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While You Were Sleeping…

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40th Annual
Tax and Financial Planning Conference
November 9, 2017

Agenda

- Introduction
- Fraud Overview
- Fraud Case Studies
- Takeaways
- Questions & Answers

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Question #1

How many of you have or know someone or company that has experienced a fraud?

- Discussion?

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Question #2

How many of you are concerned that you may be susceptible to fraud?

– What causes you to be concerned?

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Surpassing your expectations.

Predictions for 2012

- Look for significant fraud in not-for profits
- Look for continued significant fraud in small privately-held companies (check fraud)
- Look for problems with large metal scrap dealers
- Major wire transfer fraud
- Bank robberies (unfortunately)
- Personal accounts … on-line baking

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What is Fraud?

- Intentional material false statement or willful omission of material fact, either orally or in writing.
- Knowledge by the perpetrator that the statements or omissions are false and misleading.
- Intent for the misrepresentation to be acted upon.
- Reliance by the victim on the statements made.
- Damage to the victim who relied upon the statements.

Characteristics of Occupational Fraud

- Is clandestine, or hidden;
- Violates the perpetrator's fiduciary duties to the victim organization;
- Is committed for the purpose of the direct or indirect financial benefit to the perpetrator;
- Costs the employee's organization assets, revenues or reserves; and
- Fraud is a global issue.

ACFE Report to the Nations: 2016 Fraud Study

The Association of Certified Fraud Examiners ("ACFE") conducted a study comprised of **2,410** cases of occupational fraud investigated across the globe between January 2014 and October 2015.

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ACFE Report to the Nations: 2016 Fraud Study

- Median loss in the US: **$150,000**
- More than 23 percent of the cases caused at least **$1 million in losses**
- Median duration – **18 months**.
- Estimated annual revenue loss to fraud - **5 percent**.
- On a $5 million in revenue company, that is an annual fraud loss of **$250,000**.

ACFE Report to the Nations: 2016 Fraud Study

- Asset misappropriation was by far the most common form of occupational fraud, occurring in **more than 83% of cases.**
- Among the various forms of asset misappropriation, **billing schemes and check tampering schemes posed the greatest risk** based on their relative frequency and median loss.
- In 94% of the cases, the perpetrator took some effort to conceal the fraud. **The most common concealment methods were creating and altering physical documents.**

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ACFE Report to the Nations: 2016 Fraud Study

- The most prominent organizational weakness that contributed to the frauds in the study was a **lack of internal controls, followed by an override of existing internal controls**.
- Fraud perpetrators tend to display behavioral warning signs when they were engaged in their crimes. The most common red flags are **living beyond means, financial difficulties, unusually close association with a vendor or customer, excessive control issues, a general "wheeler-dealer" attitude involving unscrupulous behavior, and recent divorce or family problems.**

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ACFE Report to the Nations: 2016 Fraud Study

- The **most common fraud detection method in the study was tips**, with employees reporting fraud tips over 50% of the time.
- Organizations that had reporting hotlines were much more likely to detect fraud through tips than organizations without hotlines.
- While **telephone hotlines were the most commonly used method**, more than half of complaints were submitted via the internet (email, web-based or online form).

Case Studies: Misplaced Trust

John Osborn Masterminds Church Scam

- John Osborn is spending 5 to 15 years in prison for masterminding a nearly $400,000 theft from the United Methodist Church of Manlius.
- His wife, Mary Meyer, is serving 3 to 9 years for helping Osborn.
- Osborn and Meyer wrote checks from the church accounts to themselves after assuming roles that circumvented the church's checks and balances. They were arrested in 2013.
- They squandered the church's endowment fund on an ill-fated venture to create energy using fish farms.
- Osborn was a self-employed local businessman and financial advisor in Syracuse. Meyer was a Certified Public Accountant (CPA) and an attorney.

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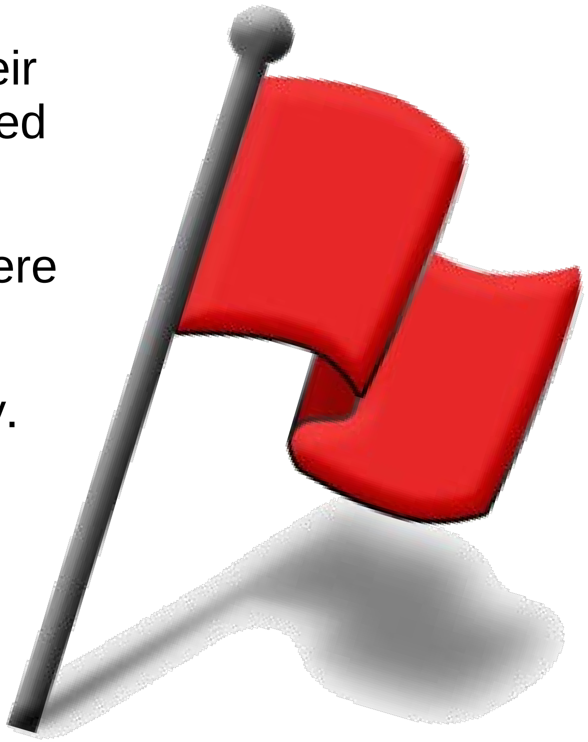
Red Flags

- Four years after Osborn and Meyer assumed their roles, the church began to experience unexplained shortfalls.
- Bills were not being paid on time and vendors were sending late notices.
- The church pastor wasn't being paid consistently.



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How the Fraud Was Discovered

- Osborn asked a fellow parishioner for a $60,000 loan to help out one of his business partners and didn't repay the money as promised.
- After Osborne didn't repay the money as promised, the parishioner investigated and discovered that 13 judgments totaling $275,000 between 1990 and 2006 had been filed against Osborn.
- These included U.S. Internal Revenue Service tax liens of $42,000 and 11 lawsuits mostly from broken business promises and unpaid debts.
- Osborn also pleaded guilty in 1992 to stealing $120,000 from the Camillus Housing Authority when he was the agency's treasurer.

How Could This Have Possibly Happened?

- A trusting environment.
- The organization allocates a minimum of resources for administration.
- Lack of formal written policies and procedures and little chance of a specific fraud deterrence policy.
- Lack of basic internal controls for safeguarding the organization's assets, and assuring proper reporting and compliance with outside laws and regulations.
- Lack of segregation of duties.

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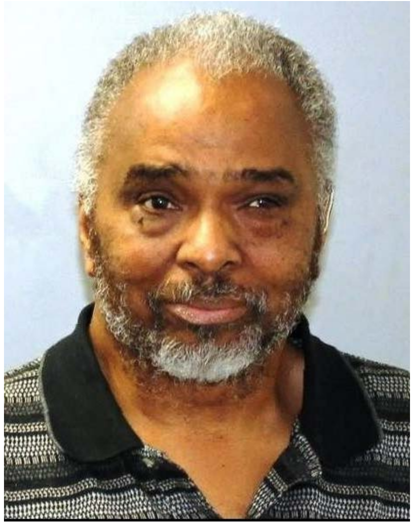
Lessons Learned

- Undertake formal background checks for board members.
- Formalize a system of internal controls and segregate duties.
- Arrange for bank statements to be mailed to someone other than the person appointed to reconcile the account.
- Board involvement: Require periodic reporting.
- Ensure that members of board of directors have diverse backgrounds and capable skill sets to installed systems to deter the fraud.
- Inquire about director and officer, crime insurance coverages.

Pop Warner Treasurer Steals From Youth Sports Group

- Preston Fagan stole $46,000 from CNY Pop Warner Football and Cheerleading while he was treasurer. Fagan was arrested in 2016 and immediately paid back $33,000. He later repaid all of the stolen cash.
- Thefts committed from 2012-2015.
- Fagan was sentenced to 5 weekends in jail and five years on probation.



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Lessons Learned

The lesson for any youth sports organization, as Ronald Reagan liked to say:

“trust, but verify”

Case Studies:
Controls for Cash Transactions

Ex-Clerk Is Accused of Stealing Court Funds

- Kimberly Amidon, Manlius county clerk, was accused of stealing $198,000 over two years in bail and fine money that was paid in cash.
- The money was used for household expenses.
- Amidon was charged with grand larceny, defrauding the government and falsifying business records, all felonies; and a misdemeanor count of official misconduct, after failing to deposit bail and fine money into the court's bank accounts.
- She was arrested in 2013 and released from prison in February 2017.

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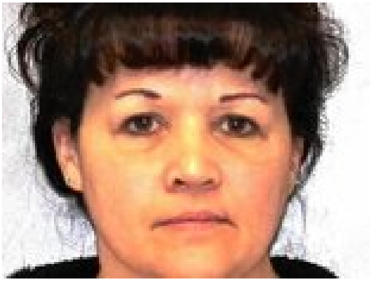
Oswego County Clerk Steals $117,000

- Margaret Bailey spent two years in prison after admitting that she stole $117,000 from the now-dissolved village of Altmar.
- Bailey stole thousands from writing checks to herself, faking mileage reimbursement forms and pocketing cash from tax payments, permit fees and the sale of a village vehicle.
- Bailey was arrested in 2014.
- Town of Albion officials discovered her crimes after taking over the books for Altmar when the village dissolved last year.



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Cash Larceny Prevention

- Establish realistic expectations for revenue from operations.
- Monitor cash receipting operations to ensure that all transactions are properly recorded.
- Budgeting: compare actual to estimated revenue on a periodic basis, and promptly investigate significant variances.
- Specifically monitor miscellaneous revenue sources since these funds are most vulnerable to loss.
- Routinely observe cashiering activities for open cash drawer operations, and listen for any unusual content in the conversations between cashiers and customers.

Cash Larceny Prevention

- Establish systems to encourage customer feedback about irregular cash receipting operations.
- Hire independent parties to promptly investigate all complaints.
- Videotape cashiering operations on a periodic basis or specifically when irregularities have been reported.
- Hire honest employees, perform background checks on cashiers.
- Establish periodic monitoring procedures as a deterrent to irregular activity at decentralized locations where one person often works alone.

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Case Study:
Balancing the Checks and Checking the Balances

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Animal Shelter Director Squanders Nearly $900,000 in Gambling Scam

- Paul Morgan, the former executive director at the CNYSPCA, is serving 4 to 12 years in prison after siphoning off nearly $900,000 over five years. Some of that money was funneled to two co-workers, Nicole Cafarchio and Taylor Gilkey, who kicked back a portion to Morgan.
- Morgan wrote more than 100 checks to himself and wrote more than 50 checks to Gilkey.
- Morgan himself stole nearly $600,000. He squandered it on gambling.
- Money was taken from an operating account at the organization.

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Animal Shelter Assistant Steals $250,000 During Romantic Relationship with Director

- Taylor Gilkey is serving 2 to 6 years in prison after admitting she stole $250,000 as part of SPCA director Paul Morgan's scam. Gilkey and Morgan traveled together to casinos, where Morgan gambled the money away. The two had a romantic relationship, authorities have said.

- Gilkey cashed checks that Morgan wrote her from the animal shelter's accounts. She then kicked part of the money back to Morgan.

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2nd Animal Shelter Assistant Admits Stealing $62K as Part of Director's Scheme

- Nicole Cafarchio was sentenced to probation after admitting that she stole $62,000 as part of SPCA director Paul Morgan's gambling scheme.
- Cafarchio cooperated with authorities against Morgan and Taylor Gilkey. She also stole the least amount of money as part of the scheme.

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The Scheme

- Money was taken from an operating account at the organization.
- Morgan's position of authority at the organization allowed him to cover up a lot of the fraud.
- Morgan and Gilkey used the money for trips to Las Vegas and New Orleans.
- Morgan later told the court he had a gambling problem and a lot of the money was lost.

Lessons Learned

- Formalize a system of internal controls and segregate duties.
- Board involvement: Require board members to perform bank reconciliations and review samples of transactions.
- Incorporate an outside auditor to review controls and practices on a regular basis.

Case Study:
Fraud Left Unreported

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Mailroom Employee Swipes Cell Phones

- Incident happened at a business complex in the Northeast U.S.
- The complex has a centralized mail system which receives and delivers all mail and packages to the tenant businesses.
- One of the tenant companies ordered a large quantity of new and expensive cell phones for all of their staff.
- Upon arrival, a mailroom employee took the boxes of cell phones home instead of delivering them, and sold them online.

How Was it Discovered?

- When the phones were not received, the company called the supplier and found out that the cell phones had already been delivered.
- They also learned that several people had already called the supplier to activate the phones, and the names associated with the activated phones were not employees.
- They were able to traced the trail to the mailroom employee's online account and he was caught and fired.

Crime Goes Unreported

- According to the ACFE Report to the Nations 2016 Fraud Study, in 40.7% of cases, the victim organizations decided not to refer their fraud cases to law enforcement.
- The most cited reason why - fear of bad publicity.

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Lessons Learned

- Inadequate internal controls or compliance programs.
- Inadequate oversight by management creates opportunity.
- Conduct unannounced in-house audits.
- Consider videotaping receiving operation.

Case Studies:
Investment Scam Flim-Flam

Jreck Subs Investment Fraud

- Christopher Swartz, Owner of Jreck Subs operated a Ponzi scheme, luring victims into investing money through inflated claims of assets and other deceptions.
- He defrauded investors and lenders of the Jreck Subs franchise of $25 million dollars and neglected to pay taxes.
- Swartz victimized 81 people in the U.S., many of them out of their life's savings or retirement accounts.
- Swartz victimized another 70 investors in the Kingdom.
- Fraud took place from 2005-2015.

The Scheme

- Swartz received money from lenders and investors.
- Swartz told investors that he was using the funds to open new restaurants.
- The funds ended up getting mishandled and diverted.
- Stakeholders expecting a return would be answered with partial payments, and excuses explaining the complications.
- The partial payments were in the form of checks that bounced.
- When lenders attempted to seize his assets, the assets and income were concealed by Swartz.

Promissory Notes: The Swartz' M-O

- In 2009, Swartz received funds from a investor group from New York City in the amount of $1.5 million.
- In exchange he agreed to a promissory note along with additional notes taken at a later date.
- Swartz told investors that he was using the funds to open new restaurants.
- The notes were backed by rebate agreements that were fictitious, and equity shares in the franchise.

Tax Fraud

- During the time of Swartz' investment fraud, he was also committing tax fraud simultaneously.
- He understated income, hid his money in company records and executed a massive amount of untraceable cash transactions.

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Crime Runs in the Family

- In 1991, H. Thomas Swartz, Christopher Swartz’ father, bought the controlling interests from Jreck Subs' founders with a $35,000 down payment to each and the promise that he'd pay them collectively the remaining $365,000.
- Thomas Swartz defaulted on these promissory notes.
- In 1996, Thomas Swartz handed over ownership to his son when he was awaiting trial on the bank fraud charges.
- The younger Swartz defaulted on new promissory notes to the founders in 2009.

Crime Runs in the Family

- In 1997, Thomas Swartz was sentenced to 3 1/2 years in prison for conspiracy, bank fraud and bribery.
- Thomas Swartz's Watertown law firm paid an official at its bank $333,000 in kickbacks to get all of the bank's legal business.
- The bank official also pushed through more than $1.8 million in loans for Thomas Swartz and his businesses.

Crime Runs in the Family

- In 2016, Christopher Swartz plead guilty to wire fraud and tax evasion.
- As part of his guilty plea, Swartz agreed to forfeit any assets he obtained as a result of his crimes.
- He was arrested again following his guilty plea, when federal prosecutors accused him of trying to conceal his assets before sentencing.
- On July 12, 2017, Swartz is sentenced to 12 ½ years in prison
- He was ordered to repay his victims $21 million, and to pay the federal government another $4.6 million in taxes he evaded.

Lessons Learned

- Research before you invest.
- Know the salesperson. Check actual qualifications even if you know the person.
- Be careful of claims that an investment will make "*incredible gains*."
- Most fraudsters spend a lot of time trying to convince investors that extremely high returns are "guaranteed" or "can't miss." Don't believe it.

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Case Studies:
Diagnosis of Health Care Schemes

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State Insurance Swindled $1.6 Million by Hearing Aids Specialist

- Joshua Miller is serving 4 to 12 years in prison after admitting that he billed state insurance for $1.6 million in unneeded hearing aids between May 2012 to December 2014.
- Miller, owner of Syracuse Hearing Aids Center, advertised high-tech gadgets with no out-of-pocket costs to state employees and families. He then billed the state as though he was providing medically necessary hearing aids.
- Auburn correction officer, Joshua Powers, admitted that he steered clients to Miller in exchange for $72,000.
- Powers avoided jail time promising to testify against Miller and was ordered to pay back $72,500 he was paid by Miller.

The Scheme

- Miller fit and sold ear pieces meant for enhanced entertainment (music, gaming etc.).
- Tunz Custom Audio Monitor headphones were used in the fraud, which range $200-$300.
- He proceeded to bill the state Empire Plan via United HealthCare, $3,000 per device sold.
- The ear pieces were falsely billed as medically necessary hearing aids, covered by insurance.
- 575 fraudulent claims, 500 involving state corrections officers and hospital staff.

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Psych Center Caregiver Steals From Patients to Buy Crack

- Alfonso Bradshaw spent 6 months in jail after pleading guilty in 2014 to stealing $170,000 in taxpayer-funded benefits meant for patients of Hutchings Psychiatric Center. Bradshaw worked in group homes run by the center.
- Bradshaw took food stamp benefit cards that belonged to patients and sold them to friends, family -- and even a South Side pizzeria -- for 50 cents on the dollar. Bradshaw said he was fueling his crack cocaine habit.

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Case Study:
Tackling Fraud in Higher Education

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OCC Cashier Steals $206,000 in Tuition Money

- Kathleen Kane spent two years in jail after admitting she stole $206,000 in tuition money from Onondaga Community College, where she worked as a cashier for 20 years. Kane said she started stealing after a divorce when the bills started to pile up.
- She admitted last year to stealing money from students who paid tuition in cash.
- She was arrested in 2012.

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Takeaways

- There's no magic formula to make your business entirely "fraud proof."
- What we can do is implement workplace fraud prevention measures and processes to help avert it and the impact it could have on your company.
- Be aware of the red flags.
- Build the control environment as best allowed by financial resources and personnel resources.

Takeaways

- All not-for-profit organizations, local municipalities and civic groups should know that they are easy targets, and fraudsters — with practiced acting talents — are quite willing to take advantage of them.
- The amount of fraud in your organization will often be determined by how effectively you segregate duties.
- Have an effective whistleblower policy and/or a fraud hotline.
- Board involvement.
- Check your insurance coverage!

Takeaways: Background Checks

- Perform meticulous and comprehensive background checks on all new employees.
- But keep in mind that background checks aren't foolproof.
- According to the ACFE Report to the Nations, only 5.2% of perpetrators had previously been convicted of a fraud-related offense.
- In over 40% of the cases, the victim organization decided not to refer their fraud cases to law enforcement, with fear of bad publicity being the most cited reason.
- Formalize and implement a system of internal controls.

Takeaways: Small Business

The internal control needs of a small business are different than for large corporation. A small business needs to concentrate on:

- Credit card security
- Fidelity bonds
- Proper use of bank accounts
- Reliable reconciliations
- Accounting service selections
- A review of corporate culture

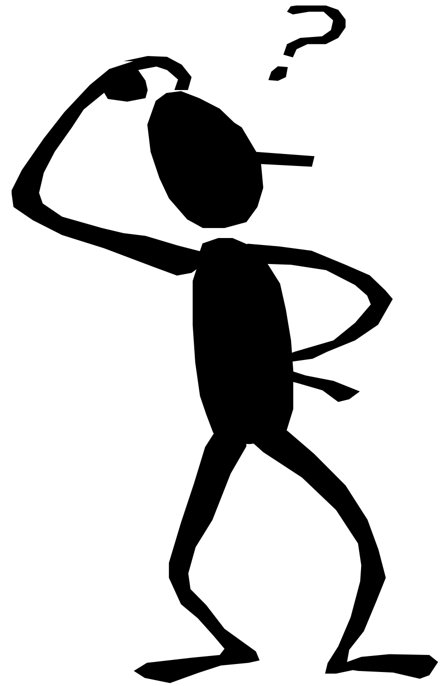
Takeaways: Segregation of Duties for Small Organizations

In small organizations, true segregation of duties might not be possible because of limited staff. So, an organization must implement some "compensating controls" and board members and management *must* play a more active role.

Common examples of compensating controls include:

- Mailing bank statements directly to board members
- Require board members to perform bank reconciliations and review samples of transactions.
- Management must set a good “Tone at the Top” by following anti-fraud policies consistently.

Questions



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