

Alba Advisors, LLC

Understanding Fraud Risks

South Carolina Association of CPAs

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What is Fraud?

- It's one of those “generally accepted” things. Like GAAP.
- It's one of those “PC” things.
- It's one of those “vigilante justice” things.

???



Defining difficult topics...

“I shall not attempt to define the kinds of material I understand to be (pornographic)... but I know it when I see it.”

Potter Stewart
US Supreme Court Justice
1964

“Personal doctrine of fairness.”



How big is Fraud?

- **ACFE - Fraud in the US totals \$1 trillion annually, 5% of all revenues. (*2018 Report to the Nations*)**
- **Fraud hits >85% of businesses each year. (*2017/18 Kroll Annual Global Fraud and Risk Report*)**
- **CAIF - Insurance Fraud costs each American household \$1,000 a year.**



The “New Normal”?

“(Executives surveyed said) Fraud, cyber and security incidents are now the ‘new normal’ for companies across the world”

2016/17 Kroll Annual Global Fraud and Risk Report



Why isn't Fraud prosecuted?

From a law enforcement perspective:

- Lack of resources and failure to use them effectively.
- The good guys have rules, the bad guys don't.



Why isn't Fraud prosecuted?

From a business perspective, based on circumstance and interpretation Fraud might be:

- Tolerated.
- Condoned.
- Required.



Why isn't Fraud prosecuted?

From a personal or moral perspective:

- Sympathy.
- Adverse publicity.
- Restitution.



How is Fraud found?

- **More than 53% of Fraud is found by accident.**
- **4% is found by external audit.**
- **#1 anti-fraud measure (listed by 80% of companies) is external audit.**

Association of Certified Fraud Examiners
2018 Report on Occupational Fraud & Abuse

Why don't external audits find Fraud?

Three things are usually required to find Fraud:

- There has to be Fraud.
- You have to look for it.
- You have to stay until you find it.

Say what?



There has to be Fraud

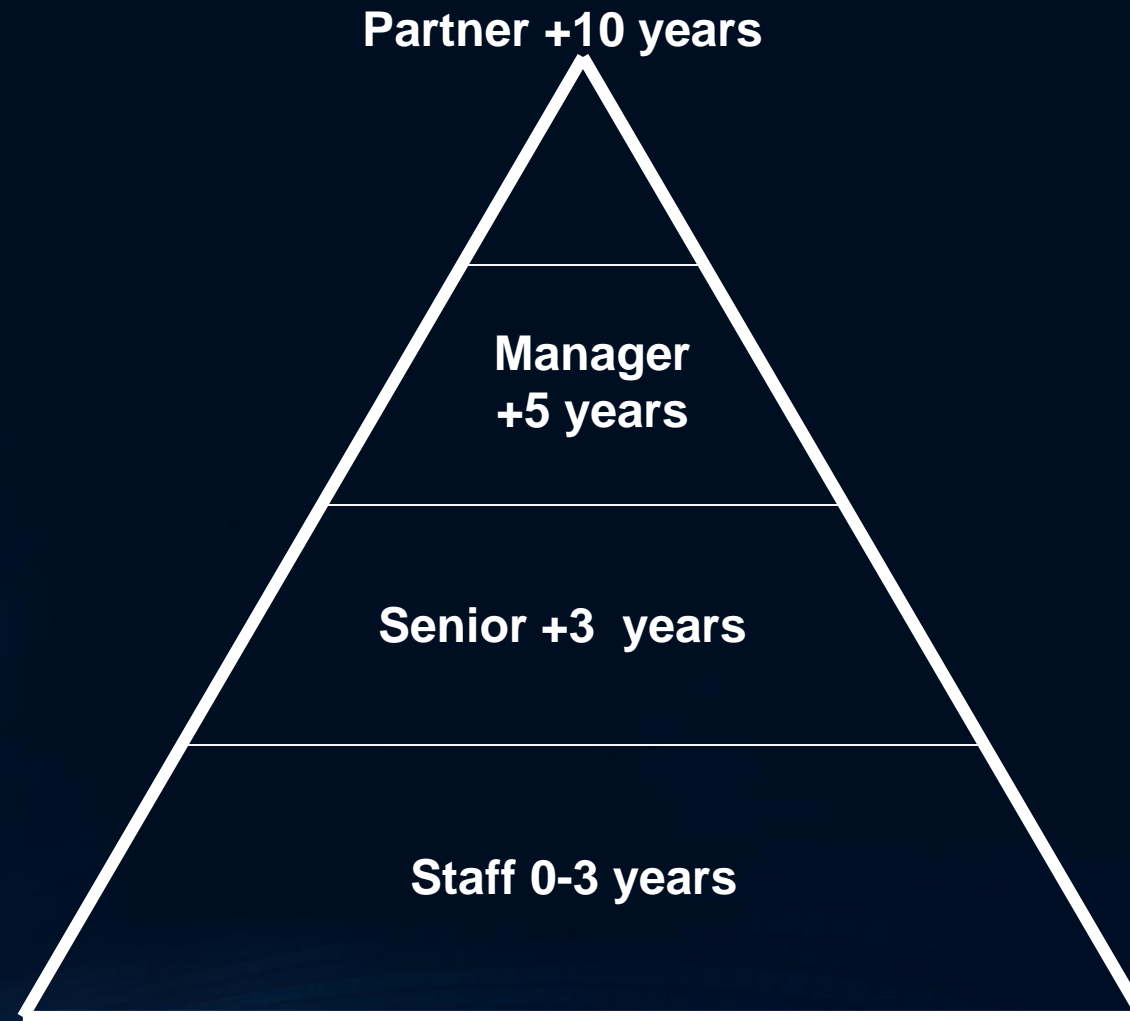
- Overwhelming % legitimate transactions.
- Judgment call.
- Not material.



You have to look for it

- Audits are painful.
- Require a spirit of cooperation.
- Youth, inexperience and ego.

The structure of large accounting firms





Stay until you find it

- Audits are expensive.
- Incentive to be timely and efficient.
- Disincentive to cause trouble.



Addressing the challenges of finding Fraud

- Finding Fraud is easier if it's always there.
- Don't be too smart.



Price Waterhouse?



Inferential Thinking in Practice

$$A = B$$

$$B = C$$



Inferential Thinking

Inferential thinking is the reasoning involved in drawing conclusions based on evidence and prior knowledge rather than observation.

Uncommon use of common sense!



Which balance sheet do you prefer?

	<u>Version # 1</u>	<u>Version # 2</u>
Cash	<u>\$1,000,000</u>	
A/R		<u>\$1,000,000</u>
R/E	<u>\$1,000,000</u>	<u>\$1,000,000</u>



Fraud is like a magic trick...

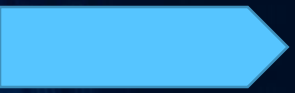
Incredibly baffling.

Until you know the secret.



Addressing the challenges of finding Fraud

- Finding Fraud is easier if it's always there.
- Don't be too smart.
- Finding the story behind the numbers.



Numbers

The language of business.



The Analytical Game Plan

- Objective process to analyze information.
- Subjective process to adapt to the current situation.

The Basic Playbook

The Mechanical Process of Analysis





Accumulate

- Establish universe of available information.
- Bank records, financial statements, tax returns.
- Bankruptcy?
- Google.
- People.
- Other ancillary information.



Select

- What are we trying to prove or find?
- Recurring, large or unusual items.
- Things that don't fit.
- Focus on things that are relevant to the circumstances.

What is relevant in the circumstance?

Audit Opinion

To the Board of Directors and Shareholders of XYZ Company, Inc.:

We have audited the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19XX and the related statements of income, retained earnings and cash flows for the year then ended.

We conducted our audit in accordance with generally accepted auditing standards. Those standards overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19XX and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

PriceWaterhouse & Co.

PriceWaterhouse & Co.

January 9, 19XX



What does this # mean to you?

\$1,000,000

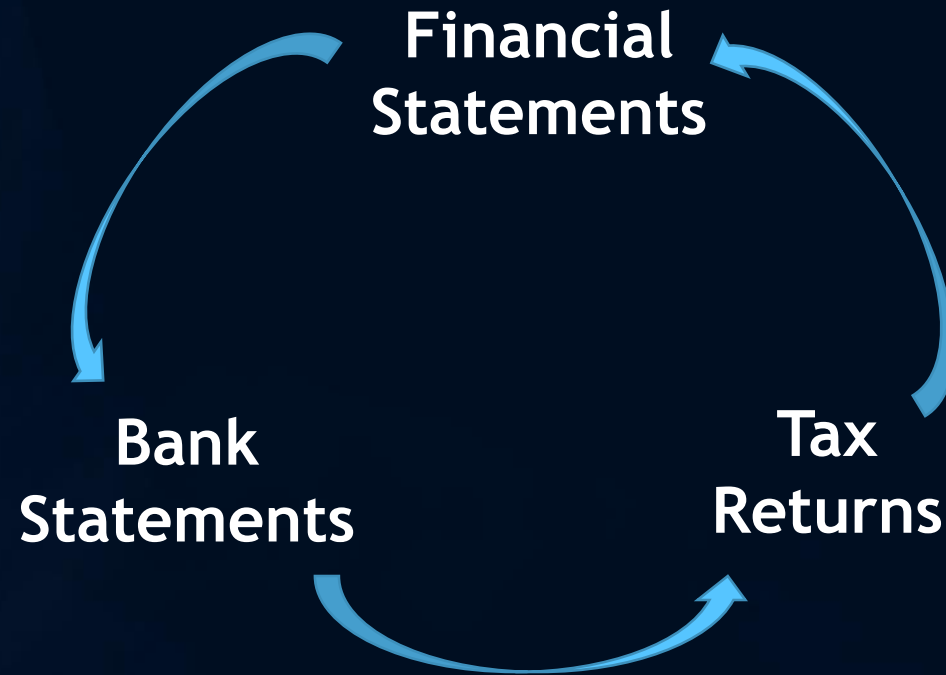
Compared to what?



Relate

- What does normal look like?
- Get a feel for trends or patterns.
- Identify things that don't fit.
- Look for contradictions.

Logical Relationships





Analyzing Relationships

**Ask questions.
Continually.**



Evaluate

- What is the analysis saying?
- Is it logical?
- Does it demonstrate the issue?
- Is more work required?



Evaluation - Is it logical?

How does it feel in your gut?



Finding the story behind the numbers

Adapting the analytical process

- Capital - Money.
- Capacity - Range of performance.
- Conditions - Environmental issues.
- Character - Integrity.



Capital - Money

- Rule #1 - Follow the money.
- Rule #2 - See rule #1.
- Determine the “value proposition.”
- How much?
- Where is it going?
- Who has access?



Capacity - Range of Performance

- Determine a reasonable range.
- Is something too good to be true?
- Is something too big or too small?



Conditions - Environmental Issues

- Internal or external factors with extreme influence.
- Circumstances that cause people to act the way they do.
- Incentives. Who wins? Who loses?
- Out of the ordinary occurrences.



Character - Integrity

- Reputation.
- Do you like them? Do they like you?
- Subtle clues.



Can widespread Fraud be stopped?

Politicians



Can widespread Fraud be stopped?

- Post Civil War.
- The 20's - Ponzi, stock market crash.
- The 80's - Ivan Bosky and Michael Milken.
- The 90's - the DOT-Comers.
- The early 2000's - World Com, Enron, Madoff.



Today

**Prominent Florida eye doctor
convicted of Medicare fraud**

**Collected \$105 million between 2008 and 2013.
Frequently billed for tests and treatment of
prosthetic eyes.**

**Associated Press
Apr 28, 2017**



Today

Wells Fargo Fined \$185 Million for Fraudulently Opening Accounts

**New York Times
Sept 8, 2016**



Today

**CEO who gouged EpiPen Price is
daughter of Democratic Senator**

**Associated Press
Aug 24, 2016**



Where do we go from here?

CPA



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Specialists in Risk and Insurance

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