

RED FLAGS OF INTERNAL FRAUD

PROFILE OF THE PERPETRATOR:

- Most frequently it is the person you trust the most
- Has the technical skills to pull off the theft secretly
- The activity is clandestine
- The activity violates the employee's fiduciary duties to the organization
- Initially, they intended to repay the money "borrowed"
- In the beginning, they usually kept track of the theft
- The theft was easier to commit after the first time
- The theft has been continuous
- Is currently experiencing a high level of stress (concern for the consequences)
- Recognizes they will never be able to repay the money
- The stolen assets are rarely recovered

BACKGROUND OF THE PERPETRATOR:

- Previously involved with issues of dishonesty
- Avoids taking vacation or sick time
- Insists on performing tasks that could be and should be performed by others
- Appear to be living beyond their means
- Recent change in lifestyle
- Feels their pay is not commensurate with responsibility
- Recently demoted, received disciplinary action, or believes their job is in jeopardy
- A wheeler-dealer attitude

- Excessive gambling or investment habits
- Strong challenge to beat the system
- Undue family pressure such as divorce
- Overwhelming desire for personal gain
- Jealous about the success of others
- Is experiencing financial difficulties, or has a high debt load
- Has close personal relationships with customers and vendors
- Brags about winning money gambling
- Secretive about their work
- Employee, or spouse, involved with a privately held business
- Unconfirmed suspicions about a drug or alcohol problem

METHODOLOGY:

- Altering documents
- Concealing or destroying evidence
- "False exculpatories" (lies)
- Voids and under-rings
- Swapping checks for cash
- Creating fictitious refunds and discounts
- False disbursements
- Kiting
- Skimming
- Improperly posting credits
- Borrowing against accounts receivable

- Creating fictitious Receivables
- Lapping
- Diverting or reselling scrap and excess materials
- Charging theft to inventory

PROFILE OF THE VICTIM BUSINESS:

- A company with 100 employees or less
- Has never taken any action to protect the company from internal theft
- Has not punished past acts of dishonesty
- Has not punished past acts of dishonesty
- Poor internal controls:
 - Lack of segregation of duties
 - Lack of physical safeguards
 - Lack of independent checks
 - Lack of proper authorization on documents and records
 - System permits overriding of existing controls
 - Inadequate accounting system
 - Does not monitor scrapped products or materials
- Employee posting cash receipts and accounts receivable responsible for collecting same

RED FLAGS

- Inventory counts are altered to match perpetual inventory
- Inventory shortages cannot be explained
- Differences in the physical and perpetual inventory charged to cost of sales

- False credits to inventory to conceal unrecorded or understated sales
- No source documents to justify inventory write-offs
- Returned merchandise not returned to inventory
- Unverified write-offs to accounts receivable
- Sales reports not matched to shipping documents
- Increased number of adjusting journal entries
- Shipping documents not matched to sales reports
- Expenses charged to petty cash have risen dramatically
- Refunds or charges to petty cash made without proper documentation or approval
- Incomplete or false customer information
- Sequentially number receipts or invoices are missing
- Employees receiving gifts from customers or vendors
- Customer always waits for favorite employee to serve them
- High number of altered or voided transactions

BUSINESS OPERATIONS:

- Shortages in inventory cannot be explained
- Variances in general ledger accounts cannot be explained
- Vertical analysis of profit and loss is unusual
- Increased cost of sales without explanation
- Diminishing cash and cash flow
- Increased accounts payable and receivable
- Increasing reclassification of income and expenses

DETECTION OF FRAUD:

- Investigate all customer complaints
- Compare receipts with deposits
- Reconcile all accounts monthly (entries and canceled checks)
- Review unusual endorsements on checks
- Perform surprise cash counts
- Compare credit memos by period
- Match shipping documents, sales invoices, and customer orders
- Match deposits between accounts
- Use the computer to analyze: missing invoices by number, numerical sequence of documents, sales volume by employee, or returned merchandise by employee
- Segregate incompatible duties, custody of assets and accounting for assets, and control over revenue and expenses
- Where segregation is not possible, diligently monitor
- Require two signatures for payments over a specified amount
- Insist the bank return canceled checks
- Insist two people reconcile bank statements
- Create the perception of detection
- Require authorization for disposing of assets
- Purchase Fidelity Coverage Insurance

INVESTIGATING SUSPECTED FRAUD:

- Do not react emotionally
- Do not reveal your suspicions to the perpetrator(s)
- Do not change operational procedures until suspicion is confirmed

- Protect any evidence (records) that could be destroyed
- Move quickly and quietly
- Retain competent, experienced counsel, certified fraud examiner, and auditor
- Do not believe the perpetrator will ever tell you the entire truth
- All employees involved with the dishonesty should be interviewed without notice
- Organization should decide upon the penalties, termination? Prosecution?
- Immediately protect Fidelity Insurance Coverage