

The background of the slide features a grayscale image of several interlocking gears, creating a mechanical and industrial aesthetic. The gears are of various sizes and are positioned in a way that they appear to be meshing together, with some in the foreground and others receding into the background.

# **ETHICS & FRAUD IN THE BUSINESS ENVIRONMENT**

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# Fraud Statistics

?% of Revenue

- 5% of Revenue
- \$5 million sales = \$250 thousand per year

Association of Certified Fraud Examiners (2012)

# Definition of Occupational Fraud

- The use of one's occupation for personal enrichment
- through the deliberate misuse or misappropriation
- of the employing organization's resources or assets

# **Description of Fraud**

**Fraud is not an acute disease threatening the whole body. It is more like a virus that, will usually drain limited resources from the host, and is always ready to flare up when the opportunity arises. Like a virus, fraud is constantly mutating, and can, if left unchecked, become life-threatening.( Source Global Fraud report 2010 )**

# **Which Companies are Fraud Victims**

All companies and organizations but

“Small companies with less than 100 employees are 100 times more likely than larger companies to experience fraud from within”

Association of Certified Fraud Examiners



# **Small Versus large Corporations**

Average loss per instance of fraud in a small corporation is 20% larger than the average loss in a large corporation

# **2012 CFE Fraud Report**

- 4 out of 5 businesses have suffered from corporate fraud in the past 3 years
- 1 in 10 large companies lose over \$100 million a year from fraud
- Money spent on due diligence and preventive measures is far cheaper than the potential costs of doing nothing

# **2012 CFE Fraud Report**

- Asset Misappropriation – most common and longest duration of 2 to 3 years
  - Payroll
  - Billing Schemes (Paying fraudulent bills)
  - Cash theft
  - Expense reporting
- Corruption
  - Conflict of Interests
  - Kickbacks and other bribery schemes



# **Profile of Perpetrators**

- Older or Younger?
- Career Criminals?
- Employees, Customers or Suppliers?
- Management or low level employees?
- New or long time employees?

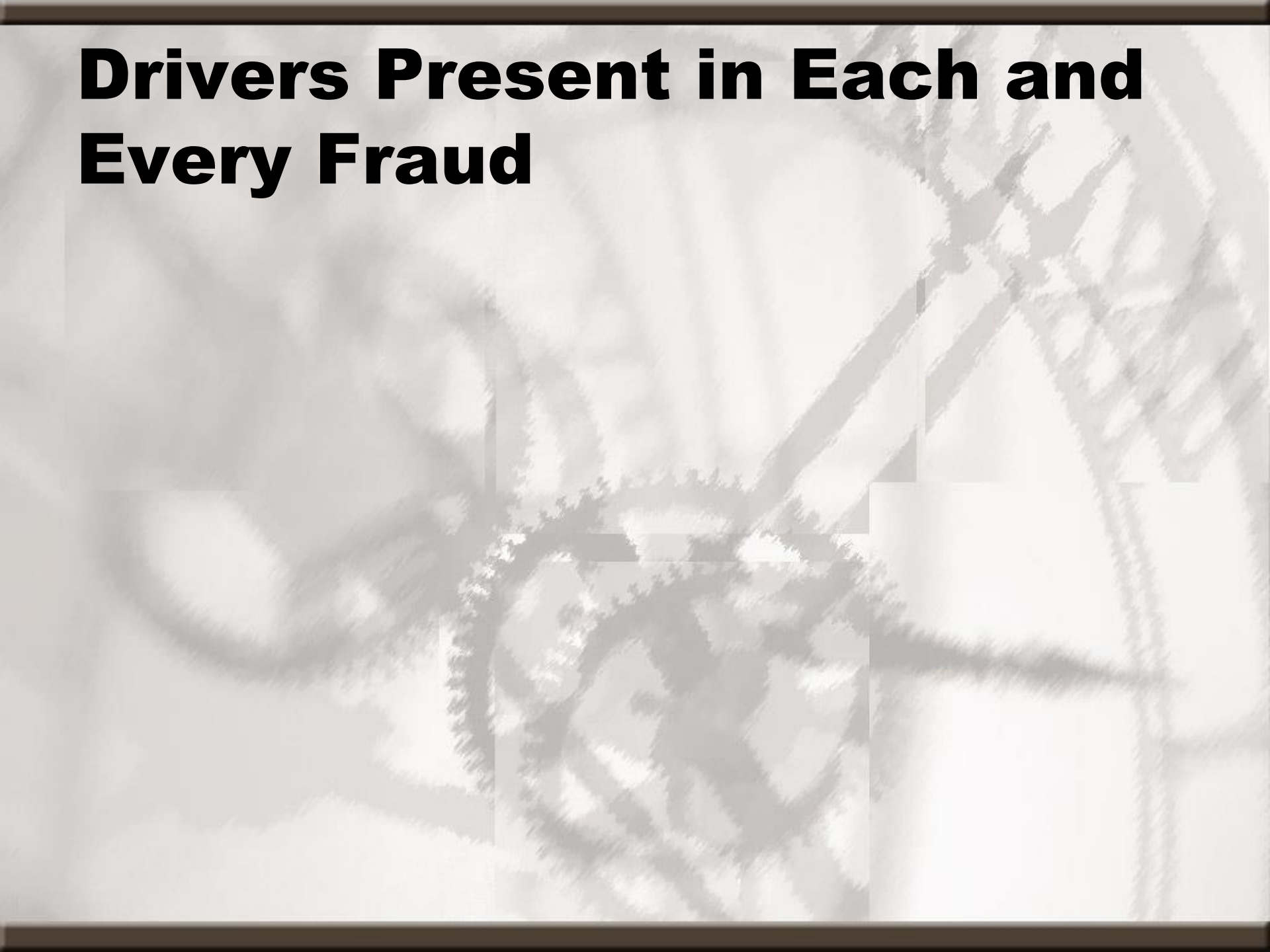
# **Profile of Perpetrators**

- 15% under age 30
- 70% between 30 and 55
- 80% first time offenders.
- 85% are employees
- Of which 85% are Management
- 13% worked < 2 years
- 22% worked >10years
- 68% acted on their own

# How are Frauds Uncovered

- 43% tips
- 7% by accident.
- 28% through internal audit and management reviews

# **Drivers Present in Each and Every Fraud**



# That Need

- Note those high spenders and employees living beyond their apparent means
- Pay employees fairly



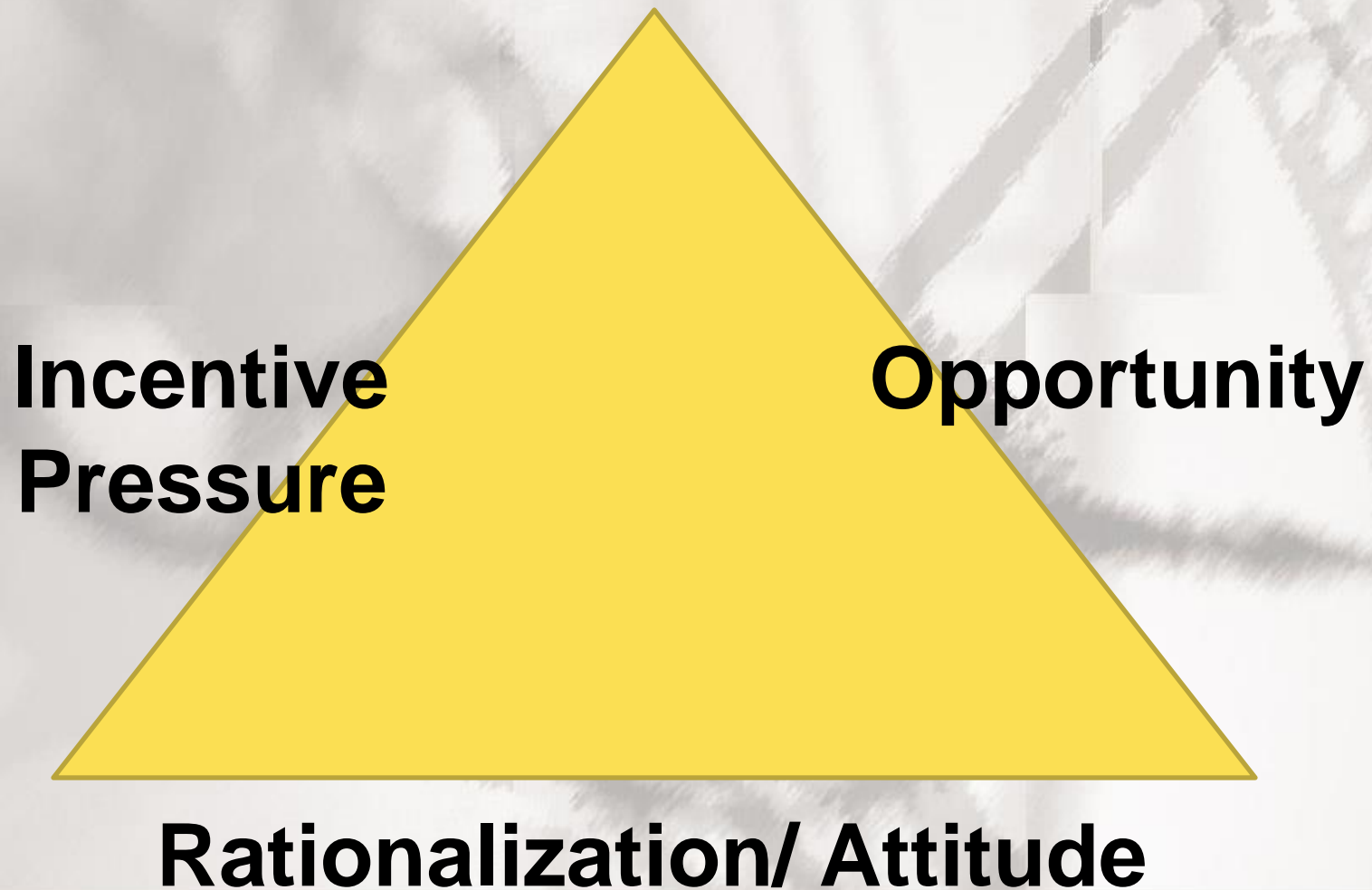
# The Opportunity

- If you make it easy you are inviting fraud
- The best defense is a strong system of internal controls
- Comprehensive Fraud & Ethics program with a hot line.

# The Rationalization

- The tone at the top is very important
  - If it is viewed as happening at the top then it is for sure occurring throughout the rest of the organization
- Note the disgruntled employees particularly those in positions of trust
- Prosecute those found, don't just fire them
- Note unusual behaviors (employees coming in early, always staying late, never taking vacations, doing their job at home even when sick)

# **Fraud Triangle**



# Ethics

- The choices that people consider to sway decisions.
- The choices that people consider to put things in the context of right and wrong.
- Those choices should weigh and consider the interests of all stakeholders and be based on truth, honesty and fairness
- It is the behavior displayed and expected in a corporation.
  - Should we disparage a competitors product true or false?

# Who are the Stakeholders?

- Shareholders / Donors / Investors
- Customers
- Employees
- Suppliers
- Competitors
- Governments
- Community
- Society as a whole &
- **You**



# Case – World Cup Tickets

- New contractor on \$5 million contract
- Get to know each other better
- World cup tickets and accommodation for you and significant other.
- Would you accept

# Questions to Answer

- Could it stand up to close public scrutiny?
- Have I considered the interest of all stakeholders?
- Am I unnecessarily harming others
- Does it make good sense?

# **BUSINESS ETHICS -10**

## **PRACTICAL GUIDELINES**

What should guide your relationship with people and employees – Trust & Honesty

1. Don't base your decision on what other people are doing. Be grounded in your own ethics and standards
2. You have been trusted. If your actions increase trust, yes. If they question trust, no.
3. Beware of emails. After you hit the send button they are public knowledge.
4. Beware of telephone conversations, they may be taped.
5. Assume someone is out to get you, so be squeaky clean.

# **BUSINESS ETHICS -10**

## **PRACTICAL GUIDELINES**

What should guide your business transactions

– Integrity & Fairness

6. The decision should always be to disclose rather than not to disclose.
7. If you will in any way personally benefit financially, lean towards no – be skeptical
8. If your involvement in a social activity would be good for business, pay for it yourself.
9. Assume that your decision will make the newspaper headlines next week.
- 10 Ensure that the headlines make your family proud of you.



# Building High Integrity Organizations

- The tone at the top, not just talking the talk but walking the walk.
- Developing a “Code of Business Conduct”
- Clarifying conflict of interest situations and making it clear to employees what is expected of them.
- Ethics Training
- Annual declarations by top executives that they have personally complied with the code and reviewed and discussed them with their direct reports.

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# **Building High Integrity Organizations**

- Majority of Board Members Should Be Independent
- Establishing an Audit Committee
- Establishing an “Ombudsman” a “Hot Line” or at a minimum a mechanism for employees to anonymously voice their concerns.
- On the one hand prosecuting employees who commit fraud.
- On the other hand recognizing and rewarding high ethical behavior.

# Corporate Governance

The framework by which the Board and Senior Management of organizations are held accountable for the operations of the institutions they oversee. The processes, customs, policies, laws and regulatory institutions affecting the way a corporation is directed, administered or controlled. The accountability and fiduciary duties of a Corporation's Board of Directors and Officers towards its stakeholders

- Shareholders / Donors / Investors
- Employees
- Customers
- Suppliers
- Community / Governments
- Society as a Whole

# Sarbanes/Oxley Act

- SOX raised the bar regarding corporate governance
- **Public Companies Accounting Oversight Board**
- Increased accountability of management of public companies
- More transparency
- Auditor independence
- Increase oversight of public accounting firms
- Enhanced White-collar Crime penalties (fraud corporate & criminal)
- Required the establishment of audit committees with members who are required to be financial experts. Frauds must now be reported

# **Sarbanes/Oxley Act Sec 302**

- CEO and CFO must
  - Prepare a statement certifying financial statements and disclosures



# **Sarbanes/Oxley Act Sec 404**

- **Management must**
  - Issue an annual assertion on the effectiveness of internal control over financial reporting
  - This involves documenting, evaluating and testing the key internal controls
- **External Auditors must**
  - Review and evaluate work performed by management
  - Perform some independent tests of controls
  - Issue a report on internal controls over financial reporting



# **How Companies Have Approached SOX Compliance**

- Identification and Documentation of Control Framework
- Bottom Up/Top Down Approach
- Key Controls and Costs of Testing
  - Preventive/Detective
  - Manual/Automated,
  - Frequency
- Importance of Control Definition

# The Importance of Internal Control

- This is the most important element in preventing and detecting fraud
- **Prevents**/acts as a deterrent to fraud. It reduces the “opportunity”. Frauds will occur when:-
  - There is a poor control environment or there is a breakdown in the controls
  - Someone has the ability to override established controls
- Ensures early **detection** of fraud
- A normal audit is not designed to detect fraud.
- Corporations should consider a periodic internal control review by IC/Fraud specialists.

# The Importance of Internal Control

- Internal control framework has to be specific to the particular business
- Controls are designed to both “**prevent**” and “**detect**” fraud
- **SOD** is perhaps the most important component in preventing fraud.
- Mandatory vacations
- **Reconciliations/Reviews** is often treated lightly and only done if time permits. However it is an extremely important component in detecting fraud
- Suspense accounts & reconciling amounts must be closely investigated. This is particularly true in financial institutions.

# **Factors that contribute to fraudulent activity**

- Weak internal controls
- Reconciliations not timely done
- Poor accounting practices
- Unqualified and untrained persons performing duties
- No policies or procedures



# **Factors that contribute to fraudulent activity contd.**

- Pressure on employees to deliver
- Overriding or by passing of controls
- Poor segregation of duties
- Disregard of audit recommendations
- No fraud prevention program



# Red Flags To Note

- People living beyond their means
- Unusual knowledge of the system
- Unexplained breaches of procedures
- In a position of trust and promoting fear
- Regular overrides by management
- Bypassing of the system
- Ability to deflect attention from activities
- Consistent top performer even in difficult times

# **Management's role in creating fraud and fraudulent activity**

- Pressure on employees to deliver
- Overriding or by passing of controls
- Abusive or poor management
- Encouragement of unethical behavior as long as success is the result
- Poorly designed job functions i.e. no separation of duties
- Disregard of audit recommendations
- Setting of unrealistic objectives
- No formal fraud prevention program
- No policy or procedures

# **IT best asset or worse liability in fraud prevention**

- IT security system based on stopping physical acts
  - Unauthorized access
  - Hacking
- IT audit activity not proactive
- IT focused on speed rather than controls
- IT controls do not focus on fraud prevention
- IT controls not configured to prevent bypassing
- IT only focused on computers and not other equipment e.g. card machines, copies
- Poor physical security around IT infrastructure

# Fraud Assessment Ratings

## Definition.

### IMPACT

Catastrophic	Major	Manageable
Affects, brand revenue and reputation. Investor confidence impacted long term effect	Affects revenue and maybe brand short to medium term effect	No serious effect on brand revenue or reputation short effect

### LIKELIHOOD

High	Medium	Low



# Overview & Wrap Up

- Prevalence of fraud.
  - More likely and larger in a smaller than large organization.
  - Money spent on prevention is much cheaper than the cost of fraud
- Typical fraudster
  - often the most “unlikely” person.
  - often the well liked dedicated employee.
  - first time offender
  - rationalizes his/her act
  - 85% are Employees of which 85% are ‘Management’
  - 3 Drivers: need, opportunity and rationalization
- Ethics
  - Its importance in corporate environment
  - Case discussions
  - 10 do’s and don’ts
- Corporate Governance
  - Increased accountability
  - More transparency



# QUESTIONS?



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**Fraudulent  
Statements**

**Financial**

**Non-  
Financial**

**Asset/Revenue  
Overstatements**

**Asset/Revenue  
Understatements**

**Employment  
Credentials**

**Timing  
Differences**

**Internal  
Documents**

**Fictitious  
Revenues**

**External  
Documents**

**Concealed  
Liabilities and Expenses**

**Improper  
Asset Valuation**

# Corruption

```
graph TD; Corruption --> Conflicts[Conflicts of Interest]; Corruption --> Bribery; Corruption --> Illegal[Illegal Gratuities]; Corruption --> Extortion[Economic Extortion]; Conflicts --> Purchases[Purchases Schemes]; Conflicts --> Sales[Sales Schemes]; Conflicts --> Other1[Other]; Bribery --> Invoice[Invoice Kickbacks]; Bribery --> Bid[Bid Rigging]; Bribery --> Other2[Other];
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**Conflicts of Interest**

**Purchases Schemes**

**Sales Schemes**

**Other**

**Bribery**

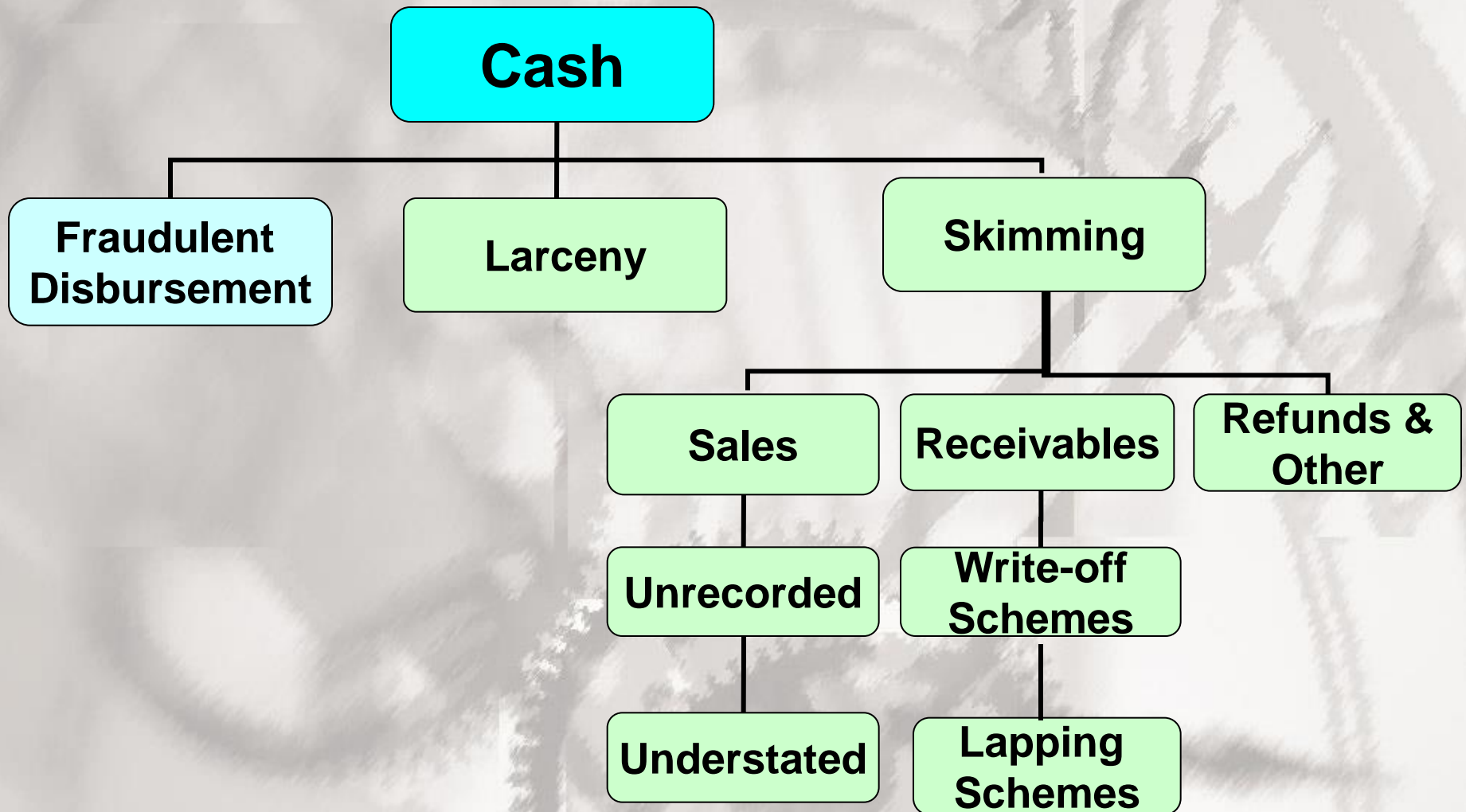
**Invoice Kickbacks**

**Bid Rigging**

**Other**

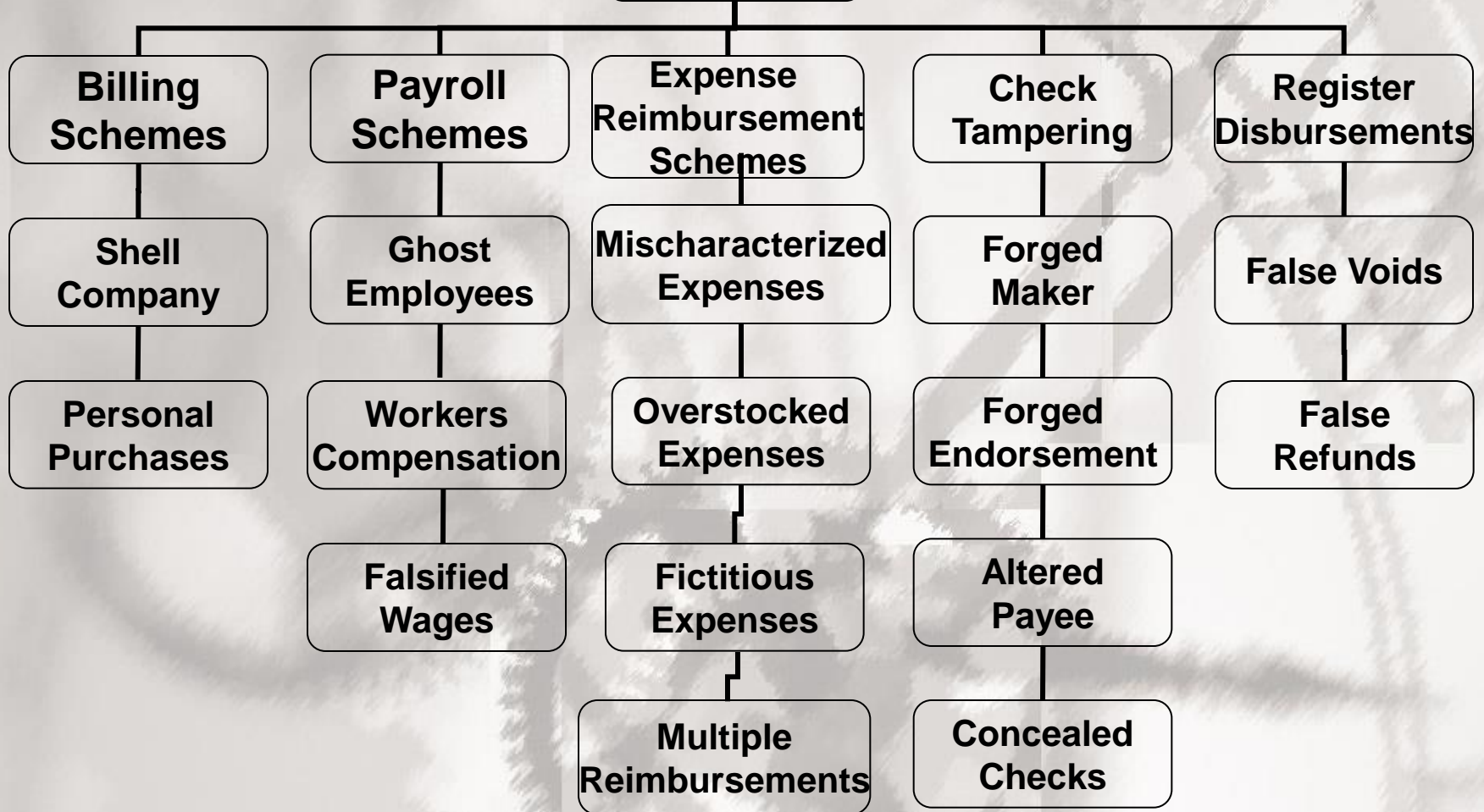
**Illegal Gratuities**

**Economic Extortion**





# Fraudulent Disbursements





# **Other Assets**

```
graph TD; A[Other Assets] --> B[Misuse]; A --> C[Larceny]; C --> D[Return Fraud]; C --> E[False Sales & Shipping]; C --> F[Asset Req. & Transfers];
```

**Misuse**

**Larceny**

**Return Fraud**

**False Sales & Shipping**

**Asset Req. & Transfers**