FRAUD INDICATORS FOR RISK MANAGEMENT PROFESSIONALS

The risk of fraud is universal. Experts estimate that the typical organization loses up to 5 percent of its annual revenues to fraud and abuse. Are you prepared to help your company or your clients proactively manage this risk? Can you recognize the indicators of fraud within an organization? This session will discuss how to improve your ability to spot and address fraud risks before they result in damage.

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James D. Ratley graduated from the University of Texas at Dallas, with a Bachelor’s Degree in Business Administration. In 1971, he joined the Dallas Police Department as a police officer.

Mr. Ratley was assigned to several police department divisions, including vice, child abuse, and internal affairs. He was a member of numerous department task forces which concentrated on major fraud cases.

In 1986, Mr. Ratley left the police department to join Wells & Associates, a forensic accounting practice, where he was in charge of fraud investigations. He handled investigations regarding internal frauds, conflicts of interest, and litigation support. In 1988, he was named Program Director for the Association of Certified Fraud Examiners and oversaw all aspects of the ACFE’s training and education programs.

In 2005, Mr. Ratley was awarded the Association of Certified Fraud Examiners’ Cressey Award. The Cressey Award is the ACFE’s highest honor. It is bestowed annually for a lifetime of achievement in the detection and deterrence of fraud.

In 2006, Mr. Ratley was named President of the ACFE. In this role, he works to promote the ACFE to the public and other professional organizations and continues to assist in the development of anti-fraud products and services to meet the needs of the ACFE’s members. In addition to his executive duties, Mr. Ratley serves as a member of the ACFE’s faculty, and teaches regularly at workshops and conferences on a variety of fraud-related subjects.

Mr. Ratley was named one of the Top 100 Most Influential People in Accounting by Accounting Today in 2012, with the magazine praising his leadership in a “changing, growing and evolving” accounting landscape. He was also selected as one of Security magazine’s Most Influential Security Executives for 2010. This honor is bestowed each year
to the top security executives who positively impact the security industry, their organizations, their colleagues and their peers.

Mr. Ratley is a member of the Association of Certified Fraud Examiners, Austin Chapter, and a member of the Board of Advisors for the Institute for Bank Director Education. He was also a Visiting Scholar at the University of Nebraska in Lincoln. In addition, he has been certified as a Master Peace Officer by the Texas Commission on Law Enforcement Standards and Education.

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Introduction
Recent economic events have brought the concept of “risk” to the public eye and to the forefront of many business operations. The particular risks threatening an organization’s success depend on many factors specific to its operations. However, the risk of fraud is present in every company, and it merits the attention of every risk management professional. The truth is that fraud occurs in all organizations, of every size, in every industry, and in every region. No entity is immune to this risk. The fundamental reason for this is that fraud is a human problem, not an accounting problem. Consequently, as long as organizations employ individuals to perform the business functions, the risk for fraud exists.

And this universal risk can be devastating if not given adequate attention; according to the ACFE’s 2012 Report to the Nations on Occupational Fraud and Abuse, the typical organization loses an estimated 5 percent of its revenues to fraud each year. Further, it is those companies whose management is least attentive to the potential for fraud that are at the greatest risk.

While anti-fraud controls are necessary, effectively managing fraud risk involves more than just implementing control mechanisms. Risk managers must know how to recognize the signs and symptoms of fraud schemes—that is, they must be able to identify and understand red flags of fraud—to effectively manage this risk.

The Pillars of Managing Fraud Risk
Managing fraud risk involves assessing the specific risks related to fraud and focusing efforts to address them before, during, and after their potential occurrence. In designing procedures to prevent, detect, and investigate fraud, those
charged with managing this risk must consider potential fraud indicators at each step in the process.

**Fraud Risk Assessment**

In the simplest terms, conducting a fraud risk assessment involves looking at what has happened in the past—both at the organization and at other organizations—and identifying where opportunity still exists for individuals to commit fraud. In doing so, management must consider the risk of fraud from both internal and external sources, as well as the increased risk that stems from collusion among parties. While most fraud schemes, in their essence, fall within a known spectrum, a fraud risk assessment involves identifying and evaluating the likelihood and significance of each of these risks based on the specifics of the organization.

To be effective, the fraud risk assessment must be an ongoing process, and should be revisited frequently to ensure the organization is remaining ahead of the risks. Further, the results of the assessment should be used to focus the organization’s fraud prevention and detection efforts on those areas assessed to be of high risk.

**Fraud Prevention**

Many fraudsters, when asked about their schemes, state that the hardest dollar to steal is the first one. Consequently, fraud prevention activities should be designed to stop employees from engaging in the first instance of fraud. Among the most important organization-wide mechanisms that can effectively deter employees engaging in fraud are:

- An *ethical tone at the top* and a *corporate culture* that clearly illustrates the value of honesty and
provides employees with visible examples of leaders doing the right thing

- Employee fraud awareness training programs that educate staff members on what fraud is and is not, the types of behaviors that are expected of employees, how fraud hurts both the organization and every employee on staff, common red flags to watch for, and how to report suspected wrongdoing

- Employee support programs, such as addiction, financial, and family counseling services, that help address the pressures that can lead otherwise honest individuals to resort to fraud

- Background checks (where legally permissible) to ensure that the company is hiring honest and ethical staff members and not letting known thieves in through the front door

- Mechanisms that increase the perception of detection in employees’ minds—that is, tools that convince employees that, if they attempt fraud, their actions will certainly and swiftly be detected

**Fraud Detection**

Even the most robust fraud prevention program will not curb all instances of fraud. Consequently, fraud risk management programs must include controls designed specifically to detect fraud as soon as possible after it has begun.

ACFE research shows that tips are consistently the most common method by which frauds are uncovered. Implementing a hotline that provides employees and other parties with an easily accessible means of coming forward with information is among the most effective anti-fraud defenses an organization can have.
Additionally, implementing an internal audit function, particularly one that undertakes periodic fraud audits that incorporate an element of surprise, can help bolster management’s ability to identify potential instances of fraud. Within these audits—or as part of other proactive measures—the use of data mining and data analysis to look for anomalies and data patterns that indicate fraud or manipulation can be an excellent fraud detection tool.

Process-specific internal controls, such as segregation of duties and management review, also provide layers of oversight and checks-and-balances that make it less likely that fraud will be able to continue undetected for long.

*Responding to Fraud Incidents*

The fraud risk management program must include protocols for responding when potential fraud is uncovered. The fraud response mechanism should include clear, formalized procedures to facilitate:

- Investigating the allegations
- Taking action against the perpetrator, such as employment sanctions, criminal prosecution, or a civil lawsuit
- Recovering amounts lost through available means, including restitution agreements and insurance claims
- Correcting any internal control deficiencies that allowed fraud to occur

*Focus on Fraud Indicators*

Throughout all anti-fraud activities, as well as daily operations, risk management professionals and other involved staff members must focus on recognizing fraud indicators. That is, to be effective, the fraud risk
management process must be anchored in understanding and identifying the red flags and warning signs of potential fraud. The red flags of fraud typically fall into the following broad categories.

**Internal Control Weaknesses**
Common internal control weaknesses that can indicate fraud symptoms include:
- Lack of segregation of duties
- Lack of physical safeguards
- Lack of independent checks
- Lack of proper authorization on documents, records, and transactions
- An inadequate accounting system
- Override of existing controls

**Accounting Anomalies**
Accounting anomalies are unusual deviations from the standard financial recording or reporting practices, which result in irregularities in the accounting system. Examples include missing documents, stale items on reconciliations, alterations on documents, photocopied documents when the original should be present, and increased past due accounts. Other symptoms might be ambiguous or unexplained journal entries, inaccuracies in the ledger accounts, and unexplained changes in financial statements.

**Operational Anomalies**
Anomalies in the organization’s operations—particularly deviations from what would appear reasonable or strategically sound—can be a warning sign of fraud. Such anomalies include unusual relationships, procedures, and events concerning the company’s operations, as well as transactions or
situations involving unexpected times, places, people, amounts, or frequencies.

**Behavioral Anomalies**

The vast majority of fraudsters display some sort of behavioral symptoms of their scheme—symptoms that coworkers or supervisors might have picked up on without realizing that they were connected to fraudulent actions.

According to the ACFE’s 2012 *Report to the Nations on Occupational Fraud and Abuse*, at the time of their frauds:
- 35% of perpetrators are living beyond their means.
- 27% of perpetrators are experiencing financial difficulties.
- 19% of perpetrators have an unusually close relationship with a vendor or customer.
- 18% of perpetrators display control issues or are unwilling to share their job duties.
- 15% of perpetrators are going through a divorce or experiencing other family problems.
- 15% of perpetrators display a wheeler-dealer attitude.
- 13% of perpetrators act noticeably irritable, suspicious, or defensive.
- 8% have known problems with addiction.

While the presence of these behaviors does not, in itself, mean that fraud is occurring, risk managers and supervisors should be educated of their frequent connection to fraud and advised to take note of them or other unexpected changes in employee behavior that might be consistent with a pressure or opportunity to engage in wrongdoing.
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<td>The risk of fraud is universal and potentially devastating. Managing this risk requires proactive mechanisms that address fraud before, during, and after it occurs. To effectively do so, risk managers must understand and focus on known fraud indicators. Only by doing so can they successfully support the organization in preventing, detecting, and minimizing the impact of fraud.</td>
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