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To Minimize Financial Fraud Risk, Watch Out for the 'Red Flags'

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As reports of global fraud continue to rise, members of corporate boards are becoming increasingly concerned about personal liability that could result from both large- and small-scale financial fraud as well as bribery, corruption and other fraudulent activities.

According to the 11th Global Fraud Survey issued in May by *Accountancy Magazine* and the accounting firm Ernst & Young, fraud also continues to be a concern of smaller, privately held companies and their advisers, who are often relied upon to provide advice relative to questionable transactions and suspicious activity.

While there is no way to eliminate fraud, with awareness of "red flag" indicators that may show the possible existence of fraud, all of us – whether lawyers, certified public accountants, investors or regulators – may be able to better spot fraudulent activity in development or before material losses from fraud have occurred. The examples below show a few case-specific red flags recently in the news and, equally important, highlight select fraud schemes and the need for increased awareness of the potential for fraud across all industries.

The Dreier and Forte Cases: Investment Fraud Schemes

All are familiar with the number, nature and significance of fraud experienced on our shores, particularly the Madoff Ponzi scheme as well as the historic cases involving Enron, WorldCom, Adelphia and others. As prevalent as fraud has become around the world, lesser known was a fraud perpetrated, around the same time as the Madoff scheme, by a prominent and allegedly successful trial lawyer, Marc Dreier, currently serving a 20 year prison sentence. Although smaller than the Madoff case, Dreier's fraud included many red flag indicators of fraudulent activity.

Dreier funded his very "successful" law firm with proceeds from the sales of falsified and worthless promissory notes, in the name of another company, to hedge funds and other investors. Furthermore, Dreier represented that the notes were issued by a New York real estate firm and longtime client of Dreier's. The longtime client discovered the fraud upon receiving a call that Dreier had offered to sell the caller notes issued by the real estate firm.

Dreier fell within the classic fraud triangle definition, feeling pressure to fund his failing law firm, seizing an opportunity to perpetrate a fraud based on his reputation and rationalizing his behavior by convincing himself, and others, that he was incredibly successful, when, in reality, his law firm was crumbling.

A little investor due diligence and awareness of typical red flags could have revealed a firm crumbling from within and likely detected the fraudulent activity. A few simple red flags should have alerted investors that something was amiss:

- The absence of an S-1 Registration statement for the issuance of the notes.
- A lawyer selling promissory notes on behalf of a real estate firm.
- The promise of extraordinarily high investment returns.
- Failure or reluctance to disclose all key facts, particularly in a private offering.

In another recent investment fraud scheme, Joseph Forte was charged with running a classic Ponzi scheme, defrauding investors to the tune of $50 million over a 12-year period. As in all Ponzi schemes, the fraud collapsed when Forte was not generating enough new investors to pay off earlier investors. Investors were promised gains that ranged between 18 and 37 percent, and, to advance the scheme, Forte provided fraudulent information to an accountant who prepared falsified investor reports. The accountant was not charged in the scheme. These reports at no time reported losses, even though losses were consistent and recurring. As in all investment frauds, the key red flag in the Forte case was the reporting of returns inconsistent with market performance. Additionally, other red flags may have tipped off Forte investors that something was not right:

- An investment manager who wants complete control of investor's funds.
- An investment manager who requests that checks be made out to him personally.
- An investment manager who guarantees performance.
- A record of returns that appears too steady or consistent in every type of market.
- Lack of an independent custodian who can verify the existence of funds.

Charter School and Higher Education Cases

Fraud is certainly not limited to the corporate environment. There has been an alarming increase in reported fraud cases in academia, highlighting the urgent need for increased levels of oversight in businesses both large and small.

In payroll fraud schemes, an individual fraudulently generates compensation to which he or she is not legally entitled. Payroll schemes are generally initiated by a false claim for payroll with the production of false documentation. In a recent well publicized case, the CFO of a charter school claimed to have worked more than 365 days each year over a several year period, serving as business manager and collecting more than $700,000 in compensation from several institutions for which he claimed to have worked. Red flags indicating potential fraud in this case were primarily:

- Employees (the charter school CFO) with both hiring and payroll approval authority and access to employees' paychecks.
- Lack of oversight and communication by the charter office of the school district.
- Conflict of interest by drawing compensation from more than one school.

- Hand-picked boards who were simply compliant and acted on a "rubber stamp" basis.

Cash theft schemes can occur through skimming – theft of cash prior to its recording in the accounting system – or larceny – theft of cash subsequent to its recording in the accounting system. In another charter school case, among other fraud schemes, a former school board president and school CEO was charged with fraud and theft of more than $500,000 from a federally funded program and filing false tax returns. Red flags in this case consisted of:

- Lack of internal control surrounding cash receipts and disbursements.
- Forged accounting records.
- As in the payroll fraud above, lack of oversight by those with oversight responsibility.
- A compliant, hand-picked, rubber stamp board.
- Lack of timely reporting and review of grant receipts and disbursements.

Billing fraud schemes are the most common form of asset misappropriations and are similar to payroll schemes in that false documentation is typically created. These schemes occur when an employee uses his or her position to issue a payment for an unauthorized and inappropriate purpose. In another recent case, a longtime college university employee allegedly authorized several million dollars of payments from the university to a fictitious food company over the course of 20 years. The university is investigating the matter with the assistance of counsel and forensic accountants, who are performing document searches and conducting interviews, two critical components of fraud investigations. The university discovered the alleged billing fraud upon the establishment of a comprehensive invoice review and control system over the past several years. The university's discovery underscores the importance of high quality internal control and accounting systems to eliminate or minimize system vulnerabilities.

Red flags in this case suggesting the presence of a fraudulent billing scheme included:

- Invoices not traceable to the receipt of goods.
- Suppliers/vendors unknown, related to someone in the organization, or are otherwise not vetted properly.
- Vendor invoices lack standard detail, such as contact information.
- Vendor pricing is out of line with the marketplace.
- Lack of adequate system of internal accounting control over purchasing.

Revenue Recognition Fraud

Financial statement fraud, commonly defined as deliberate misstatements or omissions of amounts or disclosures in financial statements for the purpose of deceiving financial statement users, is the type of fraud that occurs least frequently but results in the highest median loss per occurrence. According to the 2010 Report to the Nation on Occupational Fraud and Abuse prepared by the Association of Certified Fraud Examiners, financial statement fraud, as a percentage of reported fraud cases, occurred in 4.3 percent of fraud cases in 2010 with an associated median loss of $1.73 million. Conversely, the same study reports that asset misappropriation schemes, defined as misuse, illegal use or even outright theft of company assets – several examples of which were highlighted above – accounted for an overwhelming 89.8 percent of reported fraud cases occurring in 2010, with a median reported loss of $100,000. This is clearly a much smaller piece of the fraud loss pie, in terms of dollars lost per case, but one that cannot be ignored.

During challenging economic conditions the pressure to constantly attain projected financial results is even greater and the occurrence of fraud can increase dramatically. In periods of growth, particularly following recessionary periods, the burden to return to pre-recession earnings levels or meet market expectations can be enormous.

Revenue recognition fraud has historically been one of the most prevalent fraud schemes. It is one of hundreds of methods used to manipulate financial statements through the recognition of revenue before key parts of a transaction are complete. The pressure to achieve revenue projections is particularly intense and perhaps the primary catalyst to questionable, improper or fraudulent revenue-recognition practices by managers. When meeting with members of management, be alert for discussions suggesting significant pressure to meet earnings targets.

Recent media discussion has focused on an impending "double-dip" recession, defined as a period of recession followed by a short burst of growth, followed by another period of further economic decline. In the event of a double dip recession, there may also be a double dip occurrence of fraud, further highlighting the need for increased prevention and detection activities. While prevention is important – we highlighted some important fraud prevention techniques in an article published in January 2009 – fraud detection is critical.

A CPA was recently suspended from practice before the SEC for his involvement in a massive revenue recognition fraud while he was senior treasury manager and assistant treasurer of a software company. The company recognized revenue from non-binding agreements entered into with customers. The fraud was concealed by selling the fictitious receivables and improperly accounting for cash at the end of reporting periods. Red flags related to this fraud included:

- Lack of adequate internal control surrounding the accounts receivable recording and revenue recognition process.
- Lack of independent verification and confirmation of the revenue recognition process (the independent auditors were also sued).
- Lack of proper due diligence on the part of those who purchased the fictitious receivables.
- More than half of the receivables were more than 121 days past due.
- Significant surges in revenue at the end of each quarter.

Rising fraud occurrences demand an increased level of attention across all industries. Certified public accountants and certified fraud examiners with experience in fraud investigation and detection can play a vital role in the establishment of fraud deterrence and prevention programs as well as provide important detection services when fraud has been suspected. Individuals and businesses, through counsel, should keep these professionals close at hand and be aware of risk factors and red flags.

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