

WILEY CORPORATE F&A



Includes
SOFTWARE DEMO

CORPORATE FRAUD AND INTERNAL CONTROL

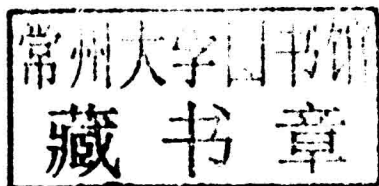
A Framework for Prevention

RICHARD E. CASCARINO

Corporate Fraud and Internal Control

A Framework for Prevention

RICHARD E. CASCARINO



John Wiley & Sons, Inc.

Copyright © 2013 by Richard E. Cascarino. All rights reserved.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 646-8600, or on the Web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at <http://www.wiley.com/go/permissions>.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books. For more information about Wiley products, visit our web site at www.wiley.com.

Library of Congress Cataloging-in-Publication Data

Cascarino, Richard.

Corporate fraud and internal control : a framework for prevention/Richard E. Cascarino.

p. cm.—(The Wiley corporate F&A series)

Includes bibliographical references and index.

ISBN 978-1-118-30156-2 (cloth); ISBN 978-1-118-41980-9 (ebk);

ISBN 978-1-118-42172-7 (ebk); ISBN (eMobi) 978-1-118-43402-4 (ebk)

1. Fraud—Prevention. 2. Auditing, Internal. I. Title.

HV6691.C38 2013

658.4'73—dc23

2012022692

Preface

DATING BACK TO 3500 BC, records of various civilizations indicate by patterns of checks and ticks that record verification took place. In ancient Egyptian, Greek, Chinese, and Roman civilizations, rulers sought to confirm official records by comparing two sets of such records. The lowest-ranking magistrate in ancient Rome was a *quaestor*, or investigator. This elected official traditionally worked within the treasury to supervise the financial affairs of the empire.

Accuracy of records was tested, typically by two officials working together. One official read from the one record sheet and the other checked against the other record sheet. The term “auditor” is derived from the Latin *auditus*, meaning a hearing.

With the fall of the Roman Empire, auditing and internal control disappeared in Europe. It was not until the Middle Ages that the growth of centralized control once again demanded proof of the adequacy and correctness of record keeping and the prevention of the defrauding of the king.

In the Orient, however, audit can trace its ancestry back to the Western Zhou Dynasty some 3000 years ago, in which it continued in various forms until the Song Dynasty in 992AD when a “royal audit court” was established. Audit in China took the form of Inspectorates until the Revolution of 1911 when an Audit Court was established, a Chamber of Audit set up, and Audit Law was issued. Auditing continued until the founding of the People's Republic of China in 1949 when audit was conducted by internal supervision within the Departments of Public Finance.

In 1982, the Constitution of the People's Republic of China was promulgated resulting in the 1983 formation of the National Audit Office of the People's Republic of China.

Today, capital markets, which have been rocked by recent corporate scandals and frauds on an international scale, are demanding that financial organizations, publicly listed companies, multinational companies, and the public

sector implement sound corporate governance. Large-scale fraud has severely eroded investor confidence; in many cases, investors are simply waiting for the next large fraud to be announced.

In the past, many organizations, companies, and government bodies have operated in a purely reactive mode to the problem of fraud. That is, only after a fraud had taken place were decisions made regarding how to combat it. With the increasing impact of corporate governance legislation and the changes in society of recent years, the need to fight fraud in a proactive manner has become paramount.

Companies now must accept their corporate responsibility to protect assets and employees from the temptations and impacts of fraud.

At the individual level, fraud is impacting every citizen, either directly through being defrauded or indirectly through the impact of higher taxation or shopping bills. Individual fraud is also creating an atmosphere in which individuals feel cheated and defrauded, and that they have the right to retaliate by cheating and defrauding others.

Police services are under increasing pressure to combat all types of crime, particularly violent crime. As a result, often white-collar crime, corruption, and fraud are treated as the “poor relation” at the low end of the resources chain and receive priority only in egregious cases when they become front-page news in the newspapers.

As a result, organizations have no choice but to develop plans and strategies to deter, detect, and, where required, prove fraud utilizing their own in-house control mechanisms and systems of internal control.

This book addresses the roles of the board and its management and audit committees in implementing a system of internal controls that adequately defends against fraudulent and corrupt practices both within the organization and against it. The book itself consists of 12 chapters.

Chapter 1, “Nature of Fraud,” introduces fraud and irregularities, covering the elements of the crimes of theft and fraud as well as the nature and cost of fraud. It includes the basics of fraud and financial irregularities and defines fraud and prejudice resulting from fraud. It also presents general safeguards to make fraud in commerce more difficult, and ways to seek redress from fraud perpetrators.

Chapter 2, “Elements of the Crimes of Theft and Fraud,” explores how fraud and conventional theft differ legally. It also helps identify the principal control elements required to reduce the likelihood of a fraud occurring and its impact, should it occur, and to increase the probability of early detection in the event of an occurrence.

Chapter 3, “Frauds Against the Individual,” identifies specific types of fraud against the individual that, left unchecked, may increase the probability of a loyal employee turning against the employer in desperation. It also identifies corporate responsibility in educating employees against potential fraud attacks against them personally.

Chapter 4, “Frauds Against the Organization,” helps readers recognize specific types of fraud against the organization, their red flags, and the failure or lack of internal controls that expose organizations to such attacks. It also differentiates between internal frauds carried out from inside the organization against the interests of the organization, and external frauds carried out against the organization from an external source with or without the cooperation of current employees.

Chapter 5, “Fighting Corruption,” identifies areas of vulnerability within the organization that expose it to managerial-level frauds and internal corruption. It also identifies areas and indicators where organizations may be—unwittingly or deliberately—the perpetrators of such corruption against third parties.

Chapter 6, “Role of Ethics in Fighting Fraud,” explores the nature and role of ethics within the organization to combat fraud and helps readers evaluate the current state of ethical structures within an organization. The chapter helps readers design a code of conduct that will reduce the likelihood of fraud occurrences and increase the probability of early detection.

Chapter 7, “Controlling Fraud,” defines the roles of corporate governance and the structures organizations utilize to prevent fraud. The chapter helps readers evaluate the system of internal control the organization relies on to minimize fraud and makes practical recommendations for improvement where required. The chapter emphasizes the role internal audit must play in controlling fraud.

Chapter 8, “Fraud Risk Management,” identifies appropriate techniques to establish the corporate fraud risk profile and clarifies the roles of internal, external, and forensic audit in the fight against fraud. It helps readers design and implement effective whistleblowing both within and external to the organization as a fraud preventive and detective measure.

Chapter 9, “Investigating Fraud,” assists the reader in identifying the red flags and indicators of fraud that should trigger a fraud investigation. It also identifies the forensic techniques available and the resources and training required to implement an appropriate fraud investigation. In addition, it covers the requirements for establishing an internal investigation function and determination of the appropriateness and the appropriate measures for tracing and recovering lost assets.

Chapter 10, "Computer Fraud and Countermeasures," helps readers identify areas of vulnerability to fraudulent use of information systems and processing of fraudulent transactions. It also helps facilitate the design and implementation of appropriate measures to defend the digital assets of the organization.

Chapter 11, "Legal Issues Surrounding Fraud," assists readers to evaluate the current legislative framework for the country or countries in which the organizations are operating and evaluate the effectiveness of deterrent mechanisms for fraud, including international electronic fraud.

Chapter 12, "Industry-Related Fraud Opportunities," identifies fraud opportunities specific to certain industries as well as government institutions. Its aim is to assist in the design of effective control mechanisms against specific risks to achieve optimal control effectiveness at minimized cost.

In addition, appendices are provided to give examples of antifraud opportunities, policies, and checklists as well as the basis for legal jurisdictions for fraud prevention and prosecution. An educational version of IDEA Data Analysis software is also provided via a web site download.

Contents

Preface xi

Chapter 1: Nature of Fraud	1
Fraud and Irregularities: Definitions and Concepts	2
Cost of Fraud	10
Notes	15
Chapter 2: Elements of the Crimes of Theft and Fraud	17
Document Fraud	20
Corroborating Documents	22
Procurement Fraud	22
Bribery and Corruption	26
Industrial Espionage	28
Check Fraud and Money Laundering	30
Notes	32
Chapter 3: Frauds Against the Individual	33
Online Auction Fraud	34
Consumer Frauds	35
Telephone Frauds	37
Charity Frauds	38
Misrepresentation of Material Facts	39
Concealment of Material Facts	40
Advance fees (4-1-9) Frauds	41
"Middleman" Frauds	42
Bait and Switch	43
Larceny	44
Extortion	45
Counterfeit Goods and Intellectual Property	45

Affinity Frauds	46
Pyramid Schemes	47
Ponzi Schemes	48
Career Opportunities	49
Cash Recovery Frauds	51

Chapter 4: Frauds Against the Organization **53**

Bankruptcy Fraud	54
Check Fraud	54
Obtaining Fraudulent Loans	54
Unsolicited Orders	57
Embezzlement	58
Bribery	60
Corruption	60
Conflicts of Interest	61
Breach of Fiduciary Duty	62
Theft of Trade Secrets	63
False Claims	65
False Conveyancing	69
Tunneling	70
Conspiracy	72
Lapping	72
Kiting	73
Fraudulent Affiliations	74
Counterfeit Money	74
Benefit Frauds	75
Insurance Fraud	76
Payment Card Frauds	80
Pension Frauds	81
Tax Fraud	83
Insider Trading and Market Abuse	84
Click Fraud	84
Counterfeit Goods and Intellectual Property	86
Procurement Fraud	87
Notes	88

Chapter 5: Fighting Corruption **91**

Bribery in Contracts	93
Red Flags at Enron and WorldCom	104
Nepotism and Favoritism	104
Abuse of Authority	108

Developing an Overall Anticorruption Culture	109
Notes	110
Chapter 6: Role of Ethics in Fighting Fraud	113
How Moral Decisions Are Made	114
Nature and Role of Ethics	115
Managing Ethical Risk	121
Reporting of Fraud	124
Notes	128
Chapter 7: Controlling Fraud	129
Corporate Governance and Fraud Prevention	130
Audit Committee's Role in Fighting Fraud	136
Internal Control and the Prevention of Fraud	143
Fighting Shrinkage	156
Internal Audit Role	157
Notes	166
Chapter 8: Fraud Risk Management	169
Establishing the Corporate Fraud Risk Profile	170
Cascarino Cube	175
Roles of the Internal, External, and Forensic Auditor	178
Whistleblowing in Detecting Fraud	183
Note	186
Chapter 9: Investigating Fraud	187
Red Flags and Indicators of Fraud	188
Corporate Fraud Indicators	193
Conducting an Investigation	203
Tools and Techniques	207
Use of the Polygraph	217
Documenting the Investigative Process	219
Evidence Analysis	219
Investigative Errors	219
After the Event	221
Establishing an Investigations Function	221
Tracing and Recovering Assets	222
Notes	226

Chapter 10: Computer Fraud and Countermeasures	227
Mainframe Architectures	230
Mainframe Communications	233
Control of Servers	234
WAN Communications	236
Workstation Security	236
Mobile Computing and the Internet	238
Cloud Computing	241
Computer and Information Fraud	243
Monitoring Tools	247
Preventing E-Commerce Fraud	249
E-commerce Control Opportunities	254
E-payments	255
Internal Control Best Practices	255
Newer Fraud Schemes	256
Protecting Digital Assets	257
Foiling the Hackers	259
Investigating Computer Fraud	260
Computer Law	271
Note	273
 Chapter 11: Legal Issues Surrounding Fraud	 275
Impact of a Constitution	277
Fraud and the Laws of Evidence	277
Asset Recovery	279
Labor Legislation and Fraud	282
Note	284
 Chapter 12: Industry-Related Fraud Opportunities	 285
Banking Fraud	286
Money Laundering	304
Health Care Fraud	307
Insurance Fraud	313
Tax Fraud	319
Social Security Fraud	325
Fraud after Death	327
Construction Fraud	328
Notes	332

Appendix A: Audit Committee Charter	335
Appendix B: Corporate Fraud Policy	339
Appendix C: Whistleblowing Policy	343
Appendix D: Fraud Prevention Checklist	347
Appendix E: Fraud Risk Questionnaire Sample	351
Appendix F: Fraud Risk Analysis	357
Appendix G: Fraud CAATs	361
Glossary	371
About the Author	377
About the Web Site	379
Index	381

CHAPTER ONE

Nature of Fraud

Fraud is like cancer. Most of us know someone who has it. We know people who will eventually have it. It has become common but we can take steps to protect ourselves through healthy choices and regular checkups using the latest tools and technology. But if people ignore the problem and live dangerously, then there's a much greater chance of becoming a victim.

—Toby Bishop, CEO, Association of Certified
Fraud Examiners

After studying this chapter, you should be able to:

- Briefly outline the definitions and concepts underlying fraud and irregularities

- Describe the basic types of fraud
- Understand the profiles and motivators of fraud
- Define the responsibilities for fraud detection and prevention

More and more incidents of private and public fraud are being reported daily in the media, and increasingly prosecutions for this offense are being conducted in the various courts. This chapter examines the phenomenon in order to obtain a full appreciation of what exactly fraud is.

FRAUD AND IRREGULARITIES: DEFINITIONS AND CONCEPTS

Throughout history, the development of negotiable instruments, from cowrie shells to plastic cards, have led to the creation of a set of rules and conventions for trade and the promotion of smooth and orderly commercial interactions among individuals and countries. The breaking of these rules and conventions helps white-collar criminals make a living—in some cases a fortune—while evading discovery. In many countries, the courts and judicial system do not afford economic crimes the priority of crimes involving violence.

Fraud itself is a legal concept existing within the criminal laws of virtually every civilized country, although slight variations exist. In most countries, fraud may be deemed to occur when these individual elements exist:

- An untrue representation about a material factor event is intentionally made by an individual or organization.
- Such representation may or may not be believed by the person or organization to which the representation was made.
- The victim could suffer the possibility of harm or prejudice as a result of the misrepresentation.

For example, within South African law, fraud may be conveniently defined as being “the unlawful and intentional making of a misrepresentation which causes actual prejudice or which is potentially prejudicial to another.”¹ Actual proprietary prejudice is not necessarily required for fraud. Even nonproprietary or potential prejudice may be sufficient. Thus, fraud is not a crime against property only; it also can be regarded as a crime against the interests of the community in general.

The Arkansas Department of Finance and Administration defines occupational fraud in this way:

Occupational fraud and abuses can be defined as the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of government resources or assets. Occupational fraud and abuses include misappropriation of assets in the form of cash theft, fraudulent disbursements, theft or personal use of inventory or other non-cash assets. Fraud can also take the form of bribery and corruption when kickbacks, gifts, or gratuities are offered to government employees from contractors or vendors to influence decisions of government agents or employees.²

A clear distinction must be drawn between the intention to deceive and an intention to defraud since a causal link is required between the misrepresentation and the actual prejudice.

Courts have traditionally worked on the basis that fraud is punished not because of the actual harm it causes but because of the potential harm or prejudice inherent in the misrepresentation, so that even if the potential victim should not believe the misrepresentation or not have acted on it the intent and possibility of harm means that a fraud has still occurred. Put more simply the intent and possibility of harm means that a fraud had been committed even if no loss occurred.

A crime that is commonly confused with fraud is *theft by false pretenses*. Fraud is always committed when a theft by false pretenses occurs, but the converse is not necessarily true since, in addition to misrepresentation and actual or potential prejudice, theft by false pretenses requires an appropriation of property capable of being stolen.

The misrepresentation leading to fraud can also be committed by means of an admission whereby the perpetrator fails to disclose a material fact that, unless revealed, could induce the victim to act to his or her prejudice if there was, in fact, a legal duty to disclose.

Once this broader definition of fraud is realized, it can be understood that occurrences of fraud are much more prevalent than we believe based on the large-scale frauds that hit the newspapers. Fraudulent misrepresentation is an everyday occurrence in our lives; it ranges from bending the truth in providing an excuse for an employer to utilizing company assets for personal benefit on the pretext that it was in the company's interest. Each of these acts falls under the heading of criminal fraud in its most literal sense and potentially

could result in a criminal conviction. Due to this broad definition, a level of white noise results, whereby fraudulent acts of a petty nature become tolerated and norms and ethical standards decline. As a result, fraud becomes acceptable if the end justifies the means. The economic stresses in today's society internationally create pressures and aspirations to attain a standard of living higher than many individuals are capable of achieving on merit. This situation, in turn, increases the likelihood of such persons achieving those aspirations by deceit.

No definitive preventive control can stop all fraud in its tracks since fraud is developed based on the ingenuity of defrauders. Some new, not-yet-anticipated variation on a theme always occurs.

Victims of Fraud

One common misconception is that frauds are carried out only by individuals against organizations. In many cases, when fraud is carried out by an individual acting on behalf of an organization, the fraudulent activity could be looked on as: *any business activity in which deceitful practices are resorted to by an organization or representative of an organization with the intent to cause economic injury that would deprive another of property or other entitlements.*

Although it is tempting to make the assumption that frauds may be confined to one class of victim—for example, the cost of insurance fraud being borne by the insurance industry—in reality, in most cases, the ultimate bearer of the cost of fraud is the general public. By the same token, government losses to taxation fraud ultimately are passed on to the taxpayers in general. Losses from corporate fraud, either from embezzlement or financial manipulation, are normally ultimately borne by customers.

In the event of fraud covered by government regulation, recourse for losses may be sought from the regulatory body. Nevertheless, ultimately they get passed on once again to the consumer or public.

In complicated cases such as payment card frauds, the ultimate loser may appear to be the cardholder (rarely and only if negligence can be shown), the merchant who accepted the fraudulent card, the merchant-acquiring bank that processes the transaction of the cardholder, and the card issuer. Once again, in reality, costs generally are passed on through higher insurance premiums, higher fees for banking services, higher interest rates, higher credit card fees, or reduced dividends to shareholders.

The net effect is that the public ends up bearing the brunt of losses from fraud. Thus, the public perception of fraud as a "victimless" crime can therefore

be seen as a false supposition and true only in that the cost may be spread over a large population. Thus, it may be seen that there are two forms of victims of fraud.

The *primary* victims are those who suffer the initial harm of fraud, whether these victims are individuals, corporations, or governmental bodies. The *secondary* victims are those who sustained the ultimate economic impact of losses attributable to fraud.

Nature of Fraud

Although many executives have an image in mind of what fraud is, the image may differ from executive to executive and may, indeed, differ widely in respect of the true nature of fraud. In order to adopt a comprehensive policy toward the minimization of fraud within the organization, a full fraud risk assessment is required to identify those opportunities specific to a given set of operations. Only once the fraud risks are understood can a system of internal controls be designed to address those specific risks. Even then, fraud can never be truly eliminated, but the internal controls can provide reasonable assurance that both instances of fraud and also waste and general misuse of resources can be reduced.

Much of the corporate fraud that takes place results from poor bookkeeping practices combined with poorly trained and inattentive staff. When this situation is combined with the inadequate internal and interdepartmental communications commonly found within organizations, the opportunities for undetected business scams grows exponentially. Making staff members aware of fraud opportunities and their responsibility in preventing and detecting fraud combined with a conduit through which to report fraud is fundamental in establishing good corporate control.

In order for fraud to occur, three elements must be in place. This trio is known as the fraud triangle (see Exhibit 1.1) and is used both in fraud prevention and fraud detection. Its origin is attributed to the criminologist Donald R. Cressey, who formulated this hypothesis regarding trust-violating behavior to explain why people commit fraud.

Pressure or Motivation

In general, the motivating factor leading individuals to commit fraud can be defined as a form of pressure. This pressure can take the form of significant financial need (or perceived need) and may include anything from medical expenses to a simple case of expensive tastes. For this pressure to translate into