RED FLAGS OF FRAUD

When we refer to red flags, it means the various situations or conditions that, over the years, have consistently been shown to be contributing factors to fraud, waste and abuse. By themselves, they don't necessarily mean anything, but the more that are present, the higher the risk that fraud, waste and abuse is occurring, or could occur.

There are two general categories of offenders – internal and external. Many government programs have external customers, such as contractors, grantees, or others who potentially can misrepresent facts to obtain money they are not entitled to. Internal offenders are people who use their positions within an organization for personal enrichment through the deliberate misuse or misapplication of the organization's resources or assets. The red flags identified here ought to aid in identifying fraud in both categories of offenders.

PROCESS RED FLAGS

1. Transactions that are different or unusual (without explanation) or suspicious as to:

   - Time (of day, week, month, year, or season)
   - Frequency (too many, too few)
   - Places (too far, too near, and too "Far out")
   - Amount (too high, too low, too consistent, too alike, too different)
   - Parties or personalities (related parties, oddball personalities, strange and estranged relationships between parties, i.e., management performing clerical functions).

2. Discrepancies in Accounting Records

   - Account balances that are significantly over or understated
   - Transactions not recorded in a complete or timely manner or improperly recorded as to amount, accounting period, classification, or organization policy
   - Unsupported or unauthorized records, balances, or transactions
   - Last minute client adjustments that significantly affect financial results (particularly those increasing income presented after submission of the proposed audit adjustments)
   - Excessive number of adjusting entries, and repetitive use of adjusting entries for no apparent purpose.

3. Conflicting or Missing Evidential Matter

   - Suspicious or missing documents
   - Unexplained items on reconciliations
   - No original documents available – only photocopied documents
   - Inconsistent, vague or implausible responses arising from inquiries or analytical procedures
   - Unusual discrepancies between the client's records and confirmation replies
   - Missing inventory or physical assets
   - Excessive voids or credits
   - Shifting of costs from one category or cost account to another
   - Common names or addresses of payees or customers – inability to verify the existence of vendors/subcontractors
   - Alterations on documents (e.g. back dating, white-out)
   - Duplications (e.g., duplicate payments)
   - Questionable handwriting on documents

4. Unusual Relationships

- Appearance of a conflict of interest
- Less than arms length bargaining
- Related party transactions
- Denied access to records or facilities
- Denied access to certain employees, customers, vendors, or others from whom program managers may seek to obtain information from
- Undue time pressures imposed by management to resolve complex or contentious issues
- Unusual delays in providing requested information
- Tips or complaints about fraud

5. Other Concerns

- Significant internal control weaknesses or prior year internal control weaknesses not corrected
- Unexplained increases in costs or claims
- Suspicious, unexpected or unusual trends or shifts in activity.
- Unusual transactions (e.g., for activities outside the normal line of business)
- Changes in accounting principles or the methods of applying them that enhances reported income
- Departure of key financial or operating personnel
- Specific instances of management's conduct that raise serious concerns as to their integrity

OPPORTUNITY RED FLAGS

Fraud Conducted By Employees Against The Organization

- Familiarity with operations (including cover-up capabilities and in a position of trust)
- Close association with suppliers and other key people
- Rapid turnover of key employees either by quitting or firing
- No mandatory vacations, periodic rotations, or transfers of key employees
- Inadequate personnel-screening policies when hiring new employees to fill positions of trust
- Operating on a crisis basis
- Unrealistic productivity measurements
- Poor compensation practices
- An organization that has a culture of having no rules, or failing to enforce rules. One that actually or by implication endorses an organizational culture that does not care about fraud and abuse. For instance, when highly placed executives are less than prudent or restrained on expenditures for travel and entertainment, furnishings of offices, gifts to visitors and directors, etc., it implies to employees that such behavior is acceptable.

Fraud Conducted By Individuals On Behalf Of The Organization

- Related party transactions – less than arms length bargaining
- A complex business structure – often unnecessarily complex business structures are created to hide fraudulent activity and money laundering.
- No effective internal auditing function
- An organization that uses several different auditing firms or changes auditors often
- An organization that is reluctant to give auditors needed data
- An organization that uses several different legal firms or changes legal counsel often

- An organization that uses an unusually large number of different banks, none of which can see the entire picture
- Continuous problems with various regulatory agencies
- Large year-end and/or unusual transactions or adjusting entries to accounting records
- An inadequate internal control system or no enforcement of the existing internal controls
- Unduly liberal accounting practices
- Poor accounting records and inadequate staffing in the accounting department
- An organization that inadequately discloses questionable or unusual accounting practices

SITUATIONAL PRESSURE RED FLAGS

Fraud Committed By Employees Against The Organization

- Significant observed changes from past behavior patterns
- High personal debts or financial losses
- Inadequate income for lifestyle
- Extensive stock market or other speculation behavior
- Excessive gambling
- Undue family, organization, or community expectations
- Excessive use of alcohol or drugs
- Perceived inequities in the organization
- Resentment of superiors and frustration with job
- Peer group pressures
- Undue desire for self-enrichment and personal gain
- Emotional trauma in home life or work life

Fraud Committed By Management On Behalf Of The Organization

- Unfavorable economic conditions within the industry
- Pressure tactics by contractors or grantees to allow questionable costs
- Dependence on one or two products, customers, or transactions
- Obsolescence – the product, the service – the need for an organization no longer existing.
- High debt
- Substantial growth beyond the industry norm. Rapid expansion through new business or product lines often leads to control issues and chaotic management.
- Reduced ability to acquire credit or restrictive loan agreements
- Financial difficulties such as frequent cash flow shortages, declining sales and/or profits, loss of market share, costs and expenses rising higher and faster than sales and revenues
- Difficulty in collecting receivables – high bad debt expenses and aged receivables 90 days or greater, depending on industry.
- Significant tax adjustments
- Urgent need for favorable earnings to support high price of stock or to meet earnings forecast - trying to meet investor expectations
- Need to gloss over a temporarily bad situation in order to maintain management position and prestige
- Significant litigation, especially between stockholders and management
- Unmarketable collateral
- Significant reduction in sales backlogs (indicates future sales have declined)
- Possibility of license being revoked or imperiled, especially if it is necessary for the continuation of business
- Pressure to merge
- Sizable inventory increase without comparable sales increases
- Consistently late reports

- Managers who regularly assume subordinates duties
- Noncompliance with corporate directives and procedures
- Payments to trade creditors supported by copies instead of originals
- Commissions not in line with increased sales
- Unable to verify the existence of vendors, subcontractors

PERSONAL CHARACTERISTIC RED FLAGS

- Rationalization of contradictory behavior
- Lack of a strong code of personal ethics
- A strong desire to beat the system
- A criminal or questionable background
- A poor credit rating and financial status
- Highly materialistic and self-centered
- Are often eccentric in the way they display their wealth or spend their money
- Are reckless or careless with facts and often twist facts to fit their agenda
- Often they may appear to be hard working, almost compulsive, but most of their time at work is spent scheming and designing short cuts to get ahead or beat the competition.
- May demonstrate hostility toward people who oppose their views
- Feel exempt from accountability and controls because of their station or position
- Tendency to override internal controls with impunity and argue forcefully for less formality in controls

With internal offenders, research has shown that about 2/3 of crime is attributable to employees, while 1/3 is attributable to managers and executives. However, the median loss in employee cases was about 14 times less than when a manager/executive was involved. Frauds typically involve a trust element to make them work, and with internal offenders, the research bore out that the longer an employee has been with an organization, the higher the loss tended to be. This is attributed to the fact that most employees gain more responsibility and trust the longer they are with an organization. Otherwise, statistics on internal offenders breaks out like this:

- About 53% are male, with 47% being female, but losses where the perpetrator was a male were over 3x higher than with females.
- About 30% of perpetrators are aged 41-50; 19% for 36-40 age group and 18% for the 31-35 age group. However, the older the perpetrator the higher the fraud loss tended to be.
- 11% of the perpetrators had postgraduate degrees, 33% had bachelors and 56% had high school or less, but once again the higher educated the perpetrator was, the higher the loss – by about a 6 ½ to 1 margin.
- About 87% of perpetrators had never been caught before.
- About 1/3 of the cases involved more than one perpetrator – the effect of collusion increased the loss by a multiple of 7.

Sources include: Professional experience of SA Daniel Coney, DOC/OIG; Association of Certified Fraud Examiners, "2004 Report to the Nation on Occupational Fraud and Abuse"; "Sawyers Internal Auditing", by Lawrence Sawyer, et.al. (Institutes of Internal Auditors, © 1996); and "Internal Auditing Manual" by James D. Wilson and Steven J. Root, (Warren, Gorham and Lamont, Inc., New York, © 1989).

AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009
WHISTLEBLOWER PROTECTION

Section 1553 of the American Recovery and Reinvestment Act of 2009 (the Act), *aka* the McCaskill Amendment, extends "whistleblower protection" to employees who reasonably believe they are being retaliated against for reporting misuse of funds received by their non-federal employer as part of the stimulus package. Specifically, an employee of any non-federal employer, such as a private company or a state or local employing agency, who reports waste, fraud or abuse as described in the act, may not be discharged, demoted or "otherwise discriminated against" because of his or her disclosure. This Act provides protection from retaliation only to ***non-federal employees*** who report waste, fraud or abuse ***connected to the use of stimulus funds***. Protection for federal employees who disclose waste, fraud, or abuse - whether or not it regards the use of stimulus funds – is provided in accordance with Title 5 USC § 2302(b)(8) and § 2302(b)(9).

KEY POINTS

The Act prohibits retaliation against a non-federal employee who discloses information that the employee reasonably believes constitutes evidence of:

- Gross mismanagement of an agency contract or grant relating to stimulus funds;
- Gross waste of stimulus funds;
- Substantial and specific danger to public health or safety related to implementation of stimulus funds;
- Abuse of authority related to implementation or use of stimulus funds; or
- Violation of law, rule, or regulation related to an agency contract or grant relating to stimulus funds.

The allegation of waste, fraud, or abuse stemming from the use of stimulus funds that resulted in the alleged retaliation must have been reported to an Office of Inspector General (OIG), the Recovery Accountability and Transparency Board, the Comptroller General, a member of Congress, a State or Federal regulatory or law enforcement agency, a court or grand jury, a Federal agency head or his/her representatives, or a person with supervisory authority over the employee (or another employee of the employer who has the authority to investigate, discover, or terminate misconduct). Such disclosures *may* be made during the course of an employee's duties.

Allegations of *reprisal* for reporting waste, fraud or abuse stemming from the use of stimulus funds may be reported to the "appropriate" Inspector General. (If multiple federal agencies are involved, please consult your Office of General Counsel (OGC) as to which IG office should handle the matter).

Within 180 Days of Receipt of a Whistleblower Complaint the OIG Must		
I. Investigate the complaint and issue a report of the findings to the complainant, the complainant's employer, the head of the appropriate federal agency, and the Recovery Accountability and Transparency Board;	**II.** Determine that the complaint is a) frivolous (and therefore does not merit investigation); b) does not relate to stimulus funds; or 3) that another federal or state judicial or administrative proceeding was invoked to resolve the complaint; **or**	**III.** Exercise its discretion not to conduct or continue an investigation. However, if exercising this discretion, a written explanation must be provided to the complainant and the employer. (Note, the 180 day limitation does not apply to this discretion, but presumably the decision would be made sooner)

<u>If the OIG is unable to complete the investigation within 180 days of receiving a complaint:</u>

- The Inspector General and the complainant may agree to an extension; or
- The Inspector General may, without agreement from the complainant, extend the investigation up to an additional 180 days, but must provide written explanation to the complainant and the complainant's employer.

<u>Federal agency response is required -- within 30 days of receipt of an OIG investigative report:</u>

- The head of the federal agency must either 1) issue an order denying relief; or 2) order the employer to take affirmative steps to remedy the reprisal. If an employer fails to comply with an order issued by the head of the agency, the agency *must* file suit in federal court to enforce the relief order. If the head of the agency denies relief or fails to take action, or if the IG office decides not to investigate the allegation, the complainant may file suit against the employer.

***The complainant has the right to access the OIG investigation file** (subject to the Privacy Act)
The OIG may exclude information that is protected by attorney-client or other codified government privilege, and information where disclosure will impede a continuing investigation, disclose law enforcement techniques and procedures, or disclose the identity of a confidential source.

	PROHIBITED PERSONNEL PRACTICES 5 U.S.C. §2302 (b)(8) and/or (b)(9)	**AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009 §1553**
WHO IS COVERED:	**Federal employees**, former employees or applicants for federal employment.	**Non-federal employees of employers receiving stimulus funds**. *(Does not cover federal employees).*
CATEGORIES OF DISCLOSURES:	A violation of law, rule, or regulation; gross mismanagement; gross waste of funds; an abuse of authority; or a substantial and specific danger to public health or safety.	***Where use or implementation of stimulus funds:*** A violation of law, rule, or regulation (including the competition for or negotiation of a contract) or grant, awarded or issued; gross mismanagement; gross waste; an abuse of authority; or a substantial and specific danger to public health or safety.
MUST REPORT TO:	Any person (other than wrongdoer)	• Recovery Accountability and Transparency Board • Inspector General • Comptroller General • Member of Congress • State or Federal regulatory or law enforcement agency • Court or grand jury • Head of a Federal agency or his/her representatives • Person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct).
COMPLAINANT MUST HAVE:	A reasonable belief that wrongdoing occurred.	A reasonable belief that wrongdoing occurred.

For more information please visit:
www.oig.doc.gov