagement: Ongoing involvement of employees in monitoring activities.

Periodic Review

- **Quarterly Assessments:** Review the fraud risk landscape and update risk profiles every quarter.
- **Annual Audits:** Conduct comprehensive audits annually to evaluate the effectiveness of controls.
- **Benchmarking:** Compare the organization's fraud risk profile against industry peers or benchmarks.

Reporting

- **Management Briefings:** Provide targeted updates to senior management on risk profiles and mitigation strategies.
- **Board Meetings:** Offer updates on high-risk areas, incidents, and action plans during board meetings.
- **Public Reporting:** Transparency in reporting can help meet ESG (Environmental, Social, and Governance) expectations.

STAKEHOLDER INVOLVEMENT

Key Personnel

- **Finance/Accounting:** Responsible for assessing financial risks and controls.
- **Operations:** Focuses on procedural and logistical risks.
- **IT Department:** Addresses technology-related risks, including cybersecurity.
- **Legal/Human Resources:** Manages risks related to employee behavior and internal policies.

External Consultants

- **Legal, Auditors, Industry Experts**

Communication Plan

- **Reporting Frequency:** Establish how often updates and reports should be made.
- **Confidential Channels:** Discuss the use of confidential communication channels for sensitive information.

Training & Awareness

- **Employee Training:** Regular training sessions to educate employees on risk awareness and controls.
- **Management Workshops:** Specialized training for managerial staff to understand and manage risks.
- **External Stakeholder Briefings:** Updates and training for external parties like investors or regulatory bodies.

Ripped from the Headlines

ALL THE QUEEN'S HORSES

- **Headline:**

- Comptroller Rita Crundwell defrauded the City of Dixon Illinois of \$53.7 million over a twenty-two year period.

- **Overview:**

- The City of Dixon, Illinois, has approximately 16,000 residents and covers approximately 8.8 square miles.
 - Dixon is approximately 100 miles southwest of Chicago and was the boyhood home of Ronald Reagan
 - For context, Middletown, RI has approximately 17,100 residents and covers approximately 14.9 square miles.

- **Timeline:**

- Crundwell started working for the City Finance Department in 1970 and became Comptroller/Treasurer in 1983.
- Between 1988 and 1990, Crundwell stole approximately \$25,000 from city account.
- In December 1990, Crundwell opened a bank account name “RSCDA – Reserve Fund” or “Reserve Sewer Capital Development Account.”
- Starting in early 1991, she began transferring funds from legitimate city accounts to the RSCDA account.
 - Total transfers in 1991 totaled \$181,000 and grew to \$5.8 million in 2008.

ALL THE QUEEN'S HORSES

- **Cover Up:**

- During the period her scheme was active, Crundwell regularly met with city officials and advocated for cuts to city services, citing “budget gaps” that were actually caused by her fraudulent activities.
- To conceal the scheme:
 - Crundwell picked up the city’s mail, including bank statements for the RSCDA account, to prevent other employees from learning about the secret account.
 - Crundwell created 159 fictitious invoices, purportedly from the State of Illinois, to show the city’s auditors that the funds she was fraudulently depositing into the RSCDA account were being used for legitimate purposes.
 - When she was away, she instructed a relative or other city employees to pick up the mail and separate any items addressed to her, including the statements for the RSCDA account, from the rest of the city’s mail.

- **Clues:**

- Crundwell’s annual salary in 2011 was \$80,000, yet she:
 - Operated horse farms and had horses spread out at facilities across the country.
 - Maintained two residences and a horse farm in Dixon, IL
 - Had a home in Englewood, Fla. and 80 acres of vacant land in Lee County
 - Possessed other assets, including a 2009 luxury motor home, more than four dozen trucks, trailers and other motorized farm vehicles, a 2005 Ford Thunderbird convertible, a 1967 Chevrolet Corvette roadster, a pontoon boat, jewelry, and approximately \$224,898 in cash from two bank accounts.

ALL THE QUEEN'S HORSES

- **Fraud Type:** Asset Misappropriation; Fraudulent Financial Reporting
- **Total Loss:** \$53.7 million
- **Duration:** 1990 – 2012 (twenty-two years)
- **Detection:** Crundwell's assistant often covered for her when she was out of town. During a vacation in 2011, the assistant requested copies of all the city's bank statements. Upon reviewing these, she discovered the RSCDA account and alerted other city officials.
- **Result:** Sentenced to 19.5 years in prison and ordered to forfeit \$53.7 million.
- **Discussion Topics:**
 - **Internal Controls:** What measures could have been in place to prevent this activity?
 - **Role of Auditors:** Should auditors have identified these schemes during their reviews?
 - **Additional Procedures:** What other types of procedures or checks could have potentially caught this activity?

Discussion/Questions