

## Anatomy of a Fraud

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## Credit is due...

Adapted from a presentation designed by  
David Cotton, CPA, CRD, CGFM  
Chairman, Cotton & Company, Alexandria, VA.

Mr. Cotton generously shared his slides and  
materials with us.

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## ***Let's Do Something Different ...***

Let's ...

- Take a deeper look at some of the characteristics of fraud;
- Determine what the typical fraud perpetrator looks like;
- And then ...

*Let's solve a crime!*

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**But first...**

**A short test.**

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## **Internal Control**

*"a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations."*

-- Council Of Sponsoring Organizations  
of the Treadway Commission

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**What is the *Most* Important Reason for Having a Strong Internal Control System?**

2. To safeguard assets from unauthorized use or misappropriation (i.e. to prevent fraud)
3. To prevent errors from occurring

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## Keep this in Mind...

- Few things are more devastating, demoralizing, and tragic than the discovery that someone you trusted has committed fraud
- There is, however, one thing that is considerably more devastating, demoralizing, and tragic ...

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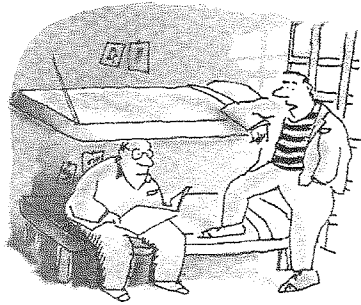
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Eric & Bill

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## Will Your Auditors Find Fraud?

- ✓ The fact of the matter is that fraud is *very* difficult to detect
- ✓ Even when fraud is present and fraud risk factors are evident and responded to properly, fraud is *very* hard to prove
- ✓ Prevention is far easier than detection
- ✓ Strong internal control is the best means of prevention
- ✓ Establishing and maintaining strong internal control is *management's* responsibility

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***And now...***

Time for another  
test.

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**True or False?**

- Internal control is *BORING!*
- It can't happen to us.
- The best control is hiring people we trust.

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**Some of the  
characteristics of  
fraud ...**

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## The Five Attributes of All Frauds

Perpetrator

Victim

Motive

Opportunity

Intent

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Motive

Perceived  
Opportunity

Rationalization  
or Justification

## The "Fraud Triangle"

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## The "10-80-10" Rule

*Would never do  
anything  
dishonest  
under any  
circumstances*

10%

*Always on the  
lookout for  
something  
to steal*

10%

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## The "10-80-10" Rule



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## Opportunity

- Every internal control weakness represents an opportunity for fraud to occur
- Lack of segregation of duties is the number one enemy
- Remember that collusion can overcome almost all controls and can thwart most generally accepted auditing procedures and techniques

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## Rationalization (or Justification)

- Some fraud perpetrators are shameless and remorseless
- Most fraud perpetrators don't want to think that they are evil people
- Hence, rationalizations/justifications allow the perpetrators to live with themselves

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## Rationalizations/Justifications

➤ Typical rationalizations/justifications:

- "We need to adjust this year's earnings; otherwise stockholders will be misled about our true condition"
- "I'm just taking what they owe me"
- "Everyone does it"
- "Management is a bunch of creeps; they deserve to be ripped off"
- "I'm not stealing; I'm just borrowing the money, and I'll pay it back"

➤ Some rationalizations are more creative than others

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## Motivation

*"Embezzlers are driven by insatiable greed."*

*according to Walter C. Jones, CPA, CFE  
Disclosures, Virginia Society of Certified  
Public Accountants, November 1999*

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## Motivation

*"Embezzlers are driven by unbearable financial pressure"*

*--according to Dave Cotton*

## Motivation

- Unbearable financial pressure
- "Unbearable" is different for different people:
  - *"I'd really like to have that new convertible"*
  - *"I'm way over my head in debt and I can't bear the humiliation of declaring bankruptcy"*
  - *"I like to gamble, I keep losing, but I know my luck will change soon"*
  - *"If I don't come up with \$75,000 for the operation, my loved one will die"*

## Motivation

- *Everyone* can have a motivation to commit fraud
- Why do some people commit fraud while others do not?
- There are three barriers to succumbing to the motivation to commit fraud ...



**An Individual's  
Fraud Defenses**

Financial  
Need

Sufficient  
Legitimate  
Sources of  
Money

A Strong  
Ethical and  
Moral  
Foundation

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**An Individual's  
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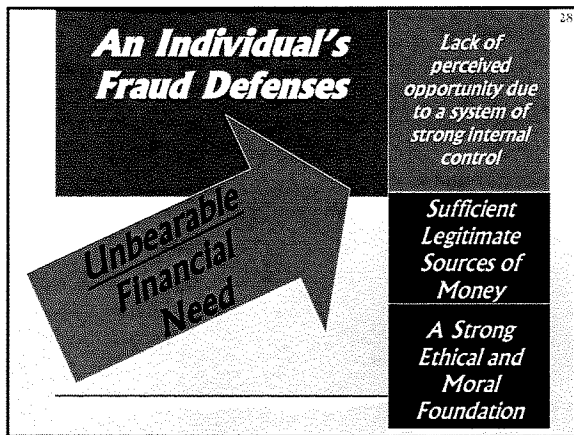
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**What does a fraud perpetrator look like?**

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**The Profile of the Fraud Perpetrator**

The block contains two black and white photographs of men. The man on the left is wearing a suit and tie, sitting at a desk. The man on the right is wearing a light-colored shirt. Below the photos is a horizontal line.

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## The Profile of the Fraud Perpetrator

The typical white-collar criminal tends to be:

- Either male or female
- Young or middle-aged or elderly
- White or some other color
- Either educated or not educated
- Religious, atheist, or agnostic
- Extroverted or introverted
- Low-income, medium-income, or high-income

## The Profile of the Fraud Perpetrator



## The Profile of the Fraud Perpetrator

The typical white-collar criminal tends to be:

- Someone just like you or me
- Who finds herself/himself faced with unbearable financial pressure

*AND*

- Perceives an opportunity to relieve that pressure without getting caught

## Who Did It?

➤ Now that you know the characteristics of fraud and what the typical fraud perpetrator looks like ...

➤ Let's see if you can identify the fraud perpetrator in a based-on-a-real-life case study.

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## NITWIT

### A Case Study in Fraud

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### **NOTE:**

- The names of the organizations and characters in this case study have been changed, and are not the real names of the organizations and persons involved in the case from which this story was derived.
- Any similarity between the organizations, characters, and events depicted in this case study and organizations, persons, and events with which you may be familiar is entirely deliberate.

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**...places, everyone!**

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**National Institute of Technicians  
Working to Improve Technology  
a not-for-profit organization**

- Theresa Kloth, Executive Director
- Cameron Shapht, Chief Financial Officer
- Heywood Jabuzzoff, Board Chair
- Anita Brewski, Senior Partner with Awl, Havva, Brewski & Company (NITWIT's independent audit firm)
- Robin "Red" Inke, Owner of Lasting Impressions Productivity Services (does all of NITWIT's printing, publishing, technology, and fundraising support work)

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**National Institute of Technicians  
Working to Improve Technology  
a not-for-profit organization**

- NITWIT receives its funding from diverse sources, including other foundations, corporations, individuals, educational institutions, and government entities

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## FRAUD RISK FACTOR

- A characteristic that provides a
  - *motivation* or *opportunity* for fraud to occur;
  - a *rationalization* for fraud; or
  - an *indicator* that fraud may have occurred

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### National Institute of Technicians Working to Improve Technology a not-for-profit organization

- As we learn a little bit about our ~~perpetrators~~ mean volunteers, see if you can identify any fraud risk factors or vulnerabilities that might indicate a higher risk of fraud.

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### Terri Kloth, Executive Director

- Terri has been NITWIT's executive director for 6 years.
- During her tenure
  - Revenue from fundraising and grants is up over 500%
  - Grant awards have risen over 400%
  - Administrative costs have dropped from 12% to 6% of the annual budget
  - Total staffing has increased by 250% while administrative staffing has only increased by 20%
- Terri is responsible for all hiring and firing decisions including all purchasing and contracting
- Everyone—particularly the board of directors—agrees that Terri has done an outstanding job of meeting the organization's mission, goals, and objectives.

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### Cam Shapht, Chief Financial Officer

- Cam is a retired high school business administration teacher
- Terri Kloth hired Cam as a bookkeeper on a part-time basis 5 years ago
- When Cam started, the books were a mess; Cam quickly brought order to what had been chaos
- As NITWIT grew, Cam agreed to work full-time to help Terri manage the growth, and became a trusted and key advisor
- Cam helped Terri keep administrative staff levels and costs low by expanding his duties as the organization grew. Cam does essentially all of the accounting work; and Terri delegated to him the authority to serve as NITWIT's purchasing and contracting officer

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### Cam Shapht, Chief Financial Officer

- Cam works long hours during the week and on most weekends, and is always cheerful; a true team player
- Cam has always been very satisfied with the modest annual pay increases Terri has given him over the years
- Everyone agrees that Cam does a terrific job; Terri always gives him a great deal of the credit for NITWIT's success
- Cam is very happy working for NITWIT and he has, in fact, turned down offers to work for larger organizations for substantial pay increases

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### Heywood Jabuzzoff, Board Chair

- Heywood is a former senior Federal executive and gained prominence for his groundbreaking work in advanced educational policy applications
- He has been on the Board for 4 years; and was elected Chairman 2 years ago
- Heywood has semi-annual Board meetings at which the executive director, Terri Kloth, gives updates on operational and programmatic activities and achievements, and Cam Shapht, the CFO, gives updates on financial matters, primarily focusing on the annual budget and tracking actual-to-budget performance
- Due to NITWIT's success and growth under her management, the Board has given Terri great latitude in day-to-day management and decisionmaking. Terri makes all hiring and firing decisions and is responsible for all purchasing decisions, including contracting with Awl, Havva, Brewski & Company, the CPA firm that does the annual audit

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**Anita Brewski, Senior Partner with Awl,  
Havva, Brewski & Company, CPAs**

- Anita has been an AHB partner for 10 years and is one of the most respected CPAs in the state
- She has served in numerous positions with the State CPA Society; she is currently chair of the Not-for-Profit Organizations Committee
- AHB has been auditing NITWIT for 4 years and won the engagement as low bidder in the initial year; Anita is partner-in-charge of the NITWIT audit
- AHB prides itself on maintaining high-quality and reasonable fees
- AHB has experienced modest growth over the past 10 years and developed a good reputation for not-for-profit and local government audit and assurance services

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**Robin "Red" Inke, Owner of  
Lasting Impressions Productivity  
Services**

- LIPS has been in business for 20 years
- LIPS bid on and won the contract to do all printing, publishing, technology, and fundraising support work for NITWIT 5 years ago
- LIPS was given the chance to bid on the NITWIT work based on a recommendation from Terri Kloth, NITWIT's executive director, shortly after Terri joined NITWIT
- The NITWIT contract started at only \$95,000 per year; but it has grown to more than \$490,000 per year and is LIPS's largest customer
- LIPS has a very good reputation for quality, timeliness, and customer service

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**Felicia "you have the right to remain silent" Goodman  
Rebekah "tough on crime" North**

- Certified Fraud Examiners hired by the NITWIT board of directors because of certain procurement anomalies found by Awl, Havva, Brewski & Company
- Directed to investigate certain suspicious transactions and quantify any improper procurements and disbursements
- Felicia & Rebekah will be assisted by Nonprofit Network auditors and investigators

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**Rebekah & Felicia were hired  
after the following:**

- In routine tests of transactions, AHB found 2 invoices for "printing and mailing services" from LIPS for \$32,266.74 (\$16,133.37 each)
- NITWIT personnel could not identify anything that had been delivered by LIPS associated with either invoice
- The invoices were stamped "approved for payment" with "T. K." in the "by:" box
- Checks for payment are signed "Terri Kloth" and "Heywood Jabuzzoff"
- AHB brought this matter to the board's attention as "evidence of potential fraud"

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**The initial review of the situation revealed:**

- During the current year under audit, 2012, there were 11 checks totaling \$177,467 disbursed to LIPS for which no goods or services could be identified
- All 11 invoices were for \$16,133.37; were stamped "approved for payment" with "T.K." in the "by:" box
- All checks have Terri Kloth's and Heywood Jabuzzoff's signatures
- In 2011, there were 8 checks (all for \$16,133.37) totaling \$129,067 disbursed to LIPS for which no goods or services could be identified; "T.K." had approved the payments and Terri Kloth and Heywood Jabuzzoff signed the checks

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**The initial review of the situation revealed:**

- In 2010, there were 6 checks (all for \$16,133.37) totaling \$96,800 disbursed to LIPS for which no goods or services could be identified; "T.K." had approved the payments and Terri Kloth and Heywood Jabuzzoff signed the checks
- In 2009, there were 4 checks (all for \$16,133.37) totaling \$64,533 disbursed to LIPS for which no goods or services could be identified; "T.K." had approved the payments and Terri Kloth and Heywood Jabuzzoff signed the checks
- Anomalous disbursements to LIPS over the 4-year period totaled \$467,868

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### Initial interviews revealed:

- Cam Shapht, CFO, says that he has no knowledge of why these apparently improper payments were made; he just processed the invoices as a matter of routine; he offered that he hired LIPS based on Terri's recommendation
- Terri Kloth, executive director, says she trusted Cam and assumed that Cam was only giving her proper invoices to approve; she said she does not have time to "audit" every invoice in the large stacks of invoices Cam gives her; she offered that Cam is in charge of contracting and made the decision to hire LIPS

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### Initial interviews revealed:

- Terri Kloth, also says that she is extremely upset that AHB failed to bring this problem to her attention sooner, "What have we been paying that firm for for the past 4 years?"
- Heywood says that since Terri had already signed the checks before him, he assumed that she had assured that the payments were proper; he also expressed anger with the CPA firm
- "Red" Inke, owner of LIPS, says that he doesn't get involved in billing or accounts receivable; his bookkeepers have handled those matters using some software that he doesn't understand; and there have been 6 different bookkeepers in the past 5 years

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### Brainstorm & Plan Your Inquiries

- Form small brainstorming groups at your tables
- Brainstorm for 7.5 minutes on what fraud scheme(s) may have occurred
- Hypothesize possible perpetrators, motives, opportunities, attitudes, or rationalizations
- *Decide on questions to ask that will help reveal the fraud*
- Then, we'll ask those questions

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## What additional questions shall we ask?

- Cam
- Terri
- Red
- Anita
- Heywood

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## Anomalous Transaction Amounts

• 2012	\$ 177,467
• 2011	129,067
• 2010	96,800
• 2009	<u>64,533</u>
Total	<u>\$ 467,867</u>

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- Terri
- Cam
- Heywood
- Anita
- Red

## Who Did It?

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**The following happened even before the investigation was concluded:**

- The Board asked for and received Heywood's resignation; he was never able to get another executive position (Heywood and Pat Awl lived happily ever after.)
- The Board asked for and received Terri Kloth's resignation; she was never able to get another executive position
- Cam Shapht resigned before being asked to; a cloud of suspicion stayed with him until he sailed off to the Caribbean
- NITWIT's revenues declined by more than 65% during the next year

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**The following happened even before the investigation was concluded:**

- NITWIT's two remaining largest donors threatened to withdraw from further support unless the remaining Board members resigned; they all did so and none ever got another board position in any organization
- LIPS's NITWIT contract was immediately terminated; and the company's three other largest customers took their business elsewhere; several claimed to have received bogus invoices from LIPS; Red filed for bankruptcy

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**The following happened even before the investigation was concluded:**

- AHB's insurance company made full restitution to NITWIT, and immediately tripled AHB's liability insurance premium
- Anita's partners asked her to resign from the firm; she is now an accounts payable clerk for a small manufacturing company; and is no longer active in the CPA society
- AHB lost several major audit clients and the firm's annual sales dropped by 60%; 50% of AHB's employees either were laid off or quit

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## Who Did It?

Please stand if you  
(*and* the character  
you are playing)  
are completely honest?

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## How the investigation was concluded

- Extensive questioning of LIPS's several bookkeepers revealed that the bookkeeper who installed the accounting software several years ago programmed it to re-generate the previous invoice amount automatically unless that automatic invoice amount was overridden by a new amount
  - Subsequent bookkeepers never stayed long enough to understand this feature and did not override the automatic invoice; they always entered new ones
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## NITWIT

What went wrong?

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**What is the *Most* Important Reason for Having a Strong Internal Control System?**

- 1.
2. To safeguard assets from unauthorized use or misappropriation (i.e. to prevent fraud)
3. To prevent errors from occurring

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**Keep this in Mind...**

- ✓ Few things are more devastating, demoralizing, and tragic than the discovery that someone you trusted has committed fraud
- ✓ There is, however, one thing that is considerably more devastating, demoralizing, and tragic ...

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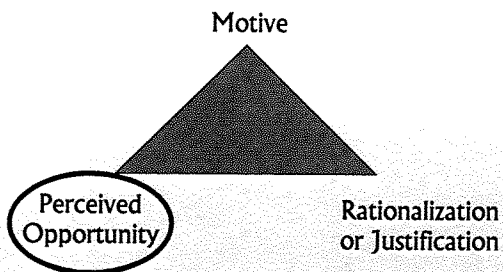
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**Which Parts of the "Fraud Triangle" Can an Organization Control?**



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**Which of the Five Attributes of All Frauds Can an Organization Control?**

- Perpetrator
- Victim
- Motive
- Opportunity
- Intent

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**NITWIT**

It could happen to you.

*Think about it!*

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**NITWIT**

*How did our five honest volunteers do?*

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Websites

Letter on Internal Control

RESOURCES

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