RED FLAGS OF FRAUD

When we refer to red flags, it means the various situations or conditions that, over the years, have consistently been shown to be contributing factors to fraud, waste and abuse. By themselves, they don't necessarily mean anything, but the more that are present, the higher the risk that fraud, waste and abuse is occurring, or could occur.

There are two general categories of offenders – internal and external. Many government programs have external customers, such as contractors, grantees, or others who potentially can misrepresent facts to obtain money they are not entitled to. Internal offenders are people who use their positions within an organization for personal enrichment through the deliberate misuse or misapplication of the organization's resources or assets. The red flags identified here ought to aid in identifying fraud in both categories of offenders.

PROCESS RED FLAGS

Transactions that are different or unusual (without explanation) or suspicious as to:

- Time (of day, week, month, year, or season)
- Frequency (too many, too few)
- Places (too far, too near, and too "Far out")
- Amount (too high, too low, too consistent, too alike, too different)
- Parties or personalities (related parties, oddball personalities, strange and estranged relationships between parties, i.e., management performing clerical functions).

Discrepancies in Accounting Records

- Account balances that are significantly over or understated
- Transactions not recorded in a complete or timely manner or improperly recorded as to amount, accounting period, classification, or organization policy
- Unsupported or unauthorized records, balances, or transactions
- Last minute client adjustments that significantly affect financial results (particularly those increasing income presented after submission of the proposed audit adjustments)
- Excessive number of adjusting entries, and repetitive use of adjusting entries for no apparent purpose.

Conflicting or Missing Evidential Matter

- Suspicious or missing documents
- Unexplained items on reconciliations
- No original documents available – only photocopied documents
- Inconsistent, vague or implausible responses arising from inquiries or analytical procedures
- Unusual discrepancies between the client's records and confirmation replies
- Missing inventory or physical assets
- Excessive voids or credits
- Shifting of costs from one category or cost account to another
- Common names or addresses of payees or customers – inability to verify the existence of vendors/subcontractors
- Alterations on documents (e.g. back dating, white-out)
- Duplications (e.g., duplicate payments)
- Questionable handwriting on documents

Unusual Relationships

- Appearance of a conflict of interest
- Less than arms length bargaining
- Related party transactions
- Denied access to records or facilities
- Denied access to certain employees, customers, vendors, or others from whom program managers may seek to obtain information from
- Undue time pressures imposed by management to resolve complex or contentious issues
- Unusual delays in providing requested information
- Tips or complaints about fraud, including whistleblowers inside the organization.

Other Concerns

- Significant internal control weaknesses or prior year internal control weaknesses not corrected
- Unexplained increases in costs or claims
- Suspicious, unexpected or unusual trends or shifts in activity.
- Unusual transactions (e.g., for activities outside the normal line of business)
- Changes in accounting principles or the methods of applying them that enhances reported income
- Departure of key financial or operating personnel
- Specific instances of management's conduct that raise serious concerns as to their integrity

OPPORTUNITY RED FLAGS

Fraud Conducted By Employees Against The Organization

- Familiarity with operations (including cover-up capabilities and in a position of trust)
- Close association with suppliers and other key people
- Rapid turnover of key employees either by quitting or firing
- No mandatory vacations, periodic rotations, or transfers of key employees
- Inadequate personnel-screening policies when hiring new employees to fill positions of trust
- Operating on a crisis basis
- Unrealistic productivity measurements
- Poor compensation practices
- An organization that has a culture of having no rules, or failing to enforce rules. One that actually or by implication endorses an organizational culture that does not care about fraud and abuse. For instance, when highly placed executives are less than prudent or restrained on expenditures for travel and entertainment, furnishings of offices, gifts to visitors and directors, etc., it implies to employees that such behavior is acceptable.

Fraud Conducted By Individuals On Behalf Of The Organization

- Related party transactions – less than arms length bargaining
- A complex business structure – often unnecessarily complex business structures are created to hide fraudulent activity and money laundering.
- No effective internal auditing function
- An organization that uses several different auditing firms or changes auditors often
- An organization that is reluctant to give auditors needed data
- An organization that uses several different legal firms or changes legal counsel often
- An organization that uses an unusually large number of different banks, none of which can see the entire picture
- Continuous problems with various regulatory agencies

- Large year-end and/or unusual transactions or adjusting entries to accounting records
- An inadequate internal control system or no enforcement of the existing internal controls
- Unduly liberal accounting practices
- Poor accounting records and inadequate staffing in the accounting department
- An organization that inadequately discloses questionable or unusual accounting practices

SITUATIONAL PRESSURE RED FLAGS

Fraud Committed By Employees Against The Organization

- Significant observed changes from past behavior patterns
- High personal debts or financial losses
- Inadequate income for lifestyle
- Extensive stock market or other speculation behavior
- Excessive gambling
- Undue family, organization, or community expectations
- Excessive use of alcohol or drugs
- Perceived inequities in the organization
- Resentment of superiors and frustration with job
- Peer group pressures
- Undue desire for self-enrichment and personal gain
- Emotional trauma in home life or work life

Fraud Committed By Management On Behalf Of The Organization

- Unfavorable economic conditions within the industry
- Pressure tactics by contractors or grantees to allow questionable costs
- Dependence on one or two products, customers, or transactions
- Obsolescence – the product, the service – the need for an organization no longer existing.
- High debt
- Substantial growth beyond the industry norm. Rapid expansion through new business or product lines often leads to control issues and chaotic management.
- Reduced ability to acquire credit or restrictive loan agreements
- Financial difficulties such as frequent cash flow shortages, declining sales and/or profits, loss of market share, costs and expenses rising higher and faster than sales and revenues
- Difficulty in collecting receivables – high bad debt expenses and aged receivables 90 days or greater, depending on industry.
- Significant tax adjustments
- Urgent need for favorable earnings to support high price of stock or to meet earnings forecast - trying to meet investor expectations
- Need to gloss over a temporarily bad situation in order to maintain management position and prestige
- Significant litigation, especially between stockholders and management
- Unmarketable collateral
- Significant reduction in sales backlogs (indicates future sales have declined)
- Possibility of license being revoked or imperiled, especially if it is necessary for the continuation of business
- Pressure to merge
- Sizable inventory increase without comparable sales increases
- Consistently late reports
- Managers who regularly assume subordinates duties
- Noncompliance with corporate directives and procedures
- Payments to trade creditors supported by copies instead of originals

- Commissions not in line with increased sales
- Unable to verify the existence of vendors, subcontractors

PERSONAL CHARACTERISTIC RED FLAGS

- Rationalization of contradictory behavior
- Lack of a strong code of personal ethics
- A strong desire to beat the system
- A criminal or questionable background
- A poor credit rating and financial status
- Highly materialistic and self-centered
- Are often eccentric in the way they display their wealth or spend their money
- Are reckless or careless with facts and often twist facts to fit their agenda
- Often they may appear to be hard working, almost compulsive, but most of their time at work is spent scheming and designing short cuts to get ahead or beat the competition.
- May demonstrate hostility toward people who oppose their views
- Feel exempt from accountability and controls because of their station or position
- Tendency to override internal controls with impunity and argue forcefully for less formality in controls

With internal offenders, research has shown that about 2/3 of crime is attributable to employees, while 1/3 is attributable to managers and executives. However, the median loss in employee cases was about 14 times less than when a manager/executive was involved. Frauds typically involve a trust element to make them work, and with internal offenders, the research bore out that the longer an employee has been with an organization, the higher the loss tended to be. This is attributed to the fact that most employees gain more responsibility and trust the longer they are with an organization. Otherwise, statistics on internal offenders breaks out like this:

- About 53% are male, with 47% being female, but losses where the perpetrator was a male were over 3x higher than with females.
- About 30% of perpetrators are aged 41-50; 19% for 36-40 age group and 18% for the 31-35 age group. However, the older the perpetrator the higher the fraud loss tended to be.
- 11% of the perpetrators had postgraduate degrees, 33% had bachelors and 56% had high school or less, but once again the higher educated the perpetrator was, the higher the loss – by about a 6 ½ to 1 margin.
- About 87% of perpetrators had never been caught before.
- About 1/3 of the cases involved more than one perpetrator – the effect of collusion increased the loss by a multiple of 7.

Sources include: Association of Certified Fraud Examiners, "2008 Report to the Nation on Occupational Fraud and Abuse"; "Sawyers Internal Auditing", by Lawrence Sawyer, et.al. (Institute of Internal Auditors, © 1996); and "Internal Auditing Manual" by James D. Wilson and Steven J. Root, (Warren, Gorham and Lamont, Inc., New York, © 1989).