

UT Arlington Department of Internal Audit

# RED FLAGS OF FRAUD\*

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## **WHAT IS FRAUD?**

Fraud encompasses an array of irregularities and illegal acts characterized by intentional deception. The elements of fraud are: a representation about a material fact that is false and made intentionally, knowingly, or recklessly so which is believed and acted upon by the victim to the victim's damage.

The phases of fraud can best be illustrated by The Fraud Triangle on the right. Employees who commit fraud generally are able to do so because there is opportunity, pressure and a rationalization.

**THE FRAUD TRIANGLE**



## **PRESSURE RATIONALIZATION**

Opportunity is generally provided through weaknesses in the internal controls. Some examples include inadequate or no:

- supervision and review,
- separation of duties,
- management approval and/or
- system controls.

Pressure can be imposed due to:

- personal financial problems,
- personal vices such as gambling, drugs, extensive debt, etc. and/or
- unrealistic deadlines and performance goals.

Rationalization occurs when the individual develops a justification for their fraudulent activities. The rationalization varies by case and individual. Some examples include:

- "I really need this money and I'll put it back when I get my paycheck."
- "I'd rather have the company on my back than the IRS."
- "I just can't afford to lose everything – my home, car, everything."



## **HOW CAN FRAUD BENEFIT THE UNIVERSITY?**

The short answer is it cannot, however, in these circumstances, it generally produces a benefit by exploiting an unfair or dishonest advantage that may also deceive an outside party. Perpetrators of such frauds usually benefit indirectly, since personal benefit usually occurs when the organization is aided by the act. Some examples are:

- sale or assignment of fictitious or misrepresented assets;
- improper payments such as illegal political contributions, bribes, kickbacks and payoffs to government officials, vendors, or customers;
- tax fraud; and
- intentional failure to disclose significant information to improve the financial picture of the organization to outside parties.



#### **HOW CAN FRAUD SERVE TO THE DETRIMENT OF THE UNIVERSITY?**

A detriment occurs when the perpetrator directly or indirectly benefits and the university incurs a loss. Some examples are:

- acceptance of bribes or kickbacks,
- embezzlement by misappropriating funds and falsifying financial records (e.g., timesheet, accounting records, etc.) to conceal the act, and/or
- diverting assets to an outsider or an employee that would normally generate income for the university.



#### **WHO IS RESPONSIBLE FOR DETERRING FRAUD?**

Management. Internal Audit is responsible for examining and evaluating the adequacy and the effectiveness of actions taken by management to fulfill this obligation. Deterrence consists of actions taken to discourage fraud and limit financial losses if it does occur. The principal mechanism for deterring fraud is strong internal controls (i.e. policies and procedures, segregation of duties, account reconciliations, etc.).



#### **WHO IS RESPONSIBLE FOR DETECTING FRAUD?**

Fraud should be detected by personnel in the normal course of performing their duties, if strong controls exist. Internal auditors should have sufficient knowledge of fraud to ensure that they may identify indicators that fraud might have been committed. If significant control weaknesses are detected, additional tests conducted by internal auditors should include tests directed toward identification of other indicators of fraud. Internal auditors are not expected to have knowledge equivalent to that of a person whose primary responsibility is to detect and investigate fraud. Audit procedures alone, even when carried out with due professional care, do not guarantee that fraud will be detected.



#### **WHO IS RESPONSIBLE FOR REPORTING SUSPECTED OR ACTUAL FRAUD?**

Anyone within the University who has reasonable suspicions of an alleged fraud or actual evidence of a fraud. All employees have an obligation to ensure the university is a well controlled environment free from wrongdoing or criminal activities.



#### **WHO SHOULD I CALL ABOUT AN ALLEGED FRAUD?**

Call the Department of Internal Audit at 2-0150. If the fraud involves stolen or misappropriated assets (e.g., cash, property, equipment, etc.), you should also call UT Arlington Police at 2-3381 to file an incident report.



#### **WHAT WILL HAPPEN IF I REPORT AN ALLEGED FRAUD?**

All information related to the specific situation is confidential. Employees are not singled out as

“whistle-blowers”, however, management is notified of the particular situation in order that a full investigation may be conducted.



#### **HOW IS A FRAUD INVESTIGATION CONDUCTED?**

Fraud investigations may be conducted by or involve the participation of the Department of Internal Audit, UT Arlington Police and others as appropriate. The Department of Internal Audit will assess the facts known relative to all fraud investigations in order to:

- determine if controls need to be implemented or strengthened and
- design audit tests to help disclose the existence of similar frauds in the future.



#### **THE OFFICE OF INTERNAL AUDIT MAY:**

- conduct inquiries to obtain an understanding of the situation,
- review supporting documentation,
- request or confirm information with outside parties such as banks,
- review departmental and university policies and procedures,
- make recommendations to management to change areas of noncompliance or strengthen controls, and/or
- contact Public Safety if a crime has been committed.



#### **HOW WILL I KNOW THAT A FRAUD HAS BEEN COMMITTED? WHAT ARE THE “RED FLAGS” OF FRAUD?**

The following is a partial list of the factors contributing to fraud. It is not intended to list all possible situations.

- Ineffective internal controls such as:
  - Not separating functional responsibilities of authorization, custodianship, and record keeping. No one should be responsible for all aspects of a function from the beginning to the end of the process.
  - Unrestricted access to assets or sensitive data (e.g., cash, personnel records, etc.)
  - Not recording transactions resulting in lack of accountability
  - Not reconciling assets with the appropriate records
  - Unauthorized transactions
  - Unimplemented controls because of the lack of or unqualified personnel
- Collusion among employees over whom there is little to no supervision

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#### **Embezzlement “Red Flags”**

- Borrowing money from co-workers
- Creditors or collectors appearing at the workplace
- Gambling beyond the ability to stand the loss
- Excessive drinking or other personal habits
- Easily annoyed at reasonable questioning
- Providing unreasonable responses to questions
- Refusing vacations or promotions for fear of detection
- Bragging about significant new purchases

- Carrying unusually large sums of money
- Rewriting records under the guise of neatness in presentation

#### **Other Common Forms of Fraud:**

- Falsifying timesheets for a higher amount of pay
- Pilfering stamps
- Stealing of any kind (e.g., cash, petty cash, supplies, equipment, tools, data, records, etc.)
- Forgery
- Lapping collections on customers' accounts
- Pocketing payments on customers' accounts, issuing receipts on self-designed receipt books
- Not depositing all cash receipts
- Creating fictitious employees and collecting the paychecks
- Failing to end personnel assignments for terminated employees and collecting the paychecks
- Paying for personal expenses with University funds
- Increasing vendor invoices through collusion
- Billing for services not rendered and collecting the cash
- Seizing checks payable to vendors
- Recording fictitious transactions on the books to cover up theft

#### **Other Fraud Danger Signals:**

- High personnel turnover
- Low employee morale
- No supporting documentation for adjusting entries
- Incomplete or untimely bank reconciliations
- Increased customer complaints
- Write-offs of inventory shortages with no attempt to determine the cause
- Unrealistic performance expectations
- Rumors of conflicts of interest
- Using duplicate invoices to pay vendors
- Frequent use of sole-source procurement contracts
- Unreconciled accounts
- Dormant accounts
- Failure to deactivate or terminate access after employees have separated from a position, unit or the university

*\*Information compiled by Wayne University.*