



RIMS '13 Annual Conference
Tuesday, April 23rd ● 10:15 - 11:30 AM

Occupational Fraud & Crime Insurance

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Agenda

- ❑ Occupational Fraud
 - Definition & Statistical Review
- ❑ The Fraud Triangle
- ❑ Profile of a Fraudster
- ❑ Risk Mitigation Techniques
- ❑ Other Considerations
- ❑ Crime Insurance
- ❑ Case Studies
- ❑ A Risk Manager's Perspective
- ❑ Q&A



Somebody once said that in looking for people to hire, you look for three qualities: Integrity, Intelligence, and Energy. And if they don't have the first, the other two will kill you.

Warren Buffett



*Desperate people do desperate things in desperate times.
We currently live in some desperate times!*



Occupational Fraud Definition & Statistical Review

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Occupational Fraud Defined

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

Occupational Fraud

All occupational fraud schemes include these 4 key elements:

- ❑ The activity is clandestine;
- ❑ The activity violates the perpetrator's fiduciary duties to the victim organization;
- ❑ The activity is committed for the purpose of direct or indirect financial benefit to the perpetrator; and
- ❑ The activity costs the employing organization assets, revenue, and/or reserves.

Occupational Fraud

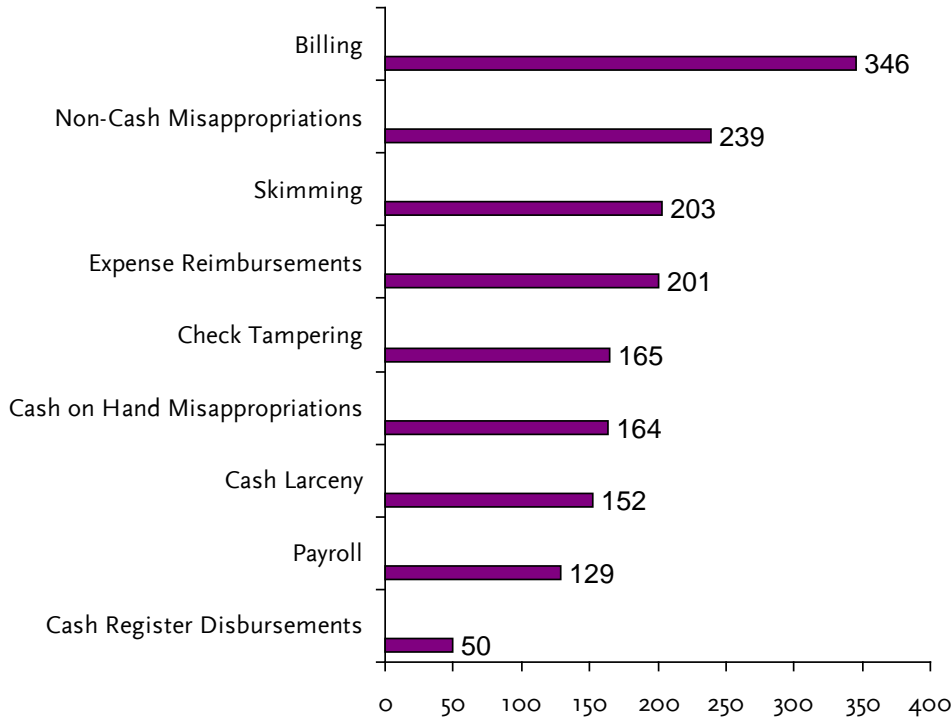
All occupational fraud falls into 3 categories:

- ❑ **Asset Misappropriations**, which involve the theft or misuse of an organization's assets.
- ❑ **Corruption**, in which fraudsters wrongfully use their influence in a business transaction in order to procure some benefit for themselves or another person, contrary to their duty to their employer or the rights of another.
- ❑ **Fraudulent Statements**, which generally involve falsification of an organization's financial statements.

Most Common Types

- ❑ **Embezzlement** - Siphoning of company money; Two methods:
 - Taking cash directly
 - Forging signatures on company or customer checks; deposit to own acct.
- ❑ **Phantom Vendors** - Working on own or in collusion
 - Employee sets up fake vendor, fake invoices, send payment to themselves
 - Partners w/ actual vendor to split money paid for no product/service
- ❑ **Vendor Kickbacks** - Business ends up overpaying for goods/services where vendor is providing payments back to employee to secure contracts
- ❑ **Padded Expense Accounts** - Charging the company for personal items or inflating the cost of legitimate expenses through fake receipts and/or lax protocols
- ❑ **Theft of Inventory** - Finished goods or raw materials “shrinkage” as employees take items home either to use or resell

Asset Misappropriation Schemes

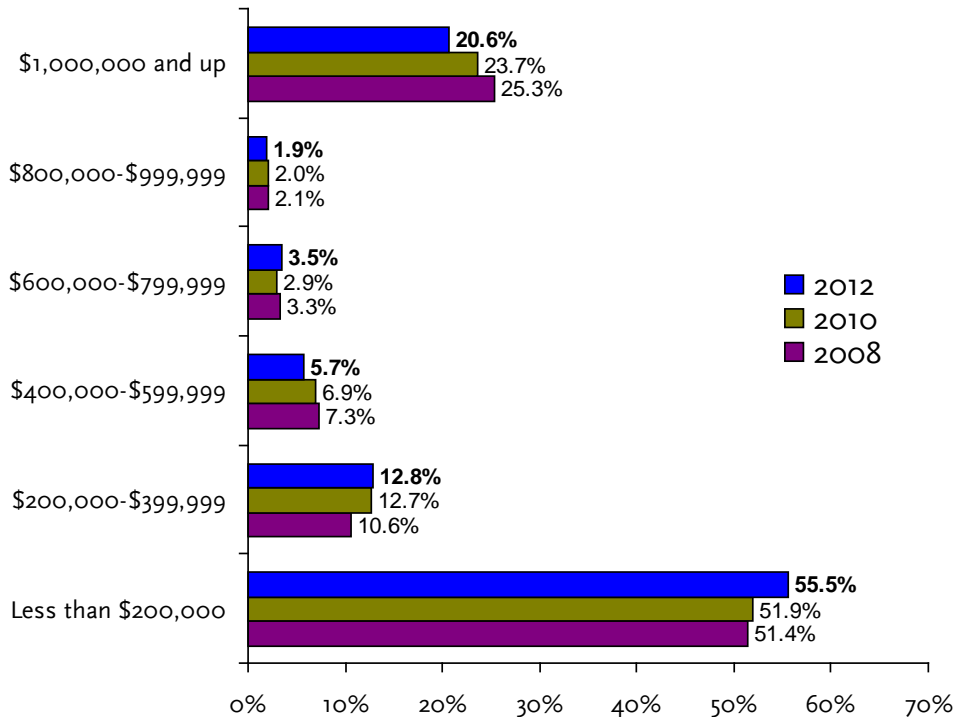


- The majority of asset misappropriation schemes focus on cash (approx. 87%)
- Frauds targeting noncash assets were both relatively common (17.2% of cases) and relatively costly (median loss of \$58,000)

Source: 2012 ACFE Report to the Nations

Fraud Statistics

Distribution of Dollar Losses



Source: 2012 ACFE Report to the Nations

- ❑ The median loss for all schemes was \$140,000
- ❑ More than 1/5 of all cases involved losses of at least \$1 million
- ❑ More than 60% of schemes caused the victim organization to suffer a loss of at least \$100,000

What Fraud Costs

1 in 10 reported losses on average of over \$ 5,000,000

+ Damage to staff morale	28% of cases
+ Damage to the brand	19% of cases
+ Damage to external business relations	19% of cases
+ Costs of dealing with the regulator	15% of cases
+ Damage to relations with the regulator	15% of cases
+ Damage to share value	2% of cases

Source: PWC 6th Biennial Global Economic Crime Survey, 2011

Losses are Going Unreported

- ❑ U.S. companies will lose 5% of their annual revenue to fraud. If this figure is applied to the GWP (Gross World Product) it equates to fraud loss of \$3.5 trillion.
- ❑ HOWEVER, global claimed net losses are typically a fraction of this number.
Why? They are not being reported.

Breakdown by Industry

Industry or Victim Organizations (Sorted by Frequency)			
Industry	# of Cases	% of Cases	Median Loss
Banking / Financial Services	229	16.7%	\$232,000
Government and Public Administration	141	10.3%	\$100,000
Manufacturing	139	10.1%	\$200,000
Healthcare	92	6.7%	\$200,000
Education	88	6.4%	\$36,000
Retail	83	6.1%	\$100,000
Insurance	78	5.7%	\$95,000
Services - Professional	55	4.0%	\$115,000
Religious, Charitable, or Social Services	54	3.9%	\$85,000
Services - Other	48	3.5%	\$150,000
Construction	47	3.4%	\$300,000
Oil and Gas	44	3.2%	\$250,000
Telecommunications	43	3.1%	\$135,000
Technology	38	2.8%	\$100,000
Transportation and Warehousing	36	2.6%	\$180,000
Arts, Entertainment, and Recreation	32	2.3%	\$71,000
Real Estate	28	2.0%	\$375,000
Wholesale Trade	27	2.0%	\$50,000
Utilities	24	1.8%	\$38,000
Mining	9	0.7%	\$500,000

- Banking / Financial Services has the highest number of cases
- Mining has the highest Median Loss (\$500,000)

Source: 2012 ACFE Report to the Nations

Departmental Breakdown

Department of Victim Organizations (Sorted by Frequency)			
Department	# of Cases	% of Cases	Median Loss
Accounting	293	22%	\$183,000
Operations	232	17.4%	\$100,000
Sales	170	12.9%	\$90,000
Executive/Upper Management	159	11.9%	\$500,000
Customer Service	92	6.9%	\$30,000
Other	79	5.9%	\$100,000
Purchasing	76	5.7%	\$200,000
Warehousing/Inventory	56	4.2%	\$67,000
Finance	49	3.7%	\$250,000
Information Technology	27	2.0%	\$100,000
Manufacturing and Production	25	1.9%	\$160,000
Board of Directors	19	1.4%	\$220,000
Human Resources	16	1.2%	\$121,000
Marketing/Public Relations	14	1.1%	\$165,000
Research & Development	9	0.7%	\$100,000
Legal	8	0.6%	\$190,000

- Accounting, Operations, Sales and Executives represents 64% of the cases.
- While frauds committed by those in the highest age groups were the most costly on average, over 54% of the frauds reported were committed by employees in the 31-50 age group.
- Most of the perpetrators were either employees (41.6%) or managers (37.5%), with owner/executives (17.6%).

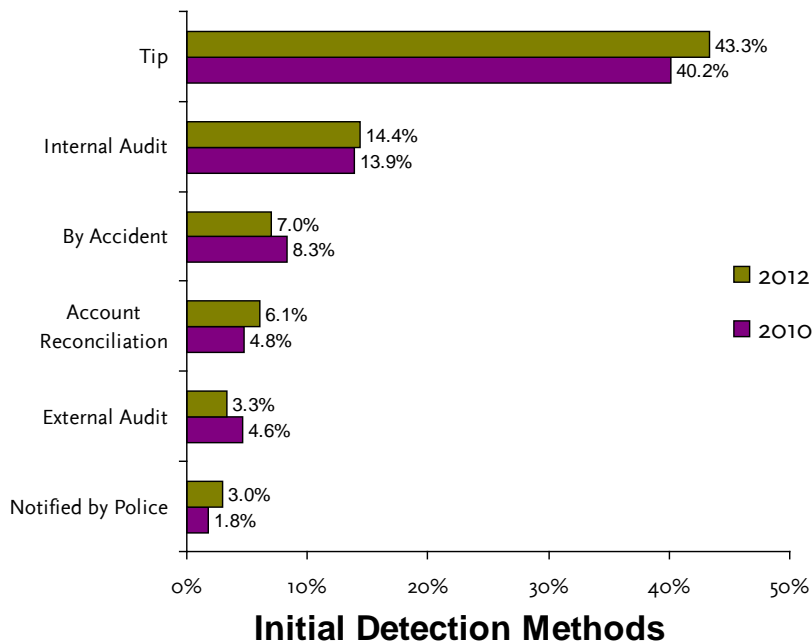
Source: 2012 ACFE Report to the Nations

Common Factors

3 most common factors allowing occupational fraud to occur:

- ❑ Lack/overriding of existing controls
- ❑ Absence of management review
- ❑ Inadequate internal/external auditing

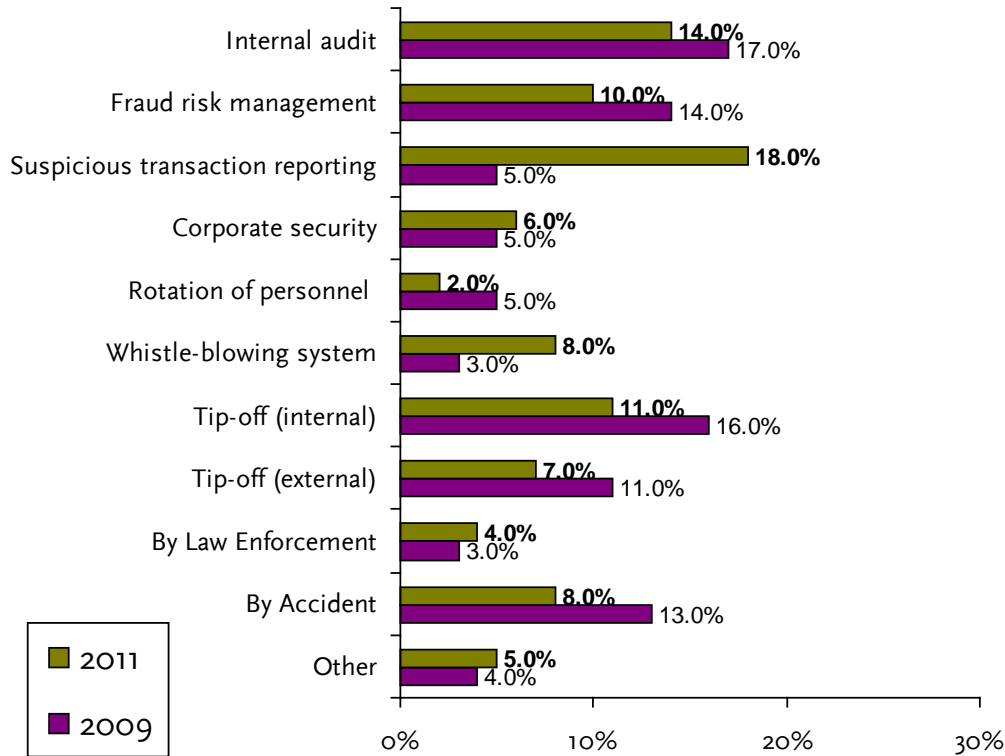
Initial Detection



- Nearly half of the cases were uncovered by a tip or complaint from an employee, customer, vendor, or other source.
- Tips have historically been the most common means of detection.
- The percentage of cases discovered by accident was lower than in 2010, while internal controls are credited with catching a larger number of frauds.

Source: 2012 ACFE Report to the Nations

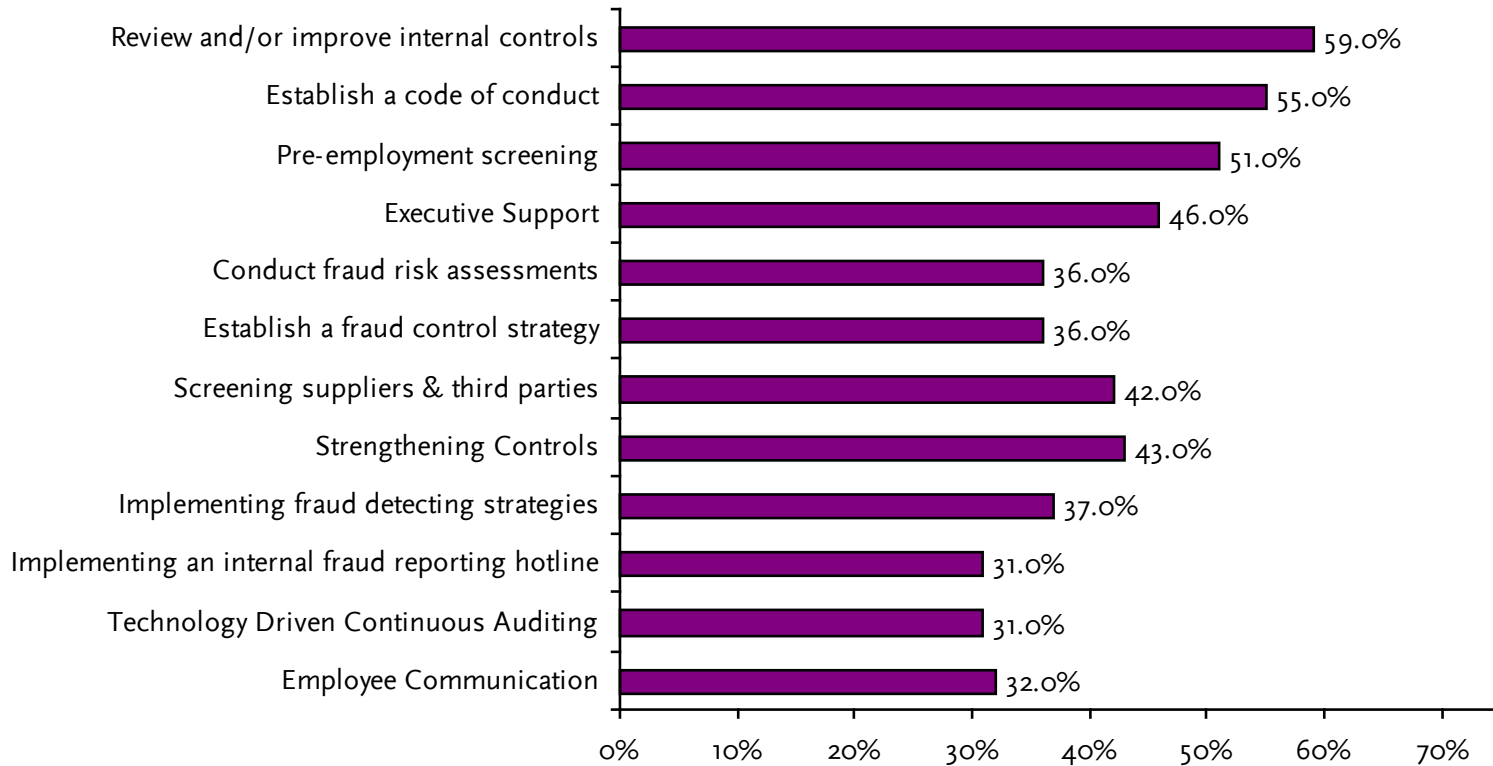
Detection – Another Perspective



Source: 6th PWC Biennial Global Economic Crime Survey, 2011

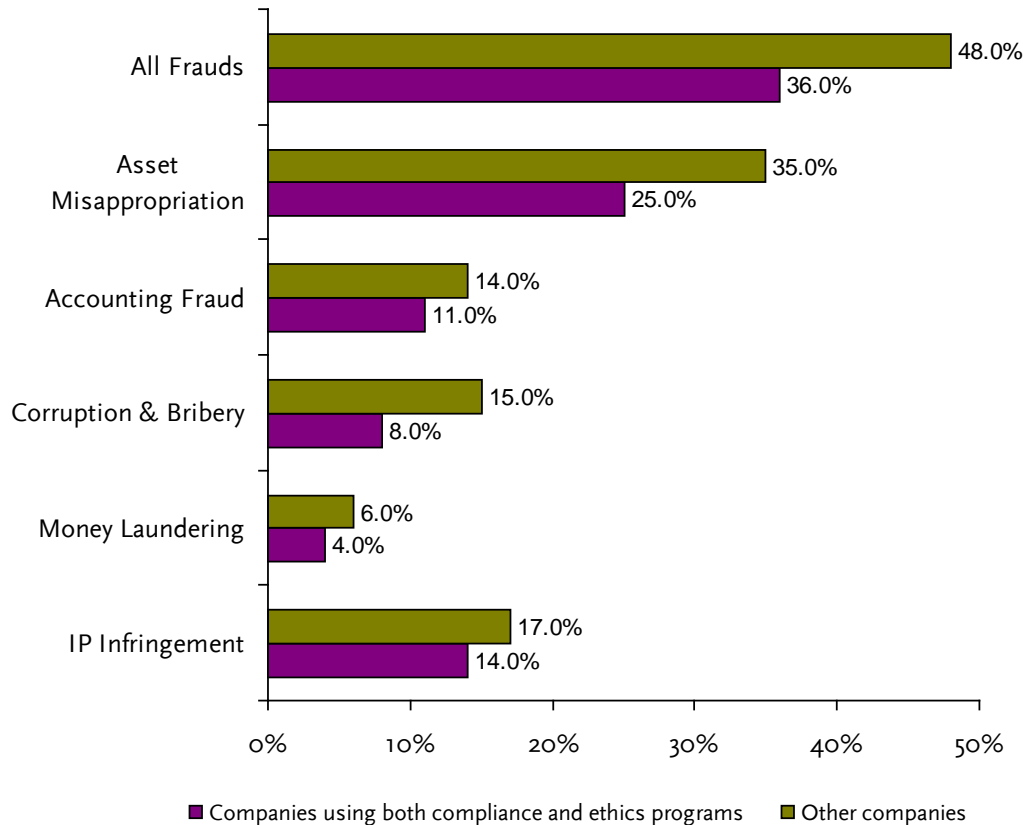
- ❑ Internal audit is able to detect approx. 14% of the cases (decreased from 2009)
- ❑ 26% of fraud detected through whistle blowing and tips
- ❑ Tip-offs are "by chance" detection method
- ❑ Taken on their own, no single control measure scores high
- ❑ If taken together with "culture" based mitigation methods, chances of detection are significantly higher.

Methods of Managing Risk



Source: KPMG Fraud Risk Management Survey, 2009

Effectiveness of Ethics/Compliance



- Organizations with both ethics and compliance programs report fewer economic crimes
- Keys to effective compliance and ethics programs:
 - Receiving professional advice on the right types of compliance and detection program(s)
 - Ensuring ethics guidelines are workable, livable and incorporate norms of criminal law

Source: PWC 5th Biennial Global Economic Crime Survey, 2009

Role of Corporate Culture

While company controls play a significant role in fraud detection and prevention, corporate culture can be equally important. For example:

- ❑ Setting the "tone at the top"
- ❑ Senior manager accountability
- ❑ Clear understanding of ethical guidelines, including staff training
- ❑ Attitude of "zero tolerance" toward fraud by all employees
- ❑ Loyalty towards company engendered by honest, fair, and transparent actions



The Fraud Triangle

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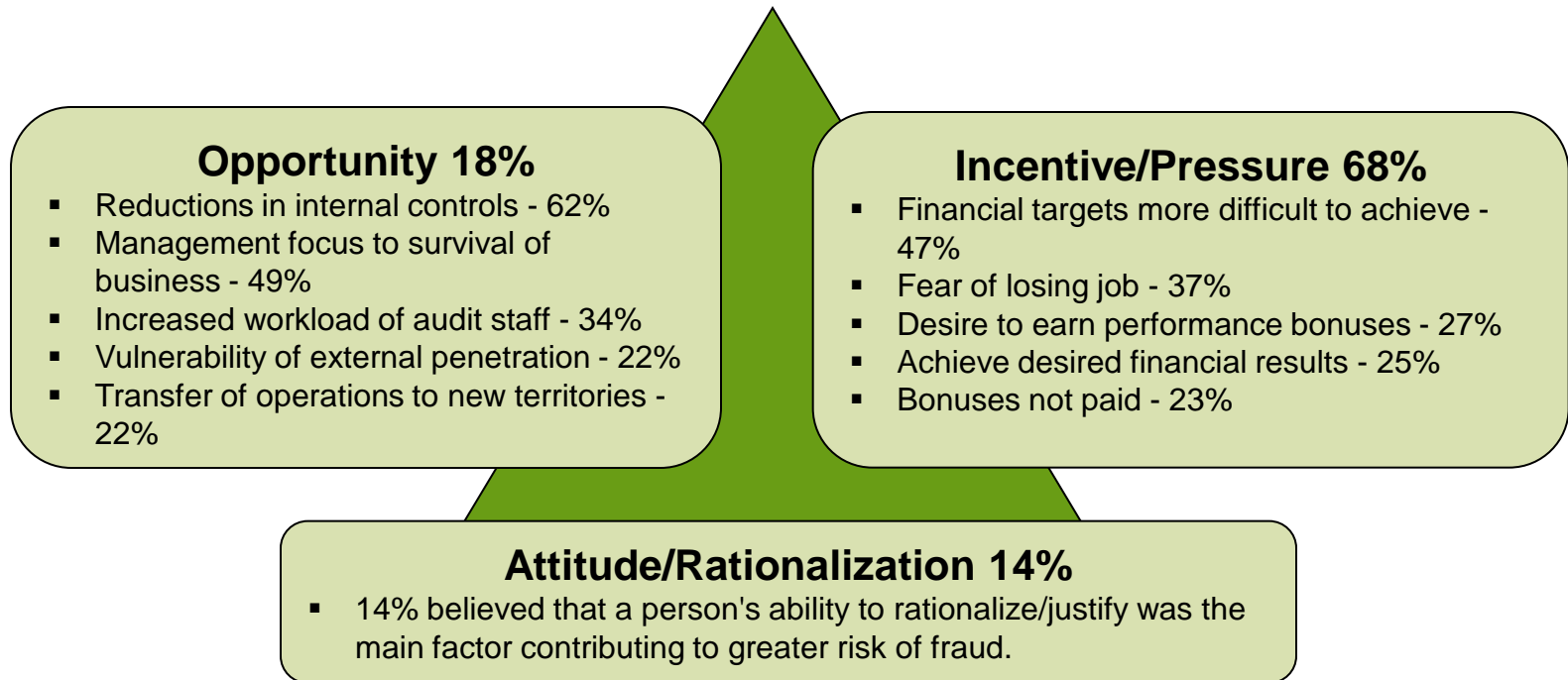
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The Fraud Triangle

Three conditions are present when fraud occurs:



Source: PWC 5th Biennial Global Economic Crime Survey, 2009



Profile of a Fraudster

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Profile of a Fraudster

- ❑ Globally, 25% of perpetrators are from senior management
- ❑ Been with the company for 7.5 years (average)
- ❑ 85% are male
- ❑ 44% are between the ages of 31 and 40
- ❑ 38% possess at least a bachelor's degree
- ❑ Most are risk takers, extroverts, decisive, career or success-oriented individuals
- ❑ Most act alone and are motivated by greed, addictions, revenge, or debt

Source: 2012 ACFE Global Report to the Nations

Recognizing the Warning Signals: Fraud Indicators

❑ Red Flags

- Behavioral and system-based clues that may be picked up by managers, colleagues, internal auditors, or subordinates which put them on notice that the individual concerned may be engaging in some form of improper or fraudulent conduct.

❑ Fraud Alerts

- Unusual aspects associated with documents or the way business is done that should put the person noticing them on guard that something is amiss.

Red Flags – For the Individual

United States — 876 Cases		
Behavioral Red Flag	Number of Cases	Percent of Cases
Financial difficulties	392	44.7%
Living beyond means	391	44.6%
Control issues, unwillingness to share duties	205	23.4%
Divorce/family problems	201	22.9%
Wheeler-dealer attitude	173	19.7%
Unusually close association with vendor	141	16.1%
Irritability, suspiciousness or defensiveness	127	14.5%
Addiction problems	124	14.2%
Past employment-related problems	85	9.7%
Past legal problems	75	8.6%
Refusal to take vacations	74	8.4%
Complaining about inadequate pay	64	7.3%
Instability in life circumstances	54	6.2%
Excessive pressure from within organization	51	5.8%
Excessive family/peer pressure	39	4.5%
Complaining about lack of authority	37	4.2%

Source: 2010 ACFE Report to the Nations

Red Flags – For the Business

- ❑ Company uses suspect financial partners, from banks to accountants
- ❑ Incomplete, missing, or non-standard documentation used in business dealings
- ❑ Suspect sham subsidiary companies/entities set up to conceal deception
- ❑ Track record of sloppy, secretive, or irregular accounting activity
- ❑ Non-adherence to company policies; Subordinates directed to bend/break rules
- ❑ Exclusive/preferred treatment, often under the guise of sole source contracts

Red Flags – For the Business

- ❑ Evergreen contracts (no end date or review)
- ❑ Previous complaints, allegations, or concerns over company/subsidiary/key employee conduct
- ❑ Conflicts of interest the norm rather than the exception
- ❑ Organizational absence or confusion about ethics
- ❑ Key individual and/or organizational due diligence comes back negative
- ❑ 25% or more of business with a single customer increasing moral hazards
- ❑ Performance based remuneration, i.e., results-at-all-costs attitude is pervasive; everyone knows the cost of everything but the value of nothing



Risk Mitigation Measures

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Best Practices in Loss Prevention

- ❑ Separation of Purchasing, A/P, Vendor Mgmt.
- ❑ Scrutinize processes/decisions continually
- ❑ Perform thorough background checks
- ❑ Evaluate Code of Ethics / Policies on Fraud
- ❑ Look at internal/external Audit Programs
- ❑ Leverage Sarbanes-Oxley work
- ❑ Educate Audit Committee and Boards

Best Practices in Loss Prevention

- ❑ Provide annual training programs
- ❑ Integrate fraud monitoring into an Enterprise Risk Management (ERM) program
- ❑ Implement a whistle blower policy
- ❑ Discuss SAS 99 with the external auditors
- ❑ Deploy technology solutions: Access controls, transaction monitoring, data access/mining

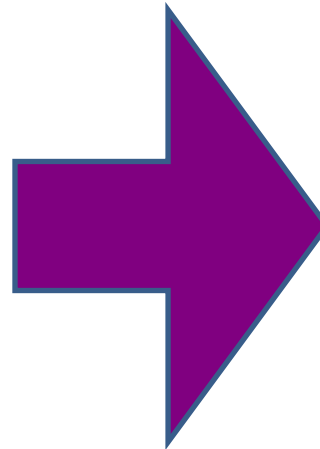
Due Diligence Investigations

- ❑ Corporate Records Review
- ❑ Accounting
- ❑ Tax Information
- ❑ Financial Information
- ❑ Legal Information (Civil/Criminal)
- ❑ Professional License Verification
- ❑ Media and Database Research
- ❑ Compliance with Laws
- ❑ Intellectual Property
- ❑ Products and Services
- ❑ Personnel Due Diligence
- ❑ Information Technology
- ❑ Insurance
- ❑ Operations
- ❑ Marketing
- ❑ Clientele
- ❑ Suppliers, Sub-Contractors, and Consultants
- ❑ Employees
- ❑ Competition
- ❑ Research and Development
- ❑ Worldwide Scan

Outcomes

Background Screenings / Due Diligence Investigations lead to:

- ❑ A more qualified workforce
- ❑ Reduced turnover
- ❑ Increased workforce productivity
- ❑ Enhanced workplace safety
- ❑ Decreased employer liability
- ❑ Reduced absenteeism
- ❑ Fewer human capital “uncertainties”



Which results in:

- ❑ Reduced human capital expenses
- ❑ More competitiveness
- ❑ Increased brand value
- ❑ Minimized risk
- ❑ Maximized profits

Key Points

- ❑ **Remember, most fraudsters have done this before**
 - Employee screenings and company/key employee due diligence is essential
- ❑ **Three part process in place for payment of vendor goods/services**
 - Contracting
 - Accounts payable
 - Inventory/purchase order
- ❑ **Most criminals have more time & money than we do to combat them**
 - Our goal should be to send them to a softer target
- ❑ **SOX 404/409 should have positive impact on control environments**
 - Not all entities subject to SOX; however lending institutions are increasingly requiring compliance
- ❑ **Setting the “Tone From The Top” is the key to establishing culture**
- ❑ **Deciding what's important...Show me what you measure and I'll tell you what you value**
- ❑ **Remember many frauds go unreported**
- ❑ **Complacency is one of our biggest enemies!**



Crime Insurance

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Why Crime Insurance?

Organizations lose 5%
of their annual revenue to fraud.

The Victims of Fraud

- ❑ Smaller organizations (<100 employees) are disproportionately victimized by fraud. These organizations are lacking anti-fraud controls.
- ❑ Industries most commonly victimized:
 - Banking/Financial Services
 - Manufacturing
 - Governmental/Public Administration Sectors
- ❑ Classification of Organizations
 - Private companies victimized more frequently
 - Public companies victim to the costliest schemes

Common Types of Losses

- ❑ Vendor Fraud
 - Billing Schemes
 - Ghost Vendors
 - Kickbacks
 - Largest and longest current running trend in crime losses
- ❑ Foreign Losses
- ❑ Check Schemes
- ❑ Payroll Schemes
 - Ghost Employees
 - Improper Overtime
- ❑ Expense Reimbursements
- ❑ Precious Metals
 - Copper wire / piping
 - Catalytic converters

Control Weaknesses

- ❑ Lack of Internal Controls
- ❑ Override of Existing Internal Controls
- ❑ Lack of Management Review
- ❑ Poor Tone at the Top
- ❑ Lack of Competent Personnel in Oversight Roles
- ❑ Lack of Independent Checks / Audits
- ❑ Lack of Employee Fraud Education
- ❑ Lack of Clear Lines of Authority
- ❑ Lack of Fraud Reporting Mechanisms

Corrective Measures

- ❑ Increased Segregation of Duties
- ❑ Management Review
- ❑ Surprise Audits
- ❑ Fraud Training for Employees
- ❑ Fraud Training for Managers / Executives
- ❑ Job Rotation / Mandatory Vacation
- ❑ Internal Audit / FE Department
- ❑ Anti-Fraud Policy / Code of Conduct / Hotline
- ❑ External Audit of Financial Statements

Evaluating a Risk – Key Controls

Key controls we look for / evaluate when underwriting a risk:

- ❑ CPA Audit
- ❑ Internal Audit
- ❑ Separation of duties
- ❑ Countersignature of checks
- ❑ Employee Screening – credit, background checks, prior acts of dishonesty
- ❑ Authorized Vendor List & Vendor Background Checks
- ❑ Are foreign operations/locations subject to the same controls as domestic operations/locations?
- ❑ Is there a precious metals exposure?
- ❑ Is IT properly utilized within the organization?

Evaluating a Risk – Loss History

- ❑ Loss details including size of loss, length of occurrence and details of how the loss occurred and how it was discovered
- ❑ Corrective measures
 - The Insured terminated the employee. Problem solved, right?
 - What did the Insured do to prevent this from happening again?
 - Were internal controls scrutinized and improved across the entire organization?



A Risk Manager's Perspective



Fraud in the CIT Industry

What stops an employee from stealing?

1. Integrity

2. Fear

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Fraud in the CIT Industry

Areas of CIT Industry Susceptible to Fraud (Ponzi, Pyramid, Shell)

- ATM's
- Currency Inventory
- Coin Inventory
- Others? (Payroll, Petty Cash etc.)

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Fraud in the CIT Industry

Who is in the best position to perpetrate a “cash loss” fraud?

- Employees with a Senior Position at branch – Branch Manager, Operations Manager, Cash Services (CMS) Manager, ATM Manager, Vault Manager, Supervisors, Leads.
- Employees with tenure (trusted) – Route employees, ATM Techs, Vault Tellers, FLM, Cash Services Tellers/Clerks, Office Administrators.
- New/probationary employees? Mechanics? Janitorial?

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Fraud in the CIT Industry

Manager Fraud Characteristics:

- Could be a Manager, Supervisor, Lead
- Need or Greed to solve a problem
- Does not stop....
- Has a significant period of loyal service prior to fraud
- Usually commits fraud over 2-3 year period.
- In position to change business practices, policies
- In position to influence subordinates
- Has subordinates contribute to fraud (unknowingly)
- No Redundancy in position
- Has unexplained financial gain

Potential Indicators:

- Makes irregular request of subordinates
- Performing work normally done by subordinate
- No succession plan – won't train replacement
- Limited or no vacation/sick time
- Considered trustworthy by company
 - Uses trust to – disable controls designed to detect fraud
 - Increases privileges to learn weakness in system
 - Discourages or instructs employees not to use integrity call in programs
- Ensures fraud losses are low to avoid detection/investigation (Low & Slow)
- No Losses (Examples – ATM, Strap Shortages)
- Higher than average profit / bonuses

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Fraud in the CIT Industry

Lower level/Tenured Employees:

- Has access to funds.
- Highly Trusted – Always willing to help
- Starts/continues fraud because of outside partner or collusion with other employee
- Need or greed
- Normally commits fraud over 18 months.
- Is suspected by co-workers

Potential Indicators:

- Position allows single access to funds or reports
- Works in restricted area environment
- No or limited Vacation/Sick Time
- May be under the control of someone outside the company (spouse/family member/friend)
- Covers fraud with less sophisticated methods
- May use “Low & Slow” approach

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Fraud in the CIT Industry

“Low & Slow Approach”

- Greater Potential for loss over longer period of time
- Can Reduce the potential of detection
- Gives Multiple opportunities to detect fraud

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Fraud in the CIT Industry

CMS / Financial Services - Inventories

Common with all frauds “Insiders” pose the greatest threat (Knowledge & Access)

- **Appears to be Loyal/Content but probably is a disgruntled Employee (Examples)**
- **Current or Former Employee (Friend)**
- **Contractor (Coin)**
- **Outsider/Customer with access to company system (third party CIT?)**

Goal - to make “short” inventory appear “in balance” to company, customer, & auditors. Ensure when fraud is discovered paperwork trail does not point to the employee who perpetrated fraud or can be used to prosecute employee.

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Fraud in the CIT Industry

Coin Inventory Fraud Methods:

- Delayed reporting of in bound deposits that have already been processed and added to inventory.
- Delayed reporting of in bound shipments (FRB,CCV) that have already been added to inventory
- Out of sequence reporting of in bound shipments (FRB,CCV)
- Delayed transfers between departments / branches / Coin Vendors
- Mixed coin on skids (Nickels for Quarters)
- Short bags on skids (1/2 bags for full bags)
- Staged Customer Audits
- False increase of coin inventory and reduction of currency inventory
- Removal of notes from straps after teller verifies deposit in balance.

Potential Indicators:

- Customer complaints of delayed credit to account
- FRB / Cash Vault escalation that inbound shipment has not been posted.
- FRB / Cash Vault escalation that inventory records are over or short.
- Branch not reporting/balancing on system of record (Excel, yellow pad etc.)
- Coin in canvas bags
- First in / First out not in place
- Commingled Inventory
- Customer does not confirm coin balance separate from currency balance.
- “In transit” shipments/transfers not properly listed on reports
- Increase in unexplained nominal shortages

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Currency Inventory Fraud Methods:

- Delayed reporting of in bound deposits that have already been processed and added to inventory.
- Delayed reporting of in bound shipments (FRB,CCV) that have already been added to inventory
- Out of sequence reporting of in bound shipments (FRB,CCV)
- Delayed preparation of outbound shipments
- Inventory reporting to multiple locations that does not match.
- Offsite / E-cash inventories double counted

Potential Indicators:

- Customer complaints of delayed credit to account
- FRB / Cash Vault escalation that inbound shipment has not been posted.
- FRB / Cash Vault escalation that inventory records are over or short.
- Customer complaint order not received
- Inventory not segregated in storage bins
- “In transit” shipments/transfers not properly listed on reports
- Branch system of record does not balance with customer system (ICOM, Adios, etc.
- Physical on site audit does not match what is reported to customers

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Fraud in the CIT Industry

Counter Measures

- Dual Custody / Control
- Separation of Duties(Prep, Deposit Verification, Inventory Count, Inventory Balance)
- Random Internal Audits
- Third Party Audits
- Customer Confirmations
- Track customer audits
- Honesty/Integrity Lines
- Others?

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Fraud in the CIT Industry

ATM Fraud Methods:

- Move portion of inbound ATM currency order to outbound residual ATM deposit
- Move portion of ATM currency to another ATM
- Input incorrect load figures/improper settlement
- Set up cross-load
- E-cash from one customer used to fill another customers ATM
- ATM “Slush” fund

Potential Indicators:

- Locations located in secured/controlled environment requiring a special clearance/badge. (SIDA-Airport, Defense Contractors)
- No ATM shortages/overages ever recorded at branch
- No ATM claims received from customers.
- Techs that do not take multiple days or full week off either sick/vacation
- Employee over eager to help all the time
- Employee over reacts to unscheduled change in assignment
- Employee will not train replacement in special ATM work

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Fraud in the CIT Industry

Counter Measures

- Random switch of ATM Crews (Sick Call – Vacation coverage does no count)
- Random audit of ATM (All ATM's including one located in restricted access areas)
- Auditable lock review
- Random testing of source cash
- Random CCTV review of ATM order prep/verification
- DNA marking / employee search
- Set up Theft Matrix (List all employees who handle currency during cycle of loss)
- Integrity/Honesty Line

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Case Studies

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Case Studies

Lack of Compliance to Existing Controls:

- ❑ Dual control not followed in vault operations
- ❑ Manager a star performer, had to be doing everything right?
- ❑ Manager left un-supervised by management do to location
- ❑ Cost millions of dollars

Case Studies

Dual Controls Must Be Enforced

A twenty-year hospital employee stole \$2,400,00 over two years by creating false accounts payable checks to fictitious hospital patients. She created fictitious patient names for accounts payable forms for patient refunds. She requested that the checks be brought back to her. She forged the patients' names on the back of the check, signed her own name, and deposited the checks in a bank account. The investigation found that a supervisor reviewed the checks. Some of the checks were initialed by the supervisor, but the supervisor never questioned the employee, who was well liked in the hospital's Accounting and Finance office.

Case Studies

A Case For Mandatory Vacations

One employee successfully “lapped” cash receipts for twenty-nine years at a cost of over \$9,500,000! Extending over the employee’s entire career with the company, the scheme was discovered only when the employee retired. The employee had access both to cash receipts and to the records establishing accountability for the receipts. The employee withheld checks from accounts receivables collections. He then took cash from later collections and covered the theft by crediting the previously withheld checks to the accounts of the customers who had paid cash. Later receipts were credited to the accounts of the customers who had sent in the first batch of checks, and so on.

Lapping requires continuous close attention. If misapplied receipts are not covered quickly, the customer receives a past-due notice and complains, and the scheme is undone. The thief must keep track of normal delinquencies and be prepared to deal with plant closings, strikes, market problems, and business disruptions of all kinds. This trusted employee was noted for his diligence. He never required help and never took a long vacation.

Q&A

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Thank You!