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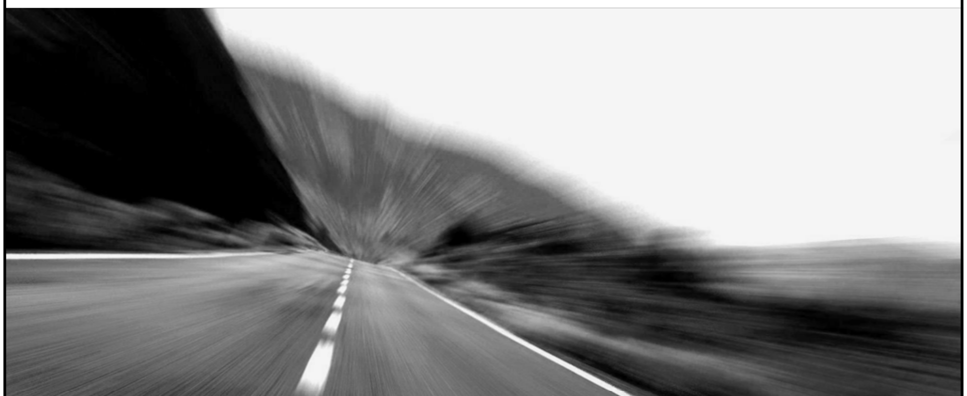
A Global Reach with a Local Perspective

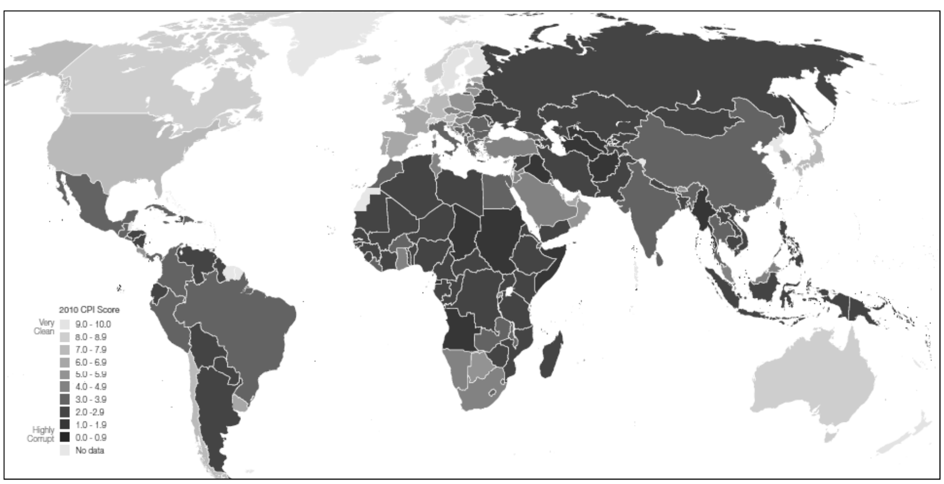


www.decosimo.com

Case Studies in Occupation Fraud – What went wrong?

A Forensic Accountant's Perspective

2010 CORRUPTION INDEX



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KPMG 2011 ANALYSIS OF GLOBAL PATTERNS OF FRAUD

- Male
- 36 to 45 years old
- Commits fraud against his employer
- Works in finance function or finance-related role
- Holds a senior management position
- Employed by the company for more than 10 years
- Works in collusion with another perpetrator

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KPMG 2011 ANALYSIS OF GLOBAL PATTERNS OF FRAUD

- Exploitation of weaknesses in internal controls by fraudsters increased significantly from 49 percent in 2007 to 74 percent by 2011.
- The increased failure to respond to red flags highlights the need for companies not only develop system for identifying red flags, but also acting on them.
- Only 23% of the frauds detected were publicly reported

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Institute of Financial Operations

- **International Accounts Payable Professionals (IAPP), International Accounts Receivable Professionals (IARP), the National Association of Purchasing & Payables (NAPP), and The Association for Work Process Improvement (TAWPI)**
- **May 15, 2011 - In informal poll of 622 managers, 72% said fraud was on the rise in back office fraud**

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WHAT IS FRAUD?

Black's Law Dictionary *- "Fraud is a generic term, and embraces all the multifarious means which human ingenuity can devise, which are resorted to by one individual, to get an advantage over another by false representations. No definite and invariable rule can be laid down as a general proposition in defining fraud, as it includes surprise, trickery, cunning and unfair ways by which another is cheated. The only boundaries defining it are those which limit human knavery."*

DECEPTION

FOR FINANCIAL GAIN

Legal Elements of Fraud -

1. A material false statement
2. Knowledge that the statement was false when it was made
3. Reliance on the false statement by the victim, and
4. Damages as a result

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OCCUPATIONAL FRAUD AND ABUSE

- **The use of one's occupation for personal enrichment**
- **The misconduct of employees, managers and executives**
- **Internal fraud**

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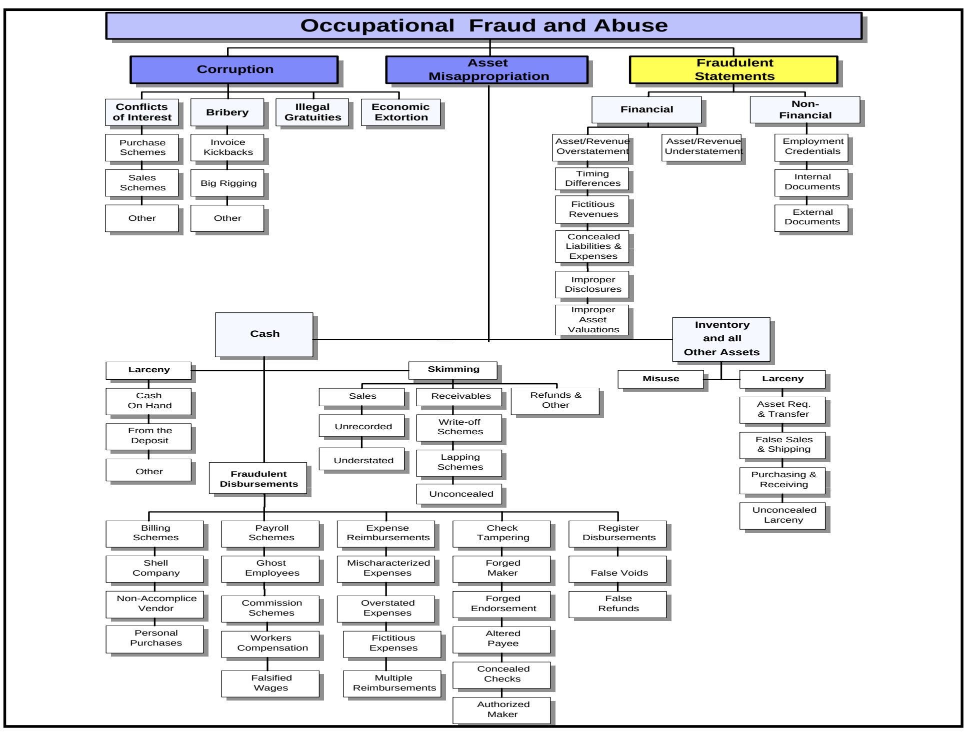
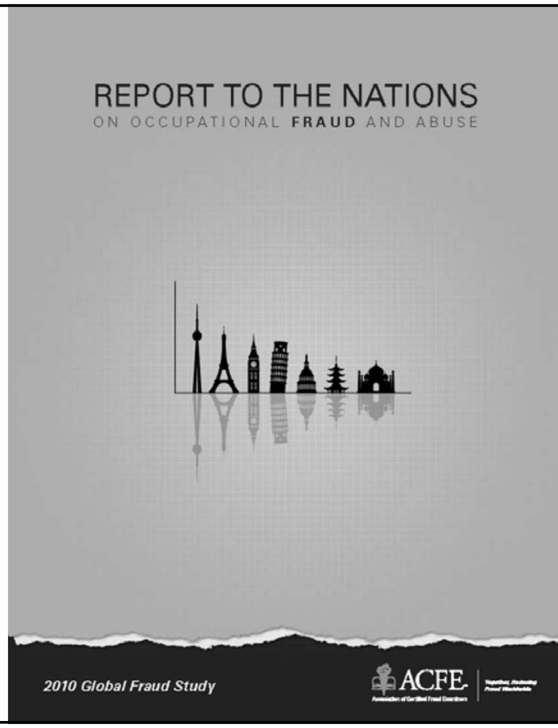
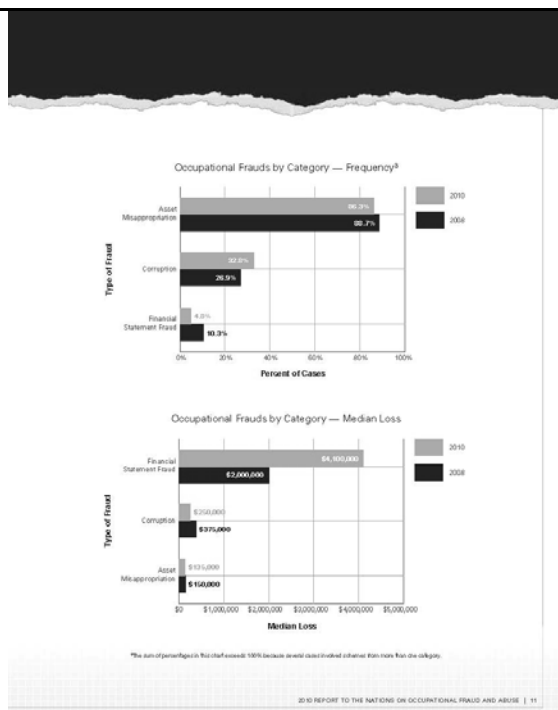


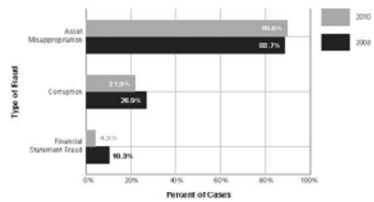

REPORT TO THE NATIONS
ON OCCUPATIONAL FRAUD AND ABUSE
2010 Global Fraud Study
ACFE
Association of Certified Fraud Examiners


Occupational Frauds by Category — Frequency
2010
2008
Type of Fraud
Asset Misappropriation
Corruption
Financial Statement Fraud
88.7%
26.9%
10.3%
0%
20%
40%
60%
80%
100%
Percent of Cases
Occupational Frauds by Category — Median Loss
2010
2008
Type of Fraud
Financial Statement Fraud
Corruption
Asset Misappropriation
$4,100,000
$2,000,000
$250,000
$375,000
$135,000
$150,000
$0
$1,000,000
$2,000,000
$3,000,000
$4,000,000
$5,000,000
Median Loss
2010 REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE

How Occupational Fraud Is Committed

As previously mentioned, our 2010 data include fraud cases from countries throughout the world, while our 2008 data contain only U.S.-based cases. In the following charts, we isolated the U.S. cases from our current study to make a more direct comparison to our 2008 data. Interestingly, while financial statement fraud remained the least common and most costly form of fraud among U.S. cases, there was a much lower percentage of financial statement cases in this study (four percent) as compared to 2008 (ten percent). Additionally, the median losses for all three categories of fraud were notably smaller in 2010 than they were in 2008.

Occupational Frauds by Category (U.S. only) — Frequency[4]



*The sum of percentages in this chart exceeds 100% because several cases involved schemes from more than one category.

Note: Because asset misappropriation schemes are both so common and so diverse in their methods, for the remainder of the Report, we will break down our analysis of the fraud schemes into 11 categories — corruption, financial statement fraud and the nine sub-categories of asset misappropriation — so as to provide a meaningful understanding of the full spectrum of ways in which employees defraud their employing organizations.

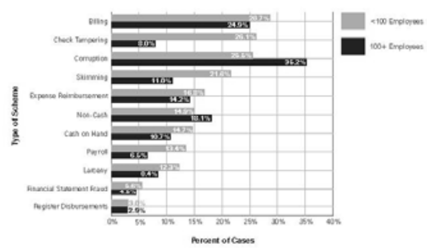
Asset Misappropriation Sub-Categories

Category	Description	Examples	Cases Reported	Percent of all cases*	Median Loss
Schemes Involving Theft of Cash Receipts					
Skimming	Any scheme in which cash is stolen from an organization *before* it is recorded on the organization's books and records	• Employee accepts payment from a customer, but does not record the sale, and instead pockets the money	267	14.5%	$60,000
Cash Larceny	Any scheme in which cash is stolen from an organization after it has been recorded on the organization's books and records	• Employee steals cash and checks from daily receipts before they can be deposited in the bank	181	9.8%	$100,000
Schemes Involving Fraudulent Disbursements of Cash					
Billing	Any scheme in which a person causes his employer to issue a payment by submitting invoices for fictitious goods or services, inflated invoices or invoices for personal purchases	• Employee creates a shell company and bills employer for services not actually rendered • Employee purchases personal items and submits invoice to employer for payment	479	26.0%	$128,000
Expense Reimbursements	Any scheme in which an employee makes a claim for reimbursement of fictitious or inflated business expenses	• Employee files fraudulent expense report, claiming personal travel, nonexistent meals, etc.	278	15.1%	$33,000
Check Tampering	Any scheme in which a person steals his employer's funds by intercepting, forging or altering a check drawn on one of the organization's bank accounts	• Employee steals blank company checks, makes them out to himself or an accomplice • Employee steals outgoing check to a vendor, deposits it into his own bank account	274	13.4%	$131,000
Payroll	Any scheme in which an employee causes his employer to issue a payment by making false claims for compensation	• Employee claims overtime for hours not worked • Employee adds ghost employees to the payroll	157	8.5%	$72,000
Cash Register Disbursements	Any scheme in which an employee makes false entries on a cash register to conceal the fraudulent removal of cash	• Employee fraudulently voids a sale on his cash register and steals the cash	55	3.0%	$23,000
Other Asset Misappropriation Schemes					
Cash on Hand Misappropriations	Any scheme in which the perpetrator misappropriates cash kept on hand at the victim organization's premises	• Employee steals cash from a company vault	121	12.6%	$23,000
Non-Cash Misappropriations	Any scheme in which an employee steals or misuses non-cash assets of the victim organization	• Employee steals inventory from a warehouse or storeroom • Employee steals or misuses confidential customer financial information	156	16.3%	$90,000

*The sum of percentages in this table exceeds 100% because several cases involved asset misappropriation schemes from more than one category.

Victim Organizations

As the chart below illustrates, check tampering schemes were much more common at small organizations than at all other entities. Skimming and payroll frauds were also more common in small organizations. These trends stand to reason, as the functions affected by such schemes — the check writing, cash collection and payroll functions, respectively — are more likely to be performed by a single individual, such as a bookkeeper, and are often subject to less oversight within a small organization than in a large company where duties are more segregated and authorization of transactions is more formalized. In contrast, although corruption schemes were the third most common fraud scheme faced by small businesses, they were less frequent within small companies than in bigger organizations.



Median Loss Based on Presence of Anti-Fraud Controls

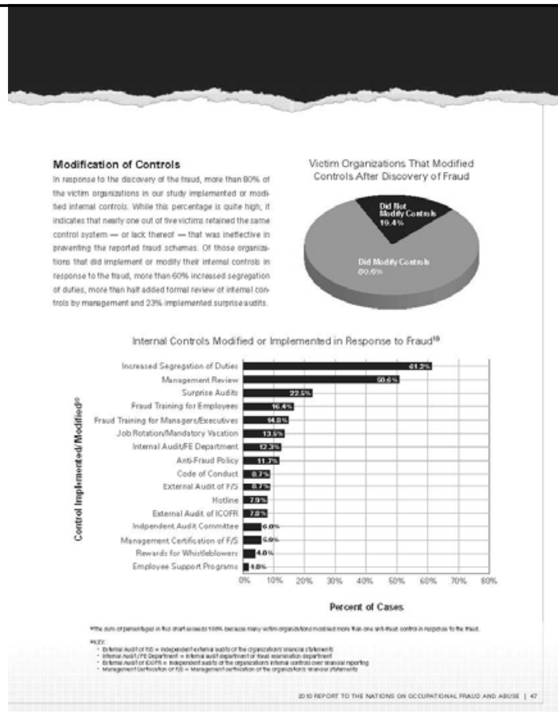
Control[17]	Percent of Cases Implemented	Control in Place	Control Not in Place	Percent Reduction
Hotline	48.6%	$100,000	$245,000	59.2%
Employee Support Programs	44.0%	$100,000	$244,000	59.0%
Surprise Audits	28.9%	$97,000	$200,000	51.5%
Fraud Training for Employees	39.6%	$100,000	$200,000	50.0%
Fraud Training for Managers/Execs	41.5%	$100,000	$200,000	50.0%
Job Rotation/Mandatory Vacation	14.6%	$100,000	$188,000	46.8%
Code of Conduct	69.9%	$140,000	$262,000	46.6%
Anti-Fraud Policy	39.0%	$120,000	$200,000	40.0%
Management Review	53.3%	$120,000	$200,000	40.0%
External Audit of ICOFR	59.3%	$140,000	$215,000	34.9%
Internal Audit/FE Department	68.4%	$145,000	$209,000	30.6%
Independent Audit Committee	53.2%	$140,000	$200,000	30.0%
Management Certification of F/S	58.9%	$150,000	$200,000	25.0%
External Audit of F/S	75.1%	$150,000	$200,000	25.0%
Rewards for Whistleblowers	7.4%	$119,000	$155,000	23.2%

Similarly, we compared the duration of fraud schemes at organizations with and without anti-fraud controls. As reflected in the table below, the presence of each control correlated with a reduction in the duration of fraud. We found it interesting that the controls associated with the greatest reduction in scheme lengths are not the same as the ones that had the most impact on median loss.

Duration Based on Presence of Anti-Fraud Controls

Control[17]	Percent of Cases Implemented	Control in Place	Control Not in Place	Percent Reduction
Management Review	53.3%	12 months	24 months	50.0%
Internal Audit/FE Department	68.4%	14 months	24 months	41.7%
External Audit of ICOFR	59.3%	15 months	24 months	37.5%
Code of Conduct	69.9%	15 months	24 months	37.5%
Surprise Audits	28.9%	12 months	19 months	36.8%
Hotline	48.6%	13 months	20 months	35.0%
Management Certification of F/S	58.9%	15 months	23 months	34.8%
Rewards for Whistleblowers	7.4%	12 months	18 months	33.3%
Job Rotation/Mandatory Vacation	14.6%	12 months	18 months	33.3%
External Audit of F/S	75.1%	16 months	24 months	33.3%
Anti-Fraud Policy	39.0%	13 months	18 months	27.8%
Fraud Training for Employees	39.6%	13 months	18 months	27.8%
Fraud Training for Managers/Execs	41.5%	13 months	18 months	27.8%
Independent Audit Committee	53.2%	15 months	20 months	25.0%
Employee Support Programs	44.0%	15 months	18 months	16.7%

[17]KEY:
- External Audit of F/S = Independent external audits of the organization's financial statements
- Internal Audit / FE Department = Internal audit department or fraud examination department
- External Audit of ICOFR = Independent audits of the organization's internal controls over financial reporting
- Management Certification of F/S = Management certification of the organization's financial statements



Modification of Controls

In response to the discovery of the fraud, more than 80% of the victim organizations in our study implemented or modified internal controls. While this percentage is quite high, it indicates that nearly one out of five victims retained the same control system — or lack thereof — that was ineffective in preventing the reported fraud schemes. Of those organizations that did implement or modify their internal controls in response to the fraud, more than 60% increased segregation of duties, more than half added formal review of internal controls by management and 23% implemented surprise audits.

ACFE 2010 REPORT TO THE NATIONS – Other Highlights

- Typical organization loses 5% of revenues to fraud
- Median loss was $160,000
- Nearly 25% involved losses of at least $1 million
- Frauds lasted a median of 18 months before detection
- Asset misappropriation schemes were in 90% of cases
- Financial statement schemes were less than 5% but caused median losses of more than $4 million
- More likely to detected by tip
- More than 80% were committed in accounting, operations, sales, upper management, customer service or purchasing
- More than 85% had never been charged or convicted
- Most common red flags were living beyond means and financial difficulties

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COSO'S FRAUDULENT FINANCIAL REPORTING 1998-2007

Common Financial Statement Fraud Techniques

❖ Improper Revenue Recognition	61%
❖ Overstatement of Assets	51%
❖ Understatement of Expenses/Liabilities	31%
❖ Misappropriation of Assets	14%
❖ Inappropriate Disclosures	1%
❖ Other Miscellaneous Techniques	20%
❖ Disguised Through Related Party Trans	18%
❖ Insider Trading Cited	24%

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COSO'S FRAUDULENT FINANCIAL REPORTING 1998-2007

Improper Revenue Recognition

- Sham sales
- Conditional sales
- Round-tripping
- Loans as sales
- Bill and hold
- Revenue before sale completed
- Improper cutoff of sales
- Improper use of percentage of completion
- Unauthorized shipments
- Consignment sales

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COSO'S FRAUDULENT FINANCIAL REPORTING 1998-2007

Asset Accounts Misstated

- Inventory
- Accounts Receivable
- Property and Equipment
- Cash/Marketable Securities
- Loans and Notes Receivable
- Investments
- Prepaid Expenses

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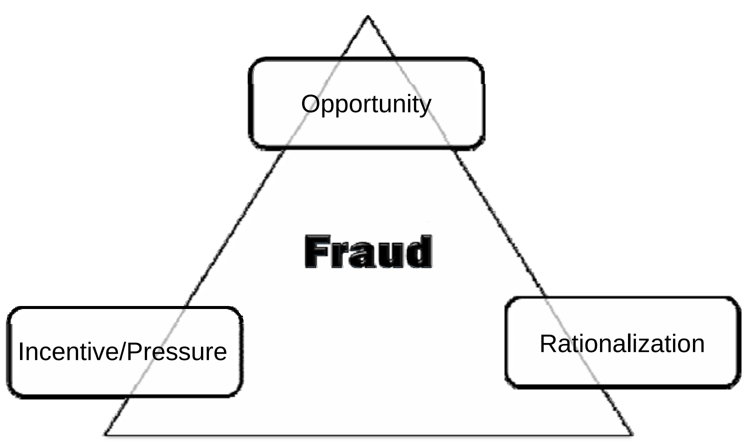
FRAUD TRIANGLE



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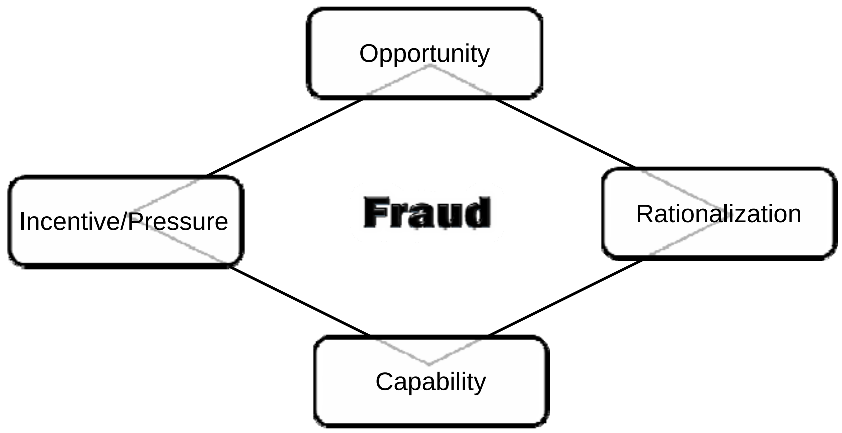
FRAUD DIAMOND



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RISKS FALLING OUTSIDE SOX

- Reputation
- Legal
- Strategic
- Operational

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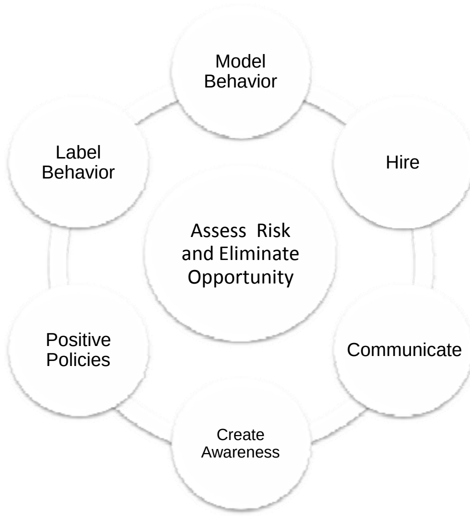
FRAUD PREVENTION



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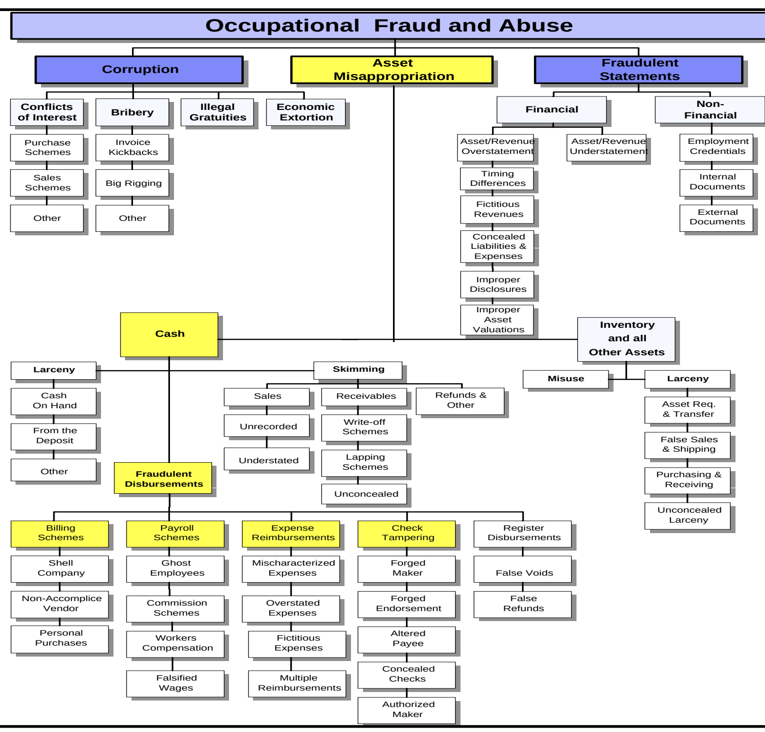

COMPREHENSIVE ANTIFRAUD PROGRAM

Control Environment			
Fraud Risk Assessment	Antifraud Control Activities	Information and Communication	Monitoring

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COMPREHENSIVE ANTIFRAUD PROGRAM

Control Environment

CODE OF ETHICS

HANDBOOKS, MANUALS, MEMOS

FRAUD POLICY

WHISTLE BLOWER POLICY

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FRAUD RISK ASSESSMENT GOALS

Provide a map to the fraud schemes and scenarios the company potentially faces with an understanding of existing controls and a list of steps needed to mitigate fraud risk on an ongoing basis.

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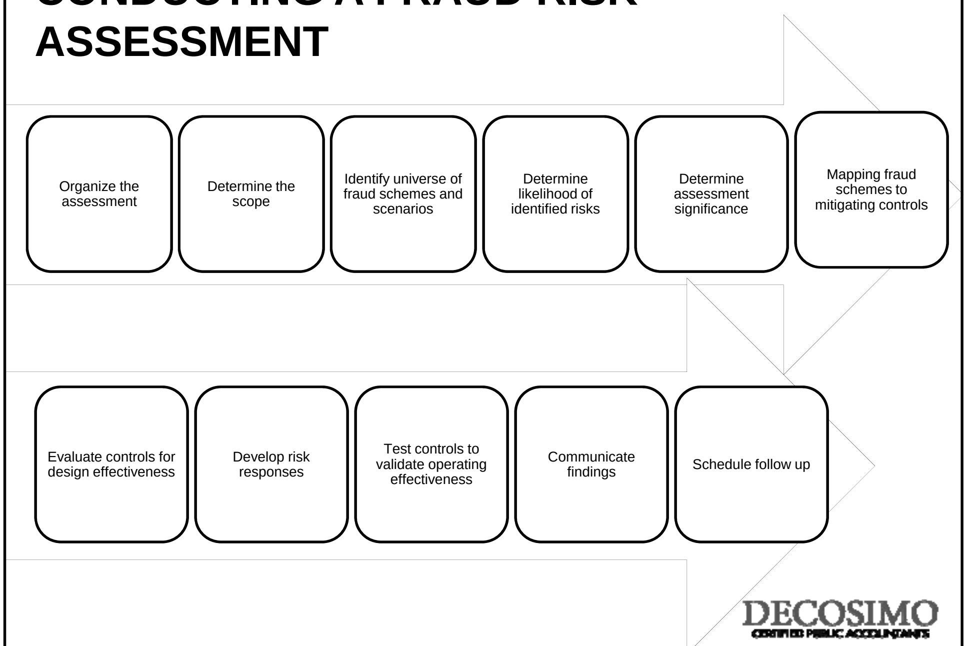
CONDUCTING A FRAUD RISK ASSESSMENT



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Preventive Controls

- Separation of duties
- Proper authorization
- Adequate documentation
- Physical control over assets and information systems

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Detective Controls

- Reviews of performance
- Analyses
- Reconciliations
- Physical observations
- Information systems
- Proactive fraud detection

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Deterrent Controls

- Controls which help eliminate risk factors which many lead to fraud

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SIX STEP APPROACH TO PROACTIVE FRAUD DETECTION

Step 1 – Understand the Business

↓

Step 2 – Identify the possible frauds that could exist

↓

Step 3 – Catalog possible fraud symptoms

↓

Step 4 – Use technology to gather data about symptoms

↓

Step 5 – Analyze the results

↓

Step 6 – Investigate the symptoms

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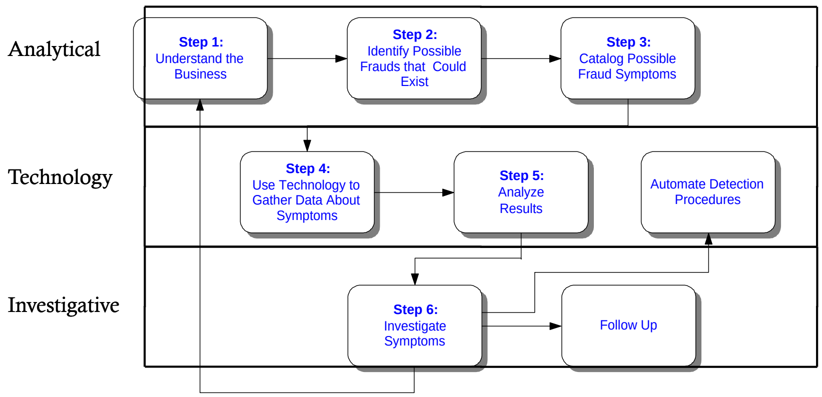
SIX STEP APPROACH TO PROACTIVE FRAUD DETECTION



TYPICAL ENVIRONMENT IN WHICH FRAUD OCCURS

- Trust is placed in employees
- Employees have detailed knowledge of the accounting systems and their weaknesses
- Management domination subverts normal internal controls
- Management adds pressure to "make the numbers"
- Expected moral behavior is not communicated to employees
- Unduly liberal accounting practices
- Ineffective or nonexistent internal auditing staff.
- Lack of effective internal controls.
- Poor accounting records.
- Related party transactions.
- Incomplete and out of date procedural documentation.
- Management sets a bad example.

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RED FLAGS IN FRAUDULENT FINANCIAL STATEMENTS

- Cash flow does not match net income
- Receivables spike relative to sales – Days' Sales in Receivables
- Management earning tied to performance
- Decrease in the Asset Quality Index – Noncurrent Assets, exclusive of PPE, relative to total assets in given year
- Exceptionally strong sales growth from one year to next
- Significant increase in Gross Margin Index
- High turnover of key management
- Sales allowances, warranties and other reserves out of line compared with others in industry
- Low Total Accruals to Total Assets – Working Capital, less Cash, less Current Taxes Payable, less Current Portion of LTD, less AD and Amortization, divided by Total Assets

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EMPLOYEE RED FLAGS

- Employee lifestyle changes
- Significant personal debt and credit problems
- Behavioral changes
- Defensive
- Fraud and Stupid look the same
- High employee turnover
- Refusal to take vacation or sick leave
- Lack of segregation of duties in a high-risk (vulnerable) area

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MANAGEMENT RED FLAGS

- Reluctance to provide information to auditors
- Photocopied or missing documents
- Decisions dominated by an individual or small group
- Excessive number of year-end transactions
- Management displays significant disrespect for regulatory bodies
- Excessive number of or frequent changes in checking accounts
- Weak internal control environment
- Unexpected overdrafts or declines in cash balances
- Accounting personnel are lax or inexperienced
- High employee turnover rate
- Compensation is out of proportion
- Decentralization without adequate monitoring
- Frequent changes in external auditors

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RED FLAGS IN PAYROLL

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

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RED FLAGS IN CASH OR ACCOUNTS REVEIVABLE

- Excessive number of voids
- Presence of personal checks in petty cash
- Sudden activity in a dormant account
- Taxpayer complaints that they are receiving non-payment notices
- Discrepancies between bank deposits and postings
- Excessive or unjustified cash transactions
- Large number of account write-offs
- Bank accounts not reconciled on a timely basis
- Unauthorized bank accounts
- Abnormal number of expense items or reimbursement to an employee

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RED FLAGS IN BILLING SCHEMES

- Remittance to PO Box
- Telephone does not match physical address
- Consistent billing in round numbers
- Address matches employee address
- Invoices consistently under approval limits
- Use of consecutive invoice numbers
- Invoice numbers and dates do not correspond
- Increasing purchases to same vendor
- Incomplete vendor master information
- Unspecified consulting or other services

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RED FLAGS CHECK TAMPERING SCHEMES

- Voided or missing checks
- Invoices posted to inconsistent accounts
- Checks used out of order
- Journal entries to cash
- Duplicate check numbers on bank reconciliations
- Altered or dual endorsements
- Customer complaints regarding payments
- Checks payable to cash
- Altered payee on checks
- Checks payable to employees

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RED FLAGS IN PURCHASING OR INVENTORY SCHEMES

- Increasing number of complaints about services
- Vendors without physical address
- Lack of physical security over assets / inventory
- Excessive inventory or slow-moving inventory
- Payments to vendors not included on an approved vendor list
- Vendor address matching employee address
- Abnormal inventory shrinkage
- Purchases that bypass normal procedures
- Charges without shipping documents
- Vendor payments picked up rather than having it mailed
- High volume of purchases from new vendors

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SYMPTOMS OR RED FLAGS

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.

Sometimes an error is just an error – Red flags should lead to some kind of appropriate action, i.e. an investigation by a measured & responsible person, but sometimes an error is just an error and no fraud exists

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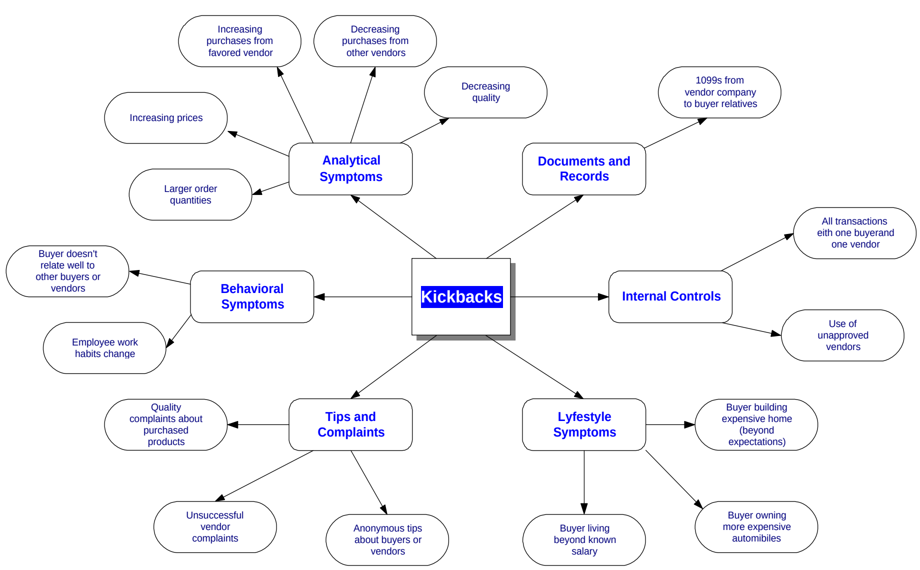
RED FLAGS PRESENT IN CORRUPTION SCHEME



Corruption Schemes

The offering, giving, receiving or soliciting any thing of value to influence an official act or business decision:

- Bribery
- Illegal gratuities
- Conflicts of interest
- Economic extortion

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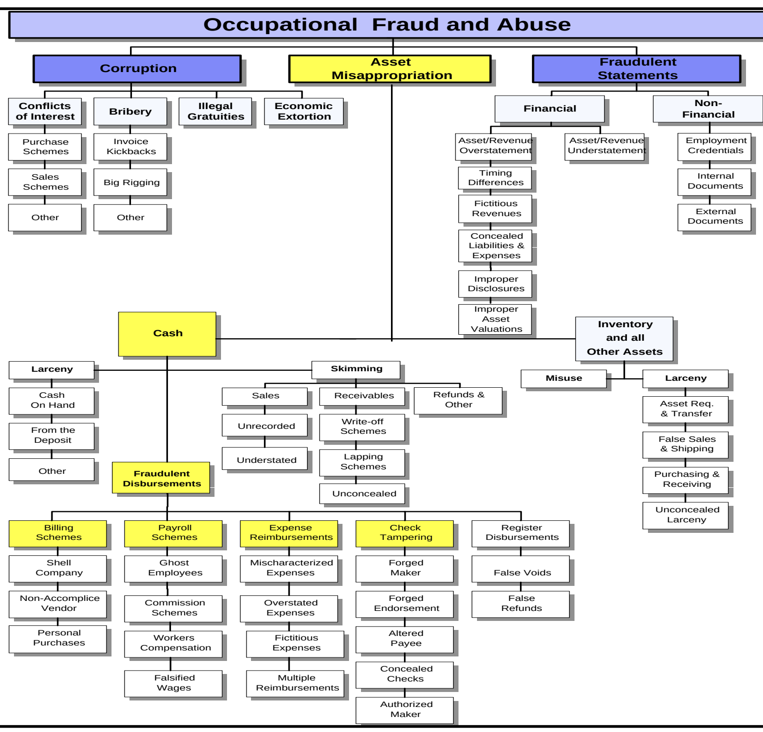

Billing Schemes

Perpetrator causes the victim organization to issue a payment by submitting invoices for fictitious goods or services, inflated invoices or personal purchases:

- Invoicing via Shell Companies
  - Submitting False Invoices
  - Pass through Entities
- Non-Accomplice Vendor
  - Pay and return
  - Overbilling or duplicate invoices
- Personal Purchases

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CASE STUDY #1
Asset Misappropriation - Billing Scheme

- A Large retail company
- Director of IT
- 10-year employee
- Could authorize expenditures up to $15,000
- Computer consultants contract ran out in prior year
- Suspect set up computer consulting in current year budget
- Created shell company and incorporated
- Self approval of invoices
- Losses were $365,000
- Asked AP to hold that check!

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CASE STUDY #1
Asset Misappropriation - Billing Scheme

Controls to Prevent or Detect

1. Promote a culture of integrity
2. Provide fraud awareness training
3. Promote the company's anonymous hotline and protect whistleblower's
4. Require reporting of management override of controls and procedures
5. Perform necessary due diligence on all new vendors

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Check Tampering Scheme

Perpetrator converts an organization's funds by forging or altering a check on one of the organization's bank accounts, or steals a check the organization has legitimately issued to another payee:

- Forged Maker
- Forged Endorsements
- Altered Payee
- Concealed Check
- Authorized Maker

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CASE STUDY #2
Asset Misappropriation – Check Tampering

- A Medium size manufacturing company
- Suspect was Assistant Controller
- 8-year employee
- Responsible for accounts payable and payroll
- Suspect has purchased new car and traveled each year
- Approximately 7 years prior, suspect has tax lien
- Check numbers and dates out of sequence
- Vendor name on check was different than records
- Losses were $650,000
- Backed up system, produced checks, restored system
- Removed checks/check copies from statement

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CASE STUDY #2
Asset Misappropriation – Check Tampering

Controls to Prevent or Detect

1. Obtain a credit report on all employees involved in handling of funds
2. Have someone independent of disbursements receive and review the bank statement and canceled checks each month
3. Have someone independent of disbursements account for all checks, including voided checks
4. Never pre sign checks
5. Have the associate roll forward the GL cash account each month in addition to reconciling the bank statement

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CASE STUDY #5
Asset Misappropriation – Skimming Sales

- Chain of 10 drug stores
- 5-year employee of the company and college student
- Was considered a very trusted employee and friend of the family
- Prescription system was not tied to cash register
- Entered “no sale” to open the register for cash sales
- Many times would enter “no sale” for friends and family
- Closed the store and insisted on closing the register for prescription sales
- Bought several cars and boat

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CASE STUDY #5
Asset Misappropriation – Skimming Sales

Controls to Prevent or Detect

1. Update systems to provide necessary accountability
2. Install surveillance camera in appropriate locations
3. Monitor and review ratio of daily cash sales/deposits
4. Have someone independent of recording sales close out the registers
5. Perform surprise audits

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CASE STUDY #3
Asset Misappropriation - Inventory

- Large parts manufacturing company
- Perpetrator was warehouse manager
- 18-year employee
- Was considered very knowledgeable about all inventory in the warehouse
- Never took vacations
- Obtained pass word from wife
- Had product picked up during third shift
- Arrived early and removed inventory and shipping information from system

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CASE STUDY #3
Asset Misappropriation - Inventory

Controls to Prevent or Detect

1. Have IT require and document the suspension of passwords when employees chance positions or leave the company

2. Have internal audit or another group “audit” the password assignments and review the password capabilities

3. Provide exception reports, by person executing the change, to management for all changes in inventory status

4. Require vacations be taken and consider job rotation

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CASE STUDY #4
Fraudulent Financial Reporting

- Large manufacturer of computer components
- CFO was 12-year employee of the company
- Several years before, the company was very profitable
- CFO was very aggressive in setting up loss contingency and other reserves
- When there was a downturn in the economy, company needed additional financing
- Loss contingencies and reserves were reversed into income
- After financing obtained, company subsequently declared bankruptcy

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CASE STUDY #4
Fraudulent Financial Reporting

Controls to Prevent or Detect

1. Promote a culture of integrity and adopt ethics policies and training
2. Provide fraud awareness training
3. Promote the company's anonymous hotline and protect whistleblower's
4. Do not tie compensation directly to bottom line results
5. Data mine email language for key words

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Discussion/Questions

billacuff@decosimo.com

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