LINDQUIST

Learn to Recognize the Signs of Fraud

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Prologue

When first faced with the question, many company executives immediately dismiss the suggestion that one or more of their colleagues or employees may be committing fraud yet it is this attitude which encourages fraud to fester, since adequate controls and attention have not been applied to deter the possibility.

First written in 1990 by Bob LINDQUIST and Jack Bologna, many of the suggested “Characteristics” were thought impossible with the advanced state of business controls, systems, government mandated policies and the audit professions. Well, once again it has been proven that when the will of either management or any one person is to commit fraud, such rules seen non applicable.

We have Sarbane-Oxley Act of 2002, yet there remains the chance that fraud might still put up a good fight, so once again we publish our 14 by 7 **Characteristics of Fraud, a One Minute** read.

Fraud awareness is the first step in making sure your organization is properly protected against this serious problem, we trust this presentation will assist.

1. 7 Characteristics of Fraud-Prone Organizations

1. Certain management is low-trust, autocratic, focused on profits and economic rewards on a short-term basis, ambivalent about social issues, hostile toward competitors, regulators, customers, stockholders and one another.

2. Financial and operational planning is poor, with persistent cash flow shortages despite an always optimistic outlook.

3. Company loyalty is poor, as is employee morale and work motivation.

4. Unusual turnover among non-supervisors, supervisors, middle managers, senior managers, outside auditors and outside counsel.

5. The company or any division dominated by one ego-manager.

6. The company has a waning line of products or services with little ongoing research and development effort.

7. The company is expanding rapidly in a highly competitive and low margin industry.

2. 7 Situations When Fraud in Books of Account is Most Likely to Occur

1. Internal controls are absent, weak or loosely enforced.

2. Company adopts aggressive accounting principles.

3. Employees are poorly managed, exploited, abused or placed under great stress to accomplish unrealistic financial objectives.

4. Certain management models are corrupt, inefficient, or incompetent.

5. A trusted employee has an irresolvable personal problem, of a financial nature, brought on by uncontrolled events.

6. The industry to which the company belongs has a history or tradition of corruption.

7. Unusual turnover in key financial positions.

3. 7 Invitations to Corporate Fraud

1. Make profit the only corporate objective and the only criteria for performance appraisal.

2. Create a corporate culture in which everyone knows the cost of everything but disregards the value of all else.

3. Create a corporate culture in which profit and economic incentives are the only motivators.

4. Failure to establish both an effective code for corporate conduct and a fraud awareness program.

5. Create strong authoritarian management controls but do not monitor them for compliance.

6. Ignore complaints from customers, stockholders, employees and vendors.

7. Fail to monitor possible management override of internal controls.

4. 7 Environmental Red Flags of Fraud

1. Do employees have an economic reason to cheat?

2. Does the company suffer from a "we-they" syndrome: Management versus non-management personnel?

3. Do conflicts abound among top management?

4. Is there evidence of spite, hate, hostility, or jealousy within top management?

5. Is the history of the firm and the industry regarding regulatory compliance poor?

6. What is the past, current and future profitability of the firm and industry?

7. Is there litigation and complaints pending against the firm by regulatory authorities, vendors, customers, and competitors?

5. 7 Trends That May Portend Fraud in Books of Account

1. Diminishing cash and cash flow.
2. Diminishing sales and income, a profit squeeze.
3. Increasing of accounts payable and receivable.
4. Significant excess inventory.
5. Increasing reclassifications of income and expense items.
6. Fully utilized line of credit for extended time period.
7. Increasing number of year-end adjusting journal entries.

6. 7 Common Management Fraud Techniques

1. Overstating revenues and assets.
2. Understating expenses and liabilities.
3. Creating off-balance sheet reserves.
4. Related party transactions below market value.
5. Spurious assets and hidden liabilities.
6. "Smoothing" profits.
7. Destruction, obliteration and alteration of supporting documents.

7. 7 Management Deceptions That Often Become Frauds

1. Booking sales that are not final.
2. Delaying necessary repairs and maintenance.
3. Not making adequate provision for doubtful accounts receivable.
4. Capitalizing expenses that should have been charged to the current year.
5. Acquiring another company to divert attention from ongoing problems.
6. Selling an asset that has appreciated in value to enhance earnings per share.
7. Recording goods or merchandise on consignment as an asset without adding the liability to the balance sheet or the goods to cost of sales.

8. 7 Ways in Which Fraud Surfaces

1. Complaints made by friends, spouses, co-workers, vendors, customers or competitors.
2. Intelligence gathered by trained security and law enforcement professionals.
3. Accident, Chance, Luck, Coincidence.
4. Fraud consideration applied to oddball event.
5. Internal audits, operational and financial.
6. External audits.
7. Anonymous letter, telephone call and whistle-blower.

9. 7 Characteristics of a Classic Embezzler

1. Usually works the crime alone.

2. Tends to be compulsive (i.e., ego, walks over others, gambles, abuses alcohol or drugs, overeats, spends money freely).

3. Inability to resolve situational pressure.

4. Create for themselves a fraud opportunity by utilizing their compulsiveness on-the-job (i.e., work quietly, work hard and work long hours).

5. Ability to rationalize their thefts.

6. Exploit weaknesses in internal controls and staff to cover up their embezzlement.

7. Have ready access to cash or its on-the-job equivalent.

10. 7 Items on the Embezzler's Opportunity Checklist

1. What are the weakest links in this system's chain of controls?

2. What deviations from conventional good accounting practices are possible in this system?

3. What would be the simplest way to compromise this system internally?

4. As in 3, but with outside 3rd party.

5. What control features in the system can be bypassed or overridden?

6. How can a fake debit/invoice be introduced into the system to get a check or credit issued?

7. What transaction authorization documents are easiest to access or forge?

11. 7 Items in the Vendor's Fraud Checklist

1. Corruption of purchaser's employees.
2. Conspiring with purchaser's employees to overlook shortages.
3. Manager performing clerical function, (i.e., approving vendor invoices).
4. Same manager annually arranges foreign contracts.
5. Full billing for partial shipments.
6. False weights, counts and quality representations.
7. Intentional overpricing and extension errors.

12. 7 Items on the Customer's Fraud Checklist

1. Corrupting sales employees.
2. Conspiring with sales employees to ship unbilled merchandise.
3. Falsification of identity and credit worthiness.
4. Substantial order with no intent to pay (planned bankruptcy).
5. False claims for refunds, discounts, returns and allowances.
6. Threatening lawsuits for spurious damage or liability claims.
7. Switching price tags.

13. 7 Items on the Competitor's Fraud Checklist

1. Predatory sales, advertising, and pricing practices.

2. Theft, conversion, or appropriation of technology, trade secrets, proprietary information, patents and copyrights.

3. Manager diverts customer to a competitor where he has a silent financial interest.

4. Corruption of competitor's employees.

5. Employee pirating.

6. Low-balling of contract bids.

7. Commercial slander.

14. 7 Things You Should Know About Computer-Related Frauds

1. Any white collar crime can be repeated as a computer fraud.

2. Abuse of computerized systems is often due to a lack of coordinated knowledge among user groups as to specific responsibility for functions and security.

3. Security systems always lag behind the latest technology. An intelligent, dedicated person will circumvent any control.

4. The majority of persons who perpetrate or abuse computer systems are insiders who have the same motivation as all other criminals.

5. Detection has been equally spread by accident, by controls, and by auditing procedures where controls were circumvented.

6. Information as an asset is capable of being stolen. Awareness of these concepts is critical to maintaining an edge over the criminal.

7. Evidentiary considerations are often more important in computer related crimes as evidence can be destroyed, altered or improperly cared for.