Financial Ethics

Cindy Seipel PhD CPA CFE
Professor of Accounting (Auditing) NMSU

Fraud

- **Fraud** is distinguished from error in that fraud involves *intent* to deceive. Errors are an unintentional act.
- **Financial fraud** is an *intentional* act involving use of deception that results in a material misstatement of financial statements of the entity.
From the Association of Certified Fraud Examiners “Report to the Nations 2014”

Survey participants estimated that the typical organization loses 5% of revenues each year to fraud. If applied to the 2013 estimated Gross World Product, this translates to a potential projected global fraud loss of nearly $3.7 trillion.


Typical Financial Fraudster

- What are the characteristics of the typical financial fraudster?
  - Gender?
    - Male
  - Age?
    - Older
  - Education level?
    - More educated
  - Ethnicity
    - Caucasian
  - Why?
From the ACFE “Report to the Nations 2014”

The higher the perpetrator’s level of authority, the greater fraud losses tend to be. Owners/executives only accounted for 19% of all cases, but they caused a median loss of $500,000. Employees, conversely, committed 42% of occupational frauds but only caused a median loss of $75,000. Managers ranked in the middle, committing 36% of frauds with a median loss of $130,000.

Financial Fraud

- Two main types of financial fraud per the American Institute of CPAs
  - Misappropriation of assets – Fraud *against* the organization
  - Fraudulent financial reporting- Fraud on *behalf* of the organization
- The Association of Fraud Examiners breaks out a third – corruption - made up of bribery, kickbacks, illegal gratuities.
Asset Misappropriation

- Involves theft or misuse of organization's assets
- Examples
  - Skimming cash
  - Stealing inventory
  - Payroll fraud
- A dominant fraud scheme perpetrated against small businesses
  - Perpetrators commonly being employees

Fraudulent Financial Reporting

- The intentional manipulation of reported financial results to misstate the economic condition of the organization
- Common ways
  - Manipulation, falsification, or alteration of accounting records or supporting documents
  - Misrepresentation or omission of events or transactions
  - Misapplication of accounting principles
- Fraudulent financial reporting is often perpetrated by high level executives
Fraudulent Financial Reporting, Cont.

• Why would someone commit this type of fraud? What do they gain? Why do we call it fraud on behalf of the organization?
  • Meet loan covenants
  • Obtain good press
  • Sometimes personal benefit follows – bonuses, etc. However even when personal gain is obtained, it is done through manipulating the results of the organization.

From the ACFE “Report to the Nations 2014”

Occupational frauds can be classified into three primary categories: asset misappropriations, corruption and financial statement fraud. Of these, asset misappropriations are the most common, occurring in 85% of the cases in our study, as well as the least costly, causing a median loss of $130,000. In contrast, only 9% of cases involved financial statement fraud, but those cases had the greatest financial impact, with a median loss of $1 million. Corruption schemes fell in the middle in terms of both frequency (37% of cases) and median loss ($200,000).
The Fraud Triangle – the three factors that need to be in place for fraud to occur

Incentives or Pressures to Commit Fraud

- Management compensation schemes
- Financial pressures for improved earnings or an improved balance sheet
- Debt covenants
- Personal wealth tied to either financial results or survival of company
- Greed
- Pressure from family, friends, or culture
- Financial need – real or perceived
- Addictions to gambling or drugs
Opportunities to Commit Fraud

- Weak or nonexistent internal controls
- Significant related-party transactions
- Company’s industry position
- Complex transactions
- Complex or difficult to understand transactions
- Ineffective monitoring of management by the board
- Complex or unstable organizational structure

What are Internal Controls?

- Internal controls are those policies and procedures that are put in place to make sure the organization runs in an efficient and effective way.
  - Examples: approval signatures, required forms, obtaining bids for services, recording of transactions on the books by a person who doesn’t handle cash, etc.
Rationalizing the Fraud

• Rationalization involves reconciling unlawful or unethical behavior
• Rationalization for fraudulent financial reporting
  • “Saving” a company or its employees
  • “The other companies are doing it”
• Rationalization for asset misappropriation
  • Mistreatment by the company
  • Sense of entitlement by the individual perpetrating the fraud

Typical Fraud in Healthcare Organizations

• Billing for services not rendered.
• Billing for a non-covered service as a covered service.
• Misrepresenting dates of service.
• Misrepresenting locations of service.
• Misrepresenting provider of service.
• Waiving of deductibles and/or co-payments.
Fraud in Healthcare Organizations. Cont.

• Incorrect reporting of diagnoses or procedures (includes unbundling).
• Overutilization of services.
• Corruption (kickbacks and bribery).
• False or unnecessary issuance of prescription drugs.
  • From “10 Popular Health Care Provider Fraud Schemes” January/February 2013

Why are Not for Profit Organizations Susceptible to Fraud?

• Control by a chief executive; employees believe that there is no one to whom they can report unusual actions or requests;
• Existence of transactions, such as contributions, which are very easy to steal;
• Environment of trust, especially in financial personnel;
• Focus on the mission to the exclusion of administrative systems of controls and risk management;
• Failure to devote sufficient resources to financial management;
Why are Not for Profit Organizations Susceptible to Fraud? Cont.

- Failure to include people with financial oversight expertise on the board;
- Failure of the board to challenge the chief executive for fear of losing the person; and,
- Fear that the cost of implementing controls will outweigh the benefit and spending money that, in their view, would be better spent on programs.


What to watch for/What can you do?

From the ACFE Report to the Nations

Most occupational fraudsters exhibit certain behavioral traits that can be warning signs of their crimes, such as living beyond their means or having unusually close associations with vendors or customers. In 92% of the cases we reviewed, at least one common behavioral red flag was identified before the fraud was detected. Managers, employees, auditors and others should be trained to recognize these warning signs that, when combined with other factors, might indicate fraud.
What to watch for/What can you do? Cont.

Tips are consistently and by far the most common detection method. Over 40% of all cases were detected by a tip — more than twice the rate of any other detection method. Employees accounted for nearly half of all tips that led to the discovery of fraud.

**Many organizations now have a hotline to report suspected ethical violations**