INTRODUCTION TO FRAUD EXAMINATION

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VII. FRAUDULENT FINANCIAL TRANSACTIONS: FRAUD SCHEMES

Introduction

Fraud can be committed internally or externally from a company by employees, customers, vendors, and other parties. *Internal fraud* is fraud that originates from within an organization and is committed by employees. *External fraud* is fraud committed by outsiders; it involves any scheme in which the perpetrator is not an employee, manager, officer, or owner of the victim company. External fraud covers a broad range of schemes, from vendor and customer frauds that attack businesses to traditional consumer frauds and confidence schemes. This section will provide an overview of some of the most common and threatening internal schemes, by addressing asset misappropriations and corruption along with contract and procurement fraud schemes that involve vendors. Fraudulent financial statements, while a type of internal fraud, will be covered in a separate section.

Asset Misappropriation Schemes

Asset misappropriation schemes include both the *theft* of company assets, such as cash, and the *misuse* and *theft* of company assets, such as using a company car for a personal trip. The asset misappropriation schemes to be discussed here are cash schemes and misuse of noncash assets, such as inventory and all other assets.

Cash Schemes

- Theft of cash on hand
- Theft of cash receipts
- Fraudulent disbursements

Theft of Cash on Hand

Theft of cash on hand is any scheme in which the perpetrator misappropriates cash kept on hand at the victim organization's premises (e.g., employee steals cash from a company vault).

Theft of Cash Receipts

- Skimming
- Larceny

SKIMMING

Skimming is the process by which cash is removed from the entity before it enters the accounting system. This is an "off-book scheme" because the receipt of the cash is never reported to the entity.

The most common skimming schemes are:

- Sales schemes
  - Unrecorded sales
  - Understated sales
- Accounts receivable schemes
  - Write-off schemes
  - Lapping schemes
  - Unconcealed receivables
- Refund and other schemes

CASH LARCENY

In the occupational fraud setting, a *cash larceny* may be defined as the intentional taking away of an employer's cash (the term *cash* includes both currency and checks) without the consent and against the will of the employer. Skimming was defined above as the theft of off-book funds. Cash larceny schemes, conversely, involve the theft of money that has already appeared on a victim company's books. Therefore, cash larceny schemes are *on-book* frauds.

Detection of Theft of Cash Receipt Schemes

Detection methods for theft of cash receipt schemes include:

- Analyze sales accounts by employee.
- Review journal entries for:
  - False credits to inventory to conceal unrecorded or understated sales
  - Other write-offs of inventory for reasons of lost, stolen, or obsolete product
  - Write-offs of accounts receivable
  - Irregular entries to cash accounts
- Compare the dates of the customer's payments with the dates the payments are posted to the customer's accounts.
- Analyze cash receipts and their recording.
- Analyze the relationship between sales, cost of sales, and returns and allowances.
- Watch for altered register tapes.
- Follow up on complaints and inquiries from customers.
- Look for unusual deposits in transit.
- Conduct surprise cash counts.
- Use surveillance.
- Analyze deposit slip books.

Fraudulent Disbursements

Fraudulent disbursements are the most common form of asset misappropriation, and they occur when an employee uses his position of employment to cause a payment for some inappropriate purpose. Fraudulent disbursements are on-book fraud schemes, meaning that cash (checks) leaves the entity fraudulently, but it is recorded on the books and thus an audit trail exists. Fraudulent disbursement schemes are broken down into the following types:

- Check tampering schemes
- Register disbursement schemes
- Billing schemes
- Expense reimbursement schemes
- Payroll schemes

CHECK TAMPERING SCHEMES

Check tampering is a type of fraudulent disbursement scheme whereby an employee either (1) prepares a fraudulent check for his own benefit or (2) intercepts a check intended for a third party and converts the check to his own benefit. Other fraudulent disbursement schemes, such as false billings or payroll fraud, tend to rely on false claims for payment. Some false document, perhaps an invoice or a time card, is submitted to the victim organization and generates the fraudulent payment. Such schemes are based on trickery—convincing the victim to make a payment based on a fraudulent invoice, time card, expense report, or other document.

Check tampering schemes are a more direct form of fraud. Instead of relying on false support to generate a fraudulent disbursement, the perpetrator of a check tampering scheme takes physical control of a check and places false information on that instrument. The fraudster might forge a signature, alter a payee, alter the amount of the check, or forge an endorsement. The key is that the perpetrator places false information on a company check and that this action enables the fraudster to illegally obtain funds from his employer.

The major methods of check tampering are:

- Forged maker schemes
- Forged endorsement schemes
- Altered check schemes
- Authorized maker schemes

Detection of Check Tampering Schemes

Detection methods for check tampering schemes include:

- Investigate customer complaints.
- Review canceled check images.

- Investigate past-due notices received by the entity.
- Review unusual endorsements on checks.
- Review unusual payee names (i.e., handwritten or typewritten vs. computer written, or employee names as payee).
- Conduct analytical reviews.
- Reconcile checks using a positive pay checking account system, which identifies checks that have not been issued and compares the amount of each check issued to the amount tendered.

REGISTER DISBURSEMENT SCHEMES

Refunds and voided sales are transactions processed at the register when a customer returns an item of merchandise purchased from that store. The transaction entered on the register indicates the merchandise is being replaced in the store's inventory and the purchase price is being returned to the customer. In other words, a refund or void shows a disbursement of money from the register as the customer gets his money back.

Fraudulent refunds and voids represent a class of occupational fraud that is a hybrid between cash theft and fraudulent disbursements. Since these schemes appear on the books as legitimate disbursements of funds from the cash register, they are classified as fraudulent disbursements. In practice, an employee physically removes cash from his cash register and absconds with it. In that respect, such schemes are very similar to cash larceny schemes.

The major register disbursement schemes are:

- False voids
- False refunds

Detection of Register Disbursement Schemes

Detection methods for register disbursement schemes include:

- Accounting for consecutive sales orders and cash register transactions
- Comparing volume of credits issued by period
- Accounting for missing register tapes
- Investigating voided transactions not properly documented
- Investigating refunds or voids just under the review limit
- Performing computer analysis of:
  - Sales volume by employee
  - Voids/refunds by employee

BILLING SCHEMES

The most common and costly example of a fraudulent disbursement is the billing scheme. *Billing schemes* attack the purchasing function of an organization. They cause the victim organization to buy goods or services that are nonexistent, overpriced, or not needed by the organization. A billing scheme can result in an illicit gain of cash, goods, or services for the fraudster. The purpose of most billing schemes is to generate cash. In a typical scheme, the perpetrator creates false support for a fraudulent purchase. The fraudulent support documents (which can include invoices, purchase orders, purchase requisitions, receiving reports, and so on) cause the victim organization to issue a check. The fraudster collects the check and cashes it, thereby reaping an illegal gain.

Employees can use utilize false billings to receive goods or services rather than cash. In these cases, the fraudster makes a personal purchase and charges it to his employer as if the purchase were a business expense. This type of scheme is accomplished in one of two ways. One method is to run a voucher for a personal purchase through the payables system. The perpetrator misrepresents the nature of the purpose, claiming that the goods or services are being bought on the company's behalf. The second method is to purchase personal goods or services on the company's credit card or on a credit account.

The following categories of billing schemes are:

- Shell companies
- Non-accomplice vendors
- Personal purchases

Detection of Billing Schemes

Detection methods for billing schemes include:

- Investigate customer complaints.
- Investigate unusual payees (e.g., employees, non-vendors, or non-corporate-sponsored credit card companies).
- Perform site visits of vendors.
- Perform computer analysis to search for:
  - Vendor addresses that match employee addresses
  - Unusual activity in "soft" accounts (e.g., consulting, professional, advertising, etc.)
  - Increased payments to certain vendors
- Investigate noticeable changes in an employee's lifestyle.
- Conduct analytical reviews.
- Review high-volume vendor activity for new vendors.
- Investigate refunds sent to addresses other than the organization's permanent address on file.
- Research state business registries.

EXPENSE REIMBURSEMENT SCHEMES

Travel and expense budgets are a common target for occupational fraud. Employees may falsify information about their business expenses and cause their employers to overcompensate them in the form of inflated expense reimbursements. This type of scheme is most commonly perpetrated by sales personnel who overstate or create fictitious expenses in areas such as client entertainment and business travel. Outside sales personnel are not the only employees who commit this type of fraud, however. Any person who is in a position to incur travel or business entertainment expenses is potentially capable of committing expense reimbursement fraud.

Expense reimbursement schemes fall into four general categories:

- Mischaracterized expenses
- Overstated expenses
- Fictitious expenses
- Multiple or duplicate reimbursements

Detection of Expense Reimbursement Schemes

Detection methods for expense reimbursement schemes include:

- Compare actual and budgeted expenses by cost center.
- Investigate reimbursements over a certain amount or in even amounts.
- Investigate reimbursements charged to unusual accounts.
- Examine accounts that have unusual activity (i.e., high reimbursements at the end of a period).
- Compare employee calendar to expenses submitted.

PAYROLL SCHEMES

Payroll schemes occur when an employee fraudulently generates overcompensation on his behalf. These schemes are similar to billing schemes in that the perpetrator generally produces some false document or otherwise makes a false claim for a distribution of funds by his employer. In billing schemes, the false claim typically comes in the form of a fraudulent invoice. In payroll schemes, the false claim generally occurs when the fraudster falsifies payroll records, timekeeping records, or some other document concerned with the payroll function.

The most common forms of payroll fraud are:

- Ghost employee schemes
- Falsified wages
- Commission schemes

Detection of Payroll Schemes

Detection methods for payroll fraud schemes include:

- Independent payroll distribution
- Analysis of payee addresses or accounts
- Search for duplicate government identification numbers
- Review of overtime
- Analysis of deductions
- Investigation of other employees' complaints

Noncash Asset Schemes

Other than stealing cash from an employer directly, some employees might steal or abuse other assets. This might include taking office supplies home for personal use or stealing expensive company equipment.

The schemes in this category are:

- Misuse of inventory and all other assets
- Larceny or theft of inventory and all other assets

Misuse of Inventory and All Other Assets

How many times have we heard someone say, "I'm just going to borrow this," or "I took it home to work on the project over the weekend?" In fact, a great deal of inventory is stolen under the pretense that it is being borrowed. In actuality, the inventory is being converted to personal use. Some employees might use company assets to do personal work on the side that can lead to productivity issues. Even if the assets are not stolen, they are exposed to additional wear and tear that decreases their value.

Theft of Inventory and All Other Assets

Most inventory fraud schemes involve misappropriating inventory for personal use, stealing inventory and scrap, or charging embezzlements to inventory. Inventory is an asset that can be stolen by employees to sell to third parties. There are many ways to convert stolen inventory into cash. On method involves selling the inventory through an employee's personal business, at flea markets, or at garage sales to unknowing purchasers or co-conspirators.

Fixed assets are the company's property, plant, and equipment. Often, fixed assets are the targets of employee theft and unauthorized personal use. Fixed assets that are easily removed from the premises (such as tools and computers) are especially prone to employee theft.

Another common asset scheme is the unauthorized personal use of fixed assets by employees. This is especially true for fixed assets that are easily removed from the company premises. For example, the personal use of computers or company-owned vehicles can develop into a fraud or an abuse situation if the subject is not addressed. In addition, the loss of productive time might be more costly than the improper usage of the asset itself.

Detection of Noncash Asset Schemes

Detection methods for noncash asset schemes include:

- Perform physical counts of fixed assets, including computer software.
- Analyze depreciation schedules for unusual patterns.
- Compare fixed asset purchases for multiple years.
- Analyze salvage and scrap sales for unusual patterns.
- Review surveillance camera videos, if available.
- Perform trend analysis comparing cost of goods sold to sales.
- Conduct physical inventory counts on a periodic basis—a surprise inventory count is even more effective.
- Investigate significant discrepancies between physical counts and perpetual inventory (shrinkage).
- Conduct a historical analysis of inventory, looking for significant levels of shrinkage.
- Compare shipping addresses to employee addresses.
- Periodically reconcile shipments of merchandise to sales records, searching for instances where merchandise was shipped but no corresponding sale was booked.
- Look for sales that were canceled after shipment.
- Make sure all outgoing invoices match sales orders and look for signs of alterations on sales records.
- Perform trend analysis, looking for unusually high levels of inventory being designated as "scrap."
- Look for unusually high levels of re-orders for particular items, which could indicate that a particular item of inventory is being stolen.
- Ensure that the beginning balance for each month's inventory ties to the ending balance from the previous month.
- Determine that the dollar value of ending inventory is reasonably close to previous comparable amounts.
- Carefully review any unexplained entries in perpetual inventory records.
- Look for an increase in bad debt expense, which might indicate that an employee is creating fraudulent sales to account for stolen inventory.
- Perform price-testing procedures to ensure that the inventory unit costs have not been artificially inflated.

Corruption

Corruption is the wrongful use of influence in a business dealing to procure a benefit for the actor or another person, contrary to the duty or the rights of others. Corruption occurs in various forms, including bribery, kickbacks, illegal gratuities, economic extortion, collusion, and conflicts of interest. The recipients of these schemes range from a low-level clerk to a chief executive officer or a public official. Corrupt payments may be in the form of food and liquor or large cash payments. Whatever the situation, corruption creates an unhealthy situation for businesses.

Corruption is broken down into the following four scheme types:

- Bribery and kickbacks
- Illegal gratuities
- Economic extortion
- Conflicts of interest

Bribery and Kickbacks

Bribery and kickbacks are off-book frauds that occur in the form of payments, gifts, or gratuities to employees from contractors or vendors. They are classified as corruption schemes because they involve collusion between employees and vendors. These schemes usually involve the purchasing function of the victim company, since purchasing employees frequently have direct contact with vendors and therefore have an opportunity to establish a collusive relationship.

Bribery can be defined as the offering, giving, receiving, or soliciting of anything of value to influence an official act or business decision. *Kickbacks* are the giving or receiving of anything of value to influence a business decision without the employer's knowledge and consent.

Unfortunately, bribery and kickback schemes can be very difficult to detect. In a sense, the victim company is being attacked from two directions. Externally, a corrupt vendor submits false invoices that induce the victim organization to pay for goods or services that it does not receive. Internally, one or more of the victim company's employees waits to corroborate the false information provided by the vendor.

Illegal Gratuities

Illegal gratuities are something of value given to an employee to reward a decision after it has been made, rather than influence it before the decision is made. This crime is similar to bribery except that an illegal gratuity does not require proof of intent to influence the employee's decision-making. Instead of paying an employee to make a decision (e.g., award a contract), the vendor pays the employee *because* of a decision the employee previously made. Illegal gratuities are merely offered as a "thank you" for something that has been done. In proving an illegal gratuity, there is no need to show that the vendor intended to influence the employee's actions; it is enough to show that the employee accepted an award based on his performance.

Economic Extortion

Economic extortion occurs when an employee or official, through the wrongful use of actual or threatened force or fear, demands money or some other consideration to refrain from discriminating against a business decision.

Economic extortion is the opposite of bribery. Instead of a vendor offering payment to an employee to influence his business decision, the employee demands that the vendor pay him for favorable treatment or to avoid unfavorable treatment.

Conflict of Interest

A *conflict of interest* occurs when an employee has an undisclosed personal or economic interest in a transaction. These schemes involve self-dealing by an employee. These include:

- An agent taking an interest in a transaction
- That is actually or potentially adverse to the interest of the principal
- Without disclosure to the principal

A conflict of interest that causes actual or potential economic loss to the principal may be prosecuted criminally or civilly as a fraud.

Methods of Making Illegal Payments

In corruption schemes, the method of payment need not be money and often is not. Any tangible benefit given or received with the intent to corruptly influence the recipient may be an illegal payment. However, there are certain traditional methods of making illegal payments that fall into the following hierarchical pattern:

- Gifts, travel, and entertainment
- Cash payments
- Checks and other financial instruments
- Hidden interests
- Other methods

Gifts, Travel, and Entertainment

Most corruption schemes begin with gifts and favors. Commonly encountered items include:

- Wine and liquor (consumables)
- Clothes and jewelry for the recipient or spouse

- Sexual favors
- Lavish entertainment
- Paid vacations
- Free transportation on corporate jets
- Free use of resort facilities
- Gifts of the briber's inventory or services, such as construction of home improvements by a contractor

Cash Payments

The next step is usually cash payments. However, cash is not practical if large sums are required because significant amounts are difficult to generate and draw attention when they are deposited or spent. The use of currency in major transactions may in itself be incriminating.

Checks and Other Financial Instruments

As the scheme grows, illicit payments are often made by normal business check, cashier's check, or wire transfer. Payments are disguised on the books of the payer as some sort of legitimate business expense, often as consulting or referral fees. Payments may be made directly or through an intermediary (the well-known "bagman"), or they may be made through a series of such people, entities, or accounts.

Hidden Interests

In the latter stages of sophisticated schemes, the payer may give a hidden interest in a joint venture or other profit-making enterprise. The recipient's interest may be concealed through a straw or nominee, hidden in a trust or other business entity, or merely included by an undocumented verbal agreement. Such arrangements are very difficult to detect. Even if identified, proof of corrupt intent may be hard to demonstrate, particularly if the intended recipient produces some type of evidence of payment for his interest. (This may still leave the individual open to conflict of interest charges.)

Other Methods

The following are other common methods of making illegal payments:

- Loans
- Payment of credit card bills
- Transfers at other than fair market value
- Promises of favorable treatment

LOANS

Three types of loans frequently turn up in corruption and fraud cases.