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Red Flags for Fraud

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Red Flags for Fraud

Introduction

Why didn't you see it? There was fraud and you missed it. Conducting a “**should of**” after a fraud happens may show that red flags were present. If you had only recognized the warning signs, then that loss may not have occurred or been substantially reduced.

Based on a recent survey by the Association of Certified Fraud Examiners (ACFE), occupational fraud substantially increases organizational costs. It is a **myth** that fraud is a big scheme that should have been uncovered sooner and easy to detect. **Fraud starts small and just gets bigger and bigger, until something becomes noticeably different or unusual.**

What is Fraud?

Occupational Fraud is defined by the ACFE as:

“The use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.”

Fraud encompasses an array of irregularities and illegal acts characterized by intentional deception. The five elements of fraud are:

- A representation about a material fact, which is false,
- And made intentionally, knowingly, or recklessly,
- Which is believed,
- And acted upon by the victim,
- To the victim’s damage.

Fraud, like other crime, can best be explained by three factors:

- 1) A supply of motivated offenders;
- 2) The availability of suitable targets;
- 3) The absence of capable guardians or a control system to “mind the store.”¹

There are four elements that must be present for a person or employee to commit fraud:

- Opportunity
- Low chance of getting caught
- Rationalization in the fraudsters mind, and
- Justification that results from the rationalization.

Facts about Fraud

According to the ACFE Report to the Nation on Occupational Fraud and Abuse, U.S. businesses will lose an estimated \$652 billion in 2006 due to fraud. The average organization loses 5 percent of revenue to fraud and abuse. In addition, based on the ACFE’s survey of more than 1,100 occupational fraud cases, approximately 24 percent of these cases resulted in losses of \$1 million or more.

¹ Cohen and Felson 1979



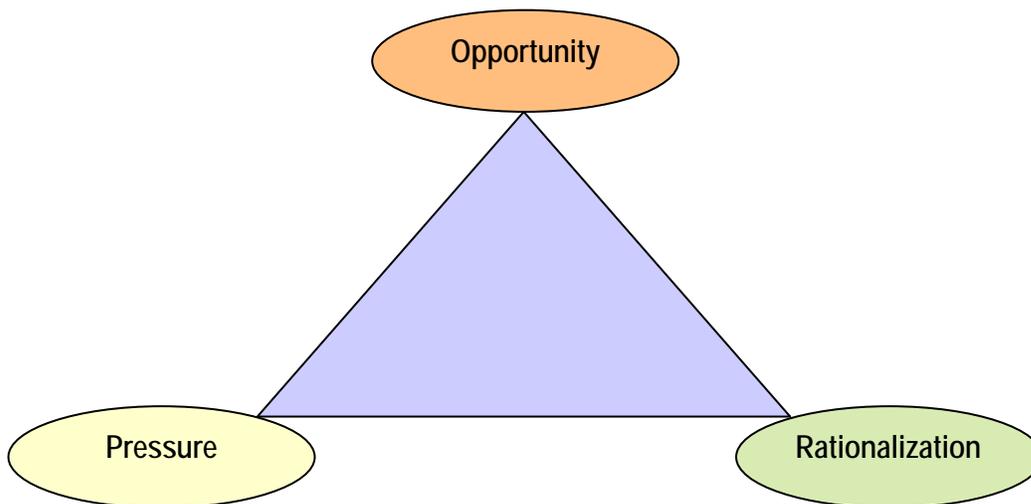
Red Flags for Fraud

The Fraud Triangle

The classic model for fraudsters continues to be *Other People's Money: A Study in the Social Psychology of Embezzlement*. The **Fraud Triangle** is a term, which is used to describe and explain the nature of fraud.

“I want something I don't have the money for”

While the specific components of each fraud may differ, the fraud triangle may be defined as this:



- ◆ ***Opportunity*** is an open door for solving a non-shareable problem in secret by violating a trust. Opportunity is generally provided through weaknesses in the internal controls. Some examples include inadequate or no:
 - Supervision and review
 - Separation of duties
 - Management approval
 - System controls

The opportunity to commit and conceal the fraud is the only element over which the local government has significant control.

- ◆ ***Pressure*** may be anything from unrealistic deadlines and performance goals to personal vices such as gambling or drugs.



Red Flags for Fraud

- ◆ **Rationalization** is a crucial component of most frauds because most people need to reconcile their behavior with the commonly accepted notions of decency and trust. Some examples include:
 - “I really need this money and I’ll put it back when I get my paycheck”
 - “I’d rather have the company on my back than the IRS”
 - “I just can’t afford to lose everything – my home, car, everything”

Factors Contributing to Fraud

Factors contributing to fraud include the following:

- ◆ Poor internal controls
- ◆ Management override of internal controls
- ◆ Collusion between employees
- ◆ Collusion between employees and third parties

How is Fraud Discovered?

Occupational fraud can be detected through a number of different methods. The ACFE’s 2006 Survey disclosed that 34.2 percent of frauds were detected through tips, 25.4 percent by accident, and 20.2 percent through internal audits.

What is a Red Flag?

A **red flag** is a set of circumstances that are unusual in nature or vary from the normal activity. It is a signal that something is out of the ordinary and may need to be investigated further. Remember that **red flags** do not indicate guilt or innocence but merely provide possible warning signs of fraud.

Why are Red Flags important?

The American Institute of Certified Public Accountants has issued a Statement on Auditing Standards (SAS) No. 99 - Consideration of Fraud in a Financial Statement Audit - that highlights the importance of fraud detection. This statement requires the auditor to specifically assess the risk of material misstatement due to fraud and it provides auditors with operational guidance on considering fraud when conducting a financial statement audit. SAS 99’s approach is also valuable for other types of audits.

Being able to recognize red flags is necessary not only for public accountants but also for any auditor working in the public sector where the potential for fraud to occur exists.



Red Flags for Fraud

Just keep in mind:

◆ **Do not ignore a red flag**

Studies of fraud cases consistently show that red flags were present, but were either not recognized or were recognized but not acted upon by anyone. Once a red flag has been noted, someone should take action to investigate the situation and determine if a fraud has been committed.

◆ **Sometimes an error is just an error**

Red flags should lead to some kind of appropriate action, however, sometimes an error is just an error and no fraud has occurred. You need to be able to recognize the difference and remember that *responsibility for follow-up investigation of a red flag should be placed in the hands of a measured and responsible person.*

Types of Red Flags and Fraud

Now that we have discussed what red flags and fraud are, it is time to talk about the types of red flags and fraud that, unfortunately, are common in the workplace today.

General Red Flags

What are the red flags that are common to most types of fraudulent activity?

Red flags that are common to most types of fraudulent activity can be categorized as **employee** and **management** red flags. Before we give you examples of employee and management red flags, it is important to understand more about employee and organizational profiles of fraud perpetrators. According to the 2006 ACFE survey of more than 1,100 occupational fraud cases, perpetrators have the following characteristics:

Fraud Perpetrator Profile:

- The majority of occupational fraud cases (41.2 percent) are committed by employees. However, the median loss for fraud committed by managers was \$218,000, which is almost three times greater than the loss resulting from an employee scheme.
- Approximately 61 percent of the fraud cases were committed by men. The median loss resulting from fraud by males was \$250,000, which is more than twice the median loss attributable to women.
- Most fraud perpetrators (87.9 percent) have never been charged or convicted of a crime. This supports previous research which has found that those who commit occupational fraud are not career criminals.
- Nearly 40 percent of all fraud cases are committed by two or more individuals. The median loss in these cases is \$485,000, which is almost five times greater than the median loss in fraud cases involving one person.



Red Flags for Fraud

- The median loss attributable to fraud by older employees is greater than that of their younger counterparts. The median loss by employees over the age of 60 was \$713,000. However, for employees 25 or younger, the median loss was \$25,000.

Organizational Profile:

- Most costly abuses occur within organizations with less than 100 employees.
- **Government and Not-for-Profit organizations have experienced the lowest median losses.**
- Management ignores irregularities.
- High turnover with low morale.
- Staff lacks training.

Employee Red Flags

- ⇒ Employee lifestyle changes: expensive cars, jewelry, homes, clothes
- ⇒ Significant personal debt and credit problems
- ⇒ Behavioral changes: these may be an indication of drugs, alcohol, gambling, or just fear of losing the job
- ⇒ High employee turnover, especially in those areas which are more vulnerable to fraud
- ⇒ **Refusal to take vacation or sick leave**
- ⇒ **Lack of segregation of duties in the vulnerable area**

Management Red Flags

- ⇒ **Reluctance to provide information to auditors**
- ⇒ Managers engage in frequent disputes with auditors
- ⇒ **Management decisions are dominated by an individual or small group**
- ⇒ Managers display significant disrespect for regulatory bodies
- ⇒ **There is a weak internal control environment**
- ⇒ Accounting personnel are lax or inexperienced in their duties
- ⇒ Decentralization without adequate monitoring
- ⇒ **Excessive number of checking accounts**
- ⇒ Frequent changes in banking accounts
- ⇒ Frequent changes in external auditors
- ⇒ Company assets sold under market value
- ⇒ Significant downsizing in a healthy market
- ⇒ Continuous rollover of loans



Red Flags for Fraud

- ⇒ **Excessive number of year end transactions**
- ⇒ High employee turnover rate
- ⇒ Unexpected overdrafts or declines in cash balances
- ⇒ Refusal by company or division to use serial numbered documents (receipts)
- ⇒ Compensation program that is out of proportion
- ⇒ Any financial transaction that doesn't make sense - either common or business
- ⇒ **Service Contracts result in no product**
- ⇒ **Photocopied or missing documents**

Changes in Behavior “Red Flags”

The following behavior changes can be “*Red Flags*” for Embezzlement:

- Borrowing money from co-workers
- Creditors or collectors appearing at the workplace
- Gambling beyond the ability to stand the loss
- Excessive drinking or other personal habits
- Easily annoyed at reasonable questioning
- Providing unreasonable responses to questions
- Refusing vacations or promotions for fear of detection
- Bragging about significant new purchases
- Carrying unusually large sums of money
- Rewriting records under the guise of neatness in presentation

Red Flags in Cash/Accounts Receivable

Since cash is the asset most often misappropriated, local government officials and auditors should pay close attention to any of these warning signs.

- ⇒ Excessive number of voids, discounts and returns
- ⇒ Unauthorized bank accounts
- ⇒ Sudden activity in a dormant banking accounts
- ⇒ Taxpayer complaints that they are receiving non-payment notices
- ⇒ Discrepancies between bank deposits and posting



Red Flags for Fraud

- ⇒ Abnormal number of expense items, supplies, or reimbursement to the employee
- ⇒ Presence of employee checks in the petty cash for the employee in charge of petty cash
- ⇒ Excessive or unjustified cash transactions
- ⇒ Large number of write-offs of accounts
- ⇒ Bank accounts that are not reconciled on a timely basis

Red Flags in Payroll

Red flags that show up in payroll are generally worthy of looking into. Although payroll is usually an automated function, it is a vulnerable area, especially if collusion is involved.

- ⇒ Inconsistent overtime hours for a cost center
- ⇒ **Overtime charged during a slack period**
- ⇒ Overtime charged for employees who normally would not have overtime wages
- ⇒ Budget variations for payroll by cost center
- ⇒ Employees with duplicate Social Security numbers, names, and addresses
- ⇒ **Employees with few or no payroll deductions**

Red Flags in Purchasing/Inventory

- ⇒ Increasing number of complaints about products or service
- ⇒ Increase in purchasing inventory but no increase in sales
- ⇒ Abnormal inventory shrinkage
- ⇒ Lack of physical security over assets/inventory
- ⇒ Charges without shipping documents
- ⇒ Payments to vendors who aren't on an approved vendor list
- ⇒ High volume of purchases from new vendors
- ⇒ Purchases that bypass the normal procedures
- ⇒ **Vendors without physical addresses**
- ⇒ **Vendor addresses matching employee addresses**
- ⇒ Excess inventory and inventory that is slow to turnover
- ⇒ **Purchasing agents that pick up vendor payments rather than have it mailed**

General Types of Fraud



Red Flags for Fraud

- ⇒ Lifestyle Fraud is often committed by trusted employees whom management know well, so it is important to be on the look out for employee lifestyle issues that may be “red flags” indicating a fraud risk.
- Some embezzlers are secretive. They don’t want to be caught and will “stash” stolen funds and be extremely careful with their spending.
 - Other “aspiring” embezzlers want to use, enjoy, share, and show off their fraudulently gained money. Explanations of “new found” wealth may include:
 - “My husband/wife just got a great promotion.”
 - “I have a few little investments that have been doing really, REALLY well.”
 - “Great Aunt Ethel passed away and I was totally surprised – she left us quite a nice little nest egg.”
 - “I finally decided to get rid of some property that’s been in the family for years.”

Fact: In many cases of fraud, perpetrators openly live beyond their means.

- ⇒ Lifestyle Problem Fraud deals with addictions. Someone who is dependent on drugs, alcohol, gambling or other addictions typically experience a slow tightening noose of financial pressures. Desperation fuels monetary needs and, therefore, the need arises to “borrow” funds to ease the financial dilemma. Employees with addiction problems may be tough to spot. Many people with addictions can function at fairly high or normal levels of behavior during work hours. Presented are a few patterns to look for:
- Absenteeism
 - Regular ill health or “shaky” appearance
 - Easily making and breaking promises and commitments
 - Series of creative “explanations”
 - High level of self absorption
 - Inconsistent or illogical behavior
 - Forgetfulness or memory loss
 - Family problems
 - Evidence of deceit (small or large)
- ⇒ Financial Pressures are faced by everyone at some period of time. For a number of reasons, perhaps beyond their control, employees may find themselves in financially stressful situations due to a variety of factors. These may include:
- Medical bills
 - Family responsibilities
 - A spouse losing a job
 - Divorce
 - Debt requirements
 - Maintaining a current lifestyle
 - Car repairs



Red Flags for Fraud

Obviously not everyone who faces undue pressure commits fraud, but the higher the stress level, the more distracted and desperate an employee may become.

Fact: Researchers conclude that the most common reason employees commit fraud has to do with motivation – the more dissatisfied the employee, the more likely he or she will engage in criminal behavior.²

Costly Types of Fraud

Some of the more costly types of fraud include but are not limited to:

- ◆ Financial Statement Fraud
- ◆ Check Forgery
- ◆ Credit Card Fraud
- ◆ Medical/Insurance Claim Fraud

Other Common Types of Fraud include but are not limited to:

- Falsifying timesheets for a higher amount of pay
- Pilfering stamps
- Stealing of any kind (e.g., cash, petty cash, supplies, equipment, tools, data, records, etc.)
- Forgery (not just check forgery, e.g. forging department head signatures on purchase orders)
- Lapping collections on customers' accounts (definition is on page 13 of the handout)
- Check Kiting (definition is on page 13 of the handout)
- Pocketing payments on customers' accounts, issuing receipts on self-designed receipt books
- Not depositing all cash receipts (deposits are not "intact")
- Creating fictitious employees and collecting the paychecks (impersonation)
- Failing to end personnel assignments for terminated employees and collecting the paychecks
- Paying for personal expenses with business funds
- Increasing vendor invoices through collusion
- Billing for services not rendered and collecting the cash
- Seizing checks payable to vendors
- Recording fictitious transactions on the books to cover up theft

² Journal of Accountancy February 2001



Red Flags for Fraud

- Conflicts of Interest
- Nepotism
- Breach of Duty
- Favoritism

Common Types of Fraud in School Districts

- Unreimbursed personal calls
- Personal purchases on the procurement card
- Inappropriate charges to a travel or account payable voucher
- Theft of inventory items
- Theft of cash from deposits
- Falsifying time card with time not worked

Other Fraud Danger Signals

- No supporting documentation for adjusting entries
- Incomplete or untimely bank reconciliations
- Increased customer complaints
- Write-offs of inventory or cash shortages with no attempt to determine the cause
- Unrealistic performance expectations
- Rumors of conflicts of interest
- Using duplicate invoices to pay vendors
- Frequent use of sole-source procurement contracts

Next Steps

Being aware of red flags is only step one and is usually not enough for the local government. Once a red flag is identified, you must take action to determine its effect. Evaluating the red flag may be accomplished by *financial analysis*, *observation* or by any other *technique* that tests an apparent weakness. Once the analysis is complete it's time to move on to correct the situation.



Red Flags for Fraud

What is the effect on the business at hand? Sometimes red flags that have no financial impact may not require a change in procedure. Remember though, that a red flag is a warning that something is or could be wrong. If you discover fraud, then an investigation is usually the next step. If it is just an error, then steps should be taken to correct the error and a procedure or follow up should be initiated to prevent it from occurring again.

Financial analysis has several applications when red flags are present. The most common is to determine what effect it has on the conduct of the local government. For example, what is the potential as well as the historical loss as the result of the red flag? What is the cost to prevent a potential loss from occurring and what will it cost to recoup the identified loss?

Computer programs have been developed that identify a red flag and can even quantify it. Computer red flags that have been used include:

- ⇒ Listing that compares actual vs. budgeted expenditures for employee reimbursements to determine unusual patterns
- ⇒ Duplicate or non existent Social Security numbers for employees or vendors
- ⇒ Taxpayer complaints
- ⇒ Unusual patterns of overtime payments

Direct **observation** is the method of choice to determine the effect a red flag has on an organization. For example, if analysis of overtime for an area suggests that one person is falsifying time cards, observing the person's start and stop times is important.

Observation is also useful when employee lifestyle changes are noted, or to get an understanding of how an area works. Does the employee in fact drive a new **Jaguar** on a salary that clearly wouldn't support it?

Whether it is **fraud** or an **error**, action should be taken to prevent the act from occurring again.

Reporting Fraud

In today's environment, it is essential that local governments have policies and procedures in place for reporting irregularities and/or suspected fraud. These policies and procedures need to be clearly communicated to all employees and reviewed periodically to ensure that they still make sense.

In addition to having policies and procedures in place, employees should be able to communicate red flags with the appropriate personnel without being concerned for their jobs or some type of retaliation. If possible, some type of anonymous form should be developed for employees to fill out. Just remember, the ACFE's 2006 Survey disclosed that approximately 34.2 percent of frauds were detected through **tips**.



Red Flags for Fraud

Conclusion

- ⇒ **Red flags are warnings that something could be or is wrong.**
- ⇒ **Auditors, employees, and management need to be aware of red flags in order to monitor the situation and then take corrective action as needed.**
- ⇒ **Employees who notice that red flags are ignored may mistakenly believe that it is okay to game the system or that they won't get caught.**
- ⇒ **A little fraud soon becomes a large one if left to grow.**



Red Flags for Fraud

Definitions Related to Fraud³

Check Kiting - In a kiting scheme, multiple bank accounts are opened and money is “deposited” from account to account, although the money **never** exists. Floating makes this possible. Floating is the additional value of funds generated in the process of collection and arises because the current holder of funds has been given credit for the funds before it clears the financial institution upon which it is drawn.

Defalcation is another name for employee fraud and embezzlement.

Direct effect illegal acts are violations of laws or government regulations by the company or its management or employees that produce direct and material effects on dollar amounts in financial statements.

Embezzlement is a type of fraud involving employees’ or non employees’ wrongfully taking money or property entrusted to their care, custody, and control, often accompanied by false accounting entries and other forms of lying and cover up.

Employee Fraud is the use of fraudulent means to take money or other property from an employer. It consists of three phrases: (1) the fraudulent act, (2) the conversion of the money or property to the fraudster’s use and (3) the cover up.

Errors are unintentional misstatements or omissions of amounts or disclosures in financial statements.

“Illegal Acts” (far removed) are violations of laws and regulations that are far removed from financial statement effects (for example, violations relating to insider securities trading, occupational health and safety, food and drug administrations, environmental protection, and equal employment opportunity).

Incentive/pressure is a motive a person experiences and believes is non-shareable with friends and confidants.

1. Psychotic: “habitual criminal” who steals for the sake of stealing.
2. Egocentric: Personal prestige, goal achievement.
3. Ideological: Cause is morally superior, justified in making other victims.
4. Economic: Desperate need for money, greed, economic achievement.

Irregularities are misstatements or omissions of amounts or disclosures in financial statements that are **NOT** unintentional.

Lapping is stealing one customer’s payment and crediting the customer’s account with the payment by another customer. The second customer’s account is later credited by yet a third customer.

Larceny is simple theft of an employer’s property that is not entrusted to an employee’s care, custody or control.

³ Auditing and Assurance Services, Tenth Edition, Jack C. Robertson and Timothy J. Louwers.



Red Flags for Fraud

Definitions Related to Fraud (cont'd)

Management Fraud is intentional misstatements or omissions of amounts or disclosures in financial statements.

Opportunity is an open door for solving the non-shareable problem in secret by violating a trust.

1. Weak internal controls
2. Circumvention of internal controls
3. The greater the position, the greater the trust and exposure to unprotected assets.

Predication is any information that gives a fraud examiner (or another person who informs the fraud examiner) a reason to believe a fraud occurred, may have occurred, or may be presently occurring. The information may come from an anonymous tip, from an employee noticing something wrong, or from an auditor noticing something suspiciously wrong.

Unimpeachable **integrity** is the ability to act in accordance with the highest moral and ethical values all the time. This is practically impossible, so fraudsters will **rationalize**:

1. I need it more than the other person.
2. I'm borrowing and will pay it back later.
3. Everybody does it.
4. The company is big enough that it won't miss it.
5. Nobody will get hurt.
6. I deserve it.
7. It's for the greater good.

White Collar Crime is fraud perpetrated by people who work in offices and steal with a pencil or a computer terminal. The contrast is violent street crime.