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Establishing an Effective Fraud Risk Management Program for Manufacturers

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.... Agenda

- Report to the Nation on Occupational Fraud and Abuse
- An Effective Fraud Risk Management Program
 - The Five Principles of Managing the Risk of Fraud
- A Thorough Fraud Risk Assessment
- Conclusion
- Real-life DM Manufacturing Fraud Engagement, with Takeaways

••• Report to the Nation on Occupational Fraud and Abuse

- 2020 Report to the Nations on Occupational Fraud and Abuse is a study conducted by the Association of Certified Fraud Examiners (ACFE).
- The report is based on 2,504 cases of occupational fraud that collectively caused more than \$3.6 billion in actual damages.
- The median loss per case is \$125,000.
- A typical organization loses approximately 5 percent of its annual revenues to fraud.

.... Report to the Nation on Occupational Fraud and Abuse

- ACFE Report Findings in the Manufacturing Industry
 - Manufacturers had the third most reported fraud cases.
 - Manufacturing companies were victims of 185 cases with a median loss of \$198k.
 - Corruption was the most common fraud schemes in manufacturing, occurring in 50% of the cases.
 - Other common fraud schemes in manufacturing include billing, noncash and expense reimbursements. Following were corruption, asset misappropriation and fraudulent financial statements.

••• Report to the Nation on Occupational Fraud and Abuse

- More than half of all occupational fraud was committed by personnel in accounting, executive/upper management, personnel in operations and sales.
- Typical fraud lasts 14 months before it is detected.
- Organizations with fraud awareness training for employees were more likely to gather tips through formal reporting mechanisms.
- The use of targeted anti-fraud controls has increased over the last decade.
- The implementation of anti-fraud controls, including a robust fraud risk management program, resulted in lower fraud losses and quicker detection.

An Effective Fraud Risk Management Program

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- Laws and regulations have been enacted to address fraud scandals which charge organizations with the responsibility of fraud risk management.
- However, these laws and regulations have not been sufficiently prescriptive on how to implement controls or programs that address fraud.

So what steps can a manufacturing company take to deter fraud in its organization?

.... An Effective Fraud Risk Management Program

- Proven strategies manufacturing companies take to deter fraud include:
 - Assessing the robustness of its fraud risk management program elements
 - Performing a thorough fraud risk assessment of possible scenarios for the organization's environment
 - Preventing and detecting fraud through technology solutions

••• An Effective Fraud Risk Management Program

- In 2008, The Institute of Internal Auditors (IIA), American Institute of Certified Public Accountants (AICPA), and the ACFE put forth a comprehensive guide, *Managing the Business Risk of Fraud: A Practical Guide*, that defines key principles and theories for fraud risk management.
- The guide details five principles, as well as essential elements that organizations should consider when developing a fraud risk management program

••• Five Principles to Managing the Risk of Fraud

Principle 1

- As part of an organization's governance structure, a fraud risk management program should be in place. It should include a written policy (or policies) to convey the expectations of the board of directors and senior management regarding fraud risk.

Principle 2

- Fraud risk exposure should be assessed periodically by the organization to identify specific potential schemes and events that the organization needs to mitigate.

••• Five Principles to Managing the Risk of Fraud

Principle 3

- Prevention techniques to avoid potential key fraud risk events should be established, where feasible, to mitigate the possibility of damage to the organization.

Principle 4

- Detection techniques should be established to uncover fraud events in case preventive measures fail or unmitigated risks are realized.

••• Five Principles to Managing the Risk of Fraud

Principle 5

- A reporting process should be in place to solicit input on potential fraud, and a coordinated approach to investigation and corrective action should be used to help ensure potential fraud is addressed appropriately and in a timely manner.

••• Fraud Risk Management Program Elements

- Roles and responsibilities
- Commitment
- Fraud awareness
- Affirmation process
- Conflicts disclosure
- Fraud risk assessment
- Reporting procedures and whistleblower protection
- Investigative process
- Corrective action
- Quality assurance
- Continuous monitoring

A Thorough Fraud Risk Assessment

••• A Thorough Fraud Risk Assessment

- A thorough fraud risk assessment is an essential component of an effective risk management program.
- Identifies areas of the organization that are most susceptible to fraud by ascertaining
 - where potential fraud and misconduct could occur;
 - who might commit such acts; and
 - what controls are in place to mitigate such risk.
- Size, structure and geographic location are important factors in determining who participates in a fraud risk assessment, as well as how fraud risk is identified and then evaluated by management.

... A Thorough Fraud Risk Assessment

- An effective fraud risk assessment process incorporates the following:
 - Identification of inherent fraud risks by developing fraud scenarios for the organization with input from board members, management and process owners.
 - Assessment of likelihood and significance of inherent fraud risks based on interviews with management and process owners, volume of transactions, significance to financial reporting, subjectivity, complexity of underlying transactions, and historical information, among other factors.
 - Identification of mitigating controls for fraud and misconduct risks rated as medium- to high-risk and assessment of controls effectiveness at reducing risk to a residual risk level that is acceptable to management.
 - Identification of gaps and performance of a cost-benefit analysis to determine whether the organization can implement preventive or detective measures.

.... A Thorough Fraud Risk Assessment

Method of Fraud	Classification	Potential Red Flags
Corruption	<ul style="list-style-type: none"> • Conflicts of interest • Bribery • Illegal Gratuities 	<ul style="list-style-type: none"> • Abnormal vendor selection • Complaints from bidders/suppliers • Price outliers on awarded contracts • Close association with suppliers (including gifts and social events) • Common names or addresses of payees or customers • Vague terms in cost-plus contracts • No “right to audit” clause in contracts • Contracts not reviewed by legal, supervisor or other party independent of buyer • Returns/deductions trends by customer

.... A Thorough Fraud Risk Assessment

Method of Fraud	Classification	Potential Red Flags
Fraudulent Disbursements	<ul style="list-style-type: none"> • Billing Schemes • Expense reimbursement schemes • Checking tampering 	<ul style="list-style-type: none"> • Payments outside the accounting system (including manual checks and petty cash) • Unusual payment patterns • Missing documents/support for payment requests • Alterations on documents (e.g., backdating) • Increase in spot buys • Consistent invoice amounts under certain approved thresholds

.... A Thorough Fraud Risk Assessment

Method of Fraud	Classification	Potential Red Flags
Fraudulent Statements	<ul style="list-style-type: none"> • Asset overstatements • Revenue overstatements 	<ul style="list-style-type: none"> • High level of related party transactions • Results that continually outperform expectations • Increased shipments at period end and/or customer returns after period end • Short payments on receivables • Unexplained reconciling items • Inconsistent, vague or implausible responses arising from inquiries or analytical procedures • Missing inventory or physical assets, including an increase in physical inventory count differences (wall-to-wall or cycle) • Difficulty in collecting receivables • Sizable inventory increase without comparable sales increases

Detecting Fraud Through Technology Solutions

••• Detecting Fraud Through Technology Solutions

- Techniques to help detect fraud within manufacturing organizations encompass a variety of manual and automated solutions,
- Dependent upon technology systems, as well as the availability of accurate data.
- More manufacturing organizations have found it is necessary to employ techniques to analyze large amounts of data effectively and efficiently in order to eliminate the “human error” associated with manual controls.

... Detecting Fraud Through Technology Solutions

- Larger and Publicly-Traded Companies: Enterprise resource planning (ERP) applications, such as SAP and Oracle, are widely used by manufacturing companies and should be part of the first line of defense in helping to monitor for fraud risk.
- Smaller and Privately-Held Companies: While segregation of duties (SoD) is often relied upon by management as an internal control, many companies today do not manage their security processes effectively, and SoD issues continue to proliferate.

••• Detecting Fraud Through Technology Solutions

- Data analysis provides the ability to look into 100 percent of the population, which can include years of transactions.
- Enables a focus their efforts on nonroutine or unusual transactions, increasing the likelihood of detection of fraudulent occurrences.

Examples of Data Analytics in a Manufacturing Environment

Cash Disbursements	Inventory	Sales/Accounts Receivable
<ul style="list-style-type: none"> • Check validity of payments made to P.O. boxes • Identify checks out of sequence • Identify vendors who are also employees • Identify duplicate payments via manual checks • Identify purchases just under the dollar limit that require additional approval • Identify unusually close sequential patterns of invoice numbers • Identify vendors with the same address • Verify existence of vendors • Identify duplicate invoices • Extract invoices posted with duplicate purchase orders 	<ul style="list-style-type: none"> • Identify duplicate SKU numbers and description or cost • Analyze the difference between standard costs and actual costs • Divide inventory into classes and compare percent investment • Reconcile unmatched pay and remittances to freight invoices • Report on items with high value balances and age • Assess the financial viability of LIFO versus FIFO management • Extract products with zero quantities or zero prices • Identify obsolete inventory by sorted turnover analysis • Isolate stock lines where the cost is greater than retail price • Compare inventory levels and turnover rates 	<ul style="list-style-type: none"> • Review associate purchases for large amounts • Determine return rates for promotional products • Identify high-volume refund customers • Identify higher than average returns over time • Identify refunds paid to company employees • Review customers with a significant percentage of low or negative margins • Identify duplicate invoices • Identify all customers in sales who are not in accounts receivable • Identify any customers with no phone number • Identify accounts without collector assignments • Identify customers with a contact phone number the same as the company's

... Conclusion

- Manufacturing organizations should have an appropriate focus on fraud risk management, including:
 - Proactively assessing compliance with leading practices and elements, focusing on understanding the key threats and vulnerabilities of fraud to the organization
 - Leveraging or implementing preventive and detective fraud controls built into existing technology systems
 - Utilizing detective analysis techniques to determine whether the preventive mechanisms are operating as intended

.... **Real-life DM Manufacturing Fraud Engagement, with Takeaways**

Questions

