

# NCPACA ANNUAL CONVENTION

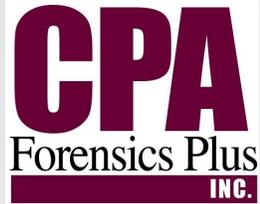
## September 2, 2018

### **FRAUD AND ITS IMPACT ON SMALL BUSINESSES**

**By Kathy A. Johnson**



# ABOUT THE SPEAKER



## Kathy A. Johnson

CPA, CFF, CGMA, MBA

### Educator

#### Court Appointed Expert

#### Forensic Accounting Services:

- ✓ Litigation Support
- ✓ Cash Flow Analysis
- ✓ Business Valuations
- ✓ Estate, Trust Tracing
- ✓ Fraud Investigations

#### Tax Preparation

- ✓ Corporate and Personal
- ✓ Estate / Trust

#### Adjunct Professor:

- ✓ Forensic Accounting / Auditing
- ✓ Financial & Cost Accounting / Budgeting
- ✓ Accounting Information Systems
- ✓ Accounting Law, Ethics and Institution

### Professional and Community Services

- ❖ California Society of CPAs - Immediate Past Chair
- ❖ AICPA - Council Member, Past Chair AICPA Controllers Conference, Awards Committee
- ❖ CBA Enforcement Advisory Committee
- ❖ Rotary - Redlands California



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**UC RIVERSIDE** Graduate School of Management





# COMMON FRAUD SCHEMES

- Advance Fee
- *Business Fraud*
- Counterfeit Prescription Drugs
  - Credit Card
- Fraud Against Seniors
  - Identity Theft
    - Cyber
  - Investment
- Ponzi Schemes

# Popular Frauds



## Well Known Frauds

# Enron



[Reuters](#)

The Houston-based energy company had a [mighty collapse](#) in 2001 after a failed merger and bankruptcy.

Committed fraud by overstating earnings.

Numerous executives were found guilty of various crimes from obstruction of justice, money laundering, and insider trading.

# Bernie Madoff



Mario Tama/Getty Images

Madoff is currently serving a sentence of 150-years in federal prison for securities fraud.

He was operating a Ponzi scheme that lost a record \$65 billion for his investors.

Madoff was turned into authorities by his two sons in 2008.

# WorldCom



Thomson Reuters

WorldCom filed for bankruptcy in 2002 and the CEO and CFO went to jail for *lying about billions of dollars* in a case of corporate accounting fraud.

# Cendant



The convicted CEO of Cendant,  
Walter Forbes. Michelle  
McLoughlin/AP

The new company, which had formed through a 1998 merger between CUC International (CUC) and Hospitality Franchise Services (HFS), was doomed because CUC ***was overstating income by more than \$500 million*** for three years.

**After SEC charges, multiple executives were found guilty of fraud for submitting false reports.**



Reuters

**Lehman Brothers (158 year old Company) - global financial services firm whose bankruptcy in 2008 was largely caused by — and accelerated — the subprime mortgage crisis. The firm was at the time the fourth-largest investment bank in the United States**



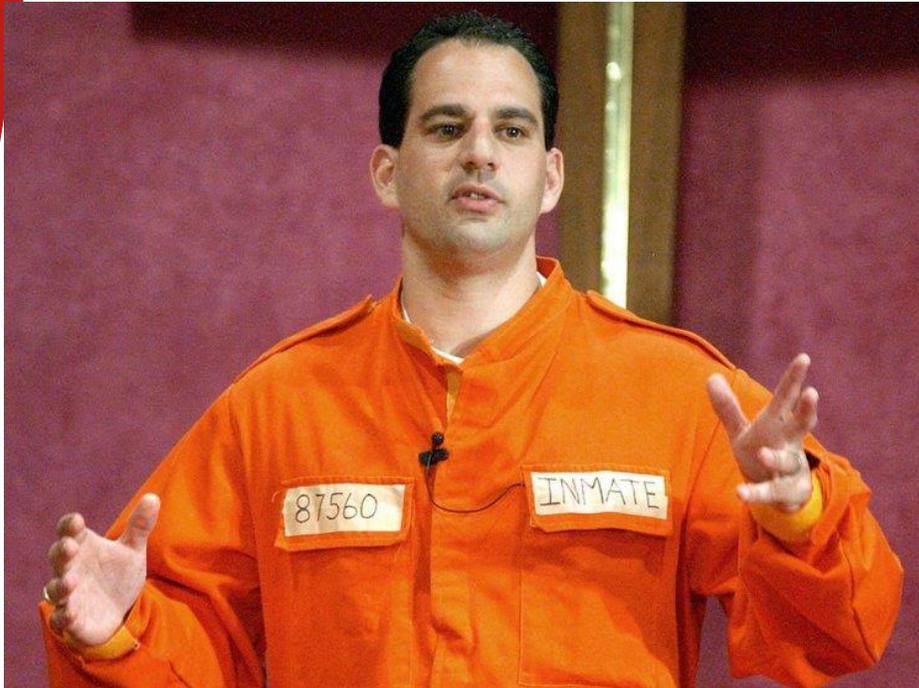
**More**

**Current**

**Frauds**

**Closer to  
Home**

## ***ZZZZ Best scam***



AP Photo/Denis Poroy

A 15-year-old Barry Minkow started a carpet cleaning company in 1980s Los Angeles. By 21, Minkow was found to have used ZZZZ Best to withdraw \$3 million for his personal account—diverted \$18 million to an associate's firm.

After being sentenced to serve 25 years in prison for 57 counts of fraud and racketeering, Minkow converted to evangelical Christianity. He became a *pastor and fraud investigator* upon receiving parole in 1995. He was sent back to jail for five years after committing a short-and-distort stock fraud.

While imprisoned, Minkow was sentenced to five additional years for stealing \$3 million from defrauded church members where he served as pastor.

## Elizabeth Holmes



WSJ

**Promised to change the world of medicine with new technology and lured investors: Henry Kissinger and James Mattis and a *partnership with Walgreen's*.**

**Holmes performed demonstrations using other company's technology while claiming it was the work of Theranos. (2010 – 2017)**

**The SEC charged Holmes with lying to create more than \$700 million for Theranos in outside investments.**

**Holmes reached a settlement and agreed to pay a \$500,000 fine, hand over 19 million shares of the company, and is not allowed to be an officer of a public company for 10 years.**



REUTERS/Noah Berger

Caught with millions of fake accounts in an instance of employees trying to meet quotas through cross-selling. (Reported 2011 / 2013)

Now, Wells Fargo is under fire for improperly handling fraud cases because it closed many of the accounts in question instead of performing the legally mandated investigation.

The bank settled with regulators to pay a fine of \$1 billion to be split by the Consumer Financial Protection Bureau

## Fraud takes a significant toll on organizations.

- Typical organization loses **5%** of revenues to fraud in a given year.
- The losses caused by fraud reported in the study totaled more than **\$6.3 billion**, an **average loss of \$2.7 million** per case.
- That average was boosted significantly by the **23.3% of cases** with losses of **\$1 million or more**.

**OCCUPATIONAL FRAUD – SMALL  
BUSINESSES**

```
graph TD; A[OCCUPATIONAL FRAUD – SMALL BUSINESSES] --> B[Medium Loss $130,000]; B --> C[Businesses less than 100 Employees suffered medial loss of $200,000 (Double 2016)];
```

**Medium Loss \$130,000**

**Businesses less than 100 Employees suffered  
medial loss of \$200,000 (Double 2016)**

# **Fraud & Cybercrime Issues for Small Businesses**

## **Risk Awareness**

- \*Misplaced Trust, dependency**
- \*Everyone is not as honest as you**
- \*Perception that You have more than you need**
- \*Intention to borrow**

## **Banking**

- \*Dedicated Computer**
- \*Password**
- \*Employee Background Checks**
- \*Insurance**
- \*Compromised Credit Cards**
- \*Signature stamp**



Expertise lies  
in your  
business  
operations

Likely to  
commit Fraud

**Long-term  
employee**



**Expertise  
lies in your  
business  
operations**

## **Controls**

- **Division of responsibilities**
- **Posting of receipts and disbursements vs bank reconciliations**
- **Management Approval**
- **System controls**
- **Publicized Rules & punishments**

## Common

- Employee having financial issues
- I don't get paid enough

## Rationalizations

- Everyone else does it
- No One Gets Hurt
- Just Borrowing

## Types

- **Check tampering schemes**, Payroll and cash larceny
- **Asset Misappropriation (Theft)** – Most common / least costly
- **Stealing** cash before it is recorded (skimming)

## Of Fraud

- Payroll fraud (increasing pay rate, unauthorized bonuses)
- Corruption (Bribery, Illegal Gratuities, Purchasing Schemes)
- Financial Statement – Less frequent; most financial impact (Fictitious Revenue, Improper Asset Valuations, Understated revenues, Timing Differences)

# Why People commit Fraud / Red Flags

**Financial Need /  
Difficulties**

**Opportunity**

**Living Beyond  
Means**

**Close Association  
with vendor /  
Customer**

**Unwillingness  
to Share Duties**

**Divorce /  
Family  
Problems**

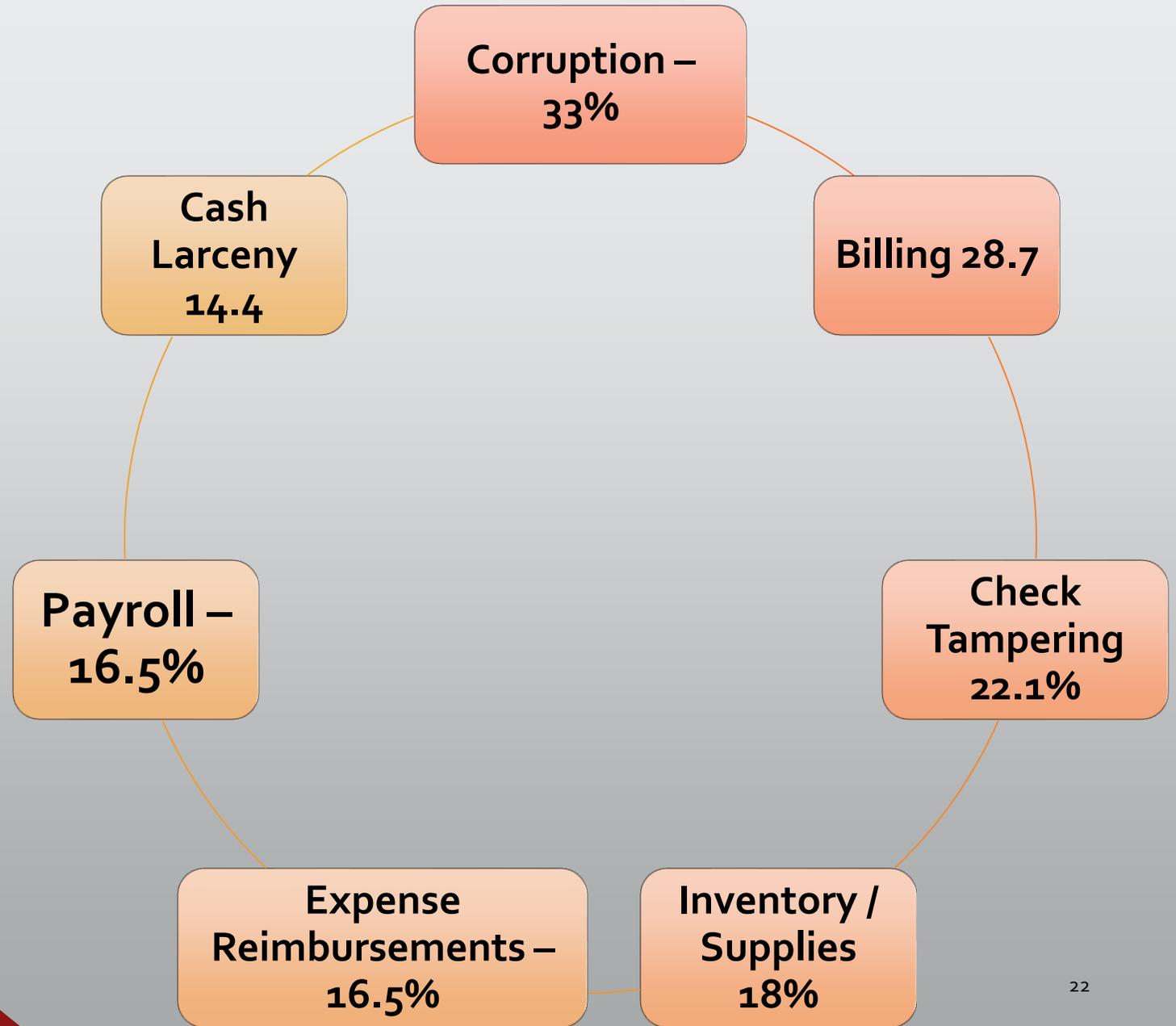
**Irritability,  
Suspiciousness  
or  
Defensiveness**

**Addiction  
Problems**

**Complained  
About  
Inadequate Pay**

**Refusal to  
Take  
Vacations**

# Ranking



# Fraud Prevention or Detection

Segregation of  
Duties

Bank  
Reconciliations  
and Payroll  
Reconciliations

Secure Inventory

Secure Supplies

Background  
Checks / extensive  
prescreen /  
references

Communicate and  
Display the Code  
of Ethics

Hotlines

Management Review  
and Internal Tips  
(most common  
detection methods)

**Difference  
between error and  
fraud is "intent"**

## ***TAKE-A-WAYS***

Anti-fraud controls appear to limit damage

Fraud schemes executed at organizations that implement anti-fraud controls continue for *significantly less time* and inflict *much smaller losses*

The percentage of organizations using hotlines topped 60% in 2016 - up 9 percentage points since 2010

Organizations also increased their use of fraud training for employees (51.6%, up from 44%), anti-fraud policy (49.6%, up from 42.8%), and codes of conduct (81.1%, up from 74.8%).

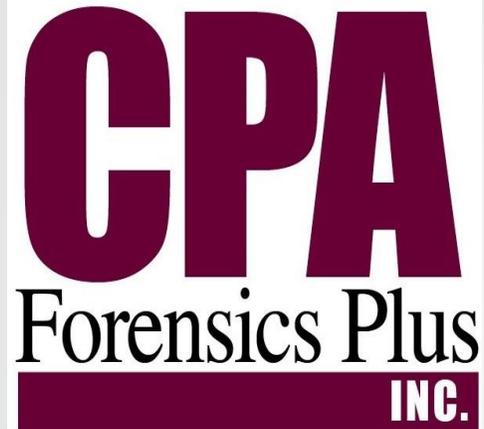


**Small  
organizations at  
most risk:**



**They have fewer resources  
to withstand losses.**

**Much less likely to have  
anti-fraud controls in place  
than larger organizations.**



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#### SOURCES

<https://www.investopedia.com/terms/l/lehman-brothers.asp>

Report to the Nations is available at [ACFE.com/RTTN](http://ACFE.com/RTTN)

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