FAMILIARIZATION WITH RED FLAGS IN DETECTION OF FRAUD

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**Red Flags - Definition**

- Red flags are nothing but *symptoms* or *indicator* of situation of fraud.

- A red flag is a set of circumstances that are *unusual* in nature or vary from the normal activity.

- It is a signal that something is *out of the ordinary* and may need to be investigated further.
**Why are Red Flags important?**

- **SA240: Auditor's Responsibility to Consider Fraud & Error**

  Effective for all audits relating to accounting periods commencing on or after 1st April 2009.

  When **planning** and **performing** audit procedures and evaluating and reporting the results thereof, the auditor should consider the risk of material misstatements in the financial statements resulting from fraud or error.

  Two types of misstatements are relevant to the auditor's consideration of fraud:
  - Misstatements arising from *misappropriation of assets*.
  - Misstatements arising from *fraudulent financial reporting*. 
**Why are Red Flags important? – CONTD.**

- Studies of fraud cases consistently show that red flags were present, but were either not recognized or were recognized but not acted upon by anyone.

- *Sometimes an error is just an error*
Types of Red Flags and Fraud

Red flags that are common to most types of fraudulent activity can be categorized as:

- Employee Red Flags
- Management Red Flags
**Fraud Perpetrator Profile:**

- According to the 2006 ACFE survey of more than 1,100 occupational fraud cases, perpetrators have the following characteristics:
  - **Majority of occupational fraud cases (41.2 percent) are committed by employees.**
  - **Approximately 61 percent of the fraud cases were committed by men.**
  - **Most fraud perpetrators (87.9 percent) have never been charged or convicted of a crime.**
  - **Nearly 40 percent of all fraud cases are committed by two or more individuals.**
  - **The median loss attributable to fraud by older employees is greater than that of their younger counterparts.**
**Organizational Profile:**

- Most costly abuses occur within organizations with less than 100 employees.
- *Government and Not-for-Profit* organizations have experienced the lowest median losses.
- Management ignores irregularities.
- High turnover with low morale.
- Staff lacks training.
**Employee Red Flags**

- Employee lifestyle changes: expensive cars, jewelry, homes, clothes
- Significant personal debt and credit problems
- Behavioral changes: these may be an indication of drugs, alcohol, gambling, or just fear of losing the job
- High employee turnover, especially in those areas which are more vulnerable to fraud
- Refusal to take vacation or sick leave
- Lack of segregation of duties in the vulnerable area
Management Red Flags

- Reluctance to provide information to auditors
- Managers engage in frequent disputes with auditors
- Management decisions are dominated by an individual or small group
- Managers display significant disrespect for regulatory bodies
- There is a weak internal control environment
- Accounting personnel are lax or inexperienced in their duties
- Decentralization without adequate monitoring
- Excessive number of checking accounts
**Management Red Flags – contd.**

- Significant downsizing in a healthy market
- Continuous rollover of loans
- *Excessive number of year end transactions*
- High employee turnover rate
- Unexpected overdrafts or declines in cash balances
- Refusal by company or division to use serial numbered documents (receipts)
- Compensation program that is out of proportion
MANAGEMENT RED FLAGS – CONT'D.

- Any financial transaction that doesn’t make sense - either common or business
- *Service Contracts result in no product*
- *Photocopied or missing documents*
- Frequent changes in banking accounts
- Frequent changes in external auditors
- Company assets sold under market value
Changes in Behavior “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
Financial Statement Fraud: Detecting the Red Flags

- Common general red flags of financial statement fraud:
  - Accounting anomalies.
  - Unusually rapid revenue and/or profit growth.
  - Readily noticeable internal control weaknesses.
  - Noticeably “aggressive” financial actions by senior management.
  - Personality or character flaws of the CEO and/or other “C-level” executives.
    - Typically, a senior executive who is inclined to “cook the books” possesses low ethical standards.
    - Secretive or distinctly evasive attitude regarding critical financial information.
DETECTION METHODS FOR GENERAL FINANCIAL STATEMENT FRAUDS:

- Internal audit is consistently engaged in substantive anti-fraud activities.
- Auditors aggressively apply standards SA 240
- Frequent and thorough fraud-oriented ratio analysis—focusing in particular on long-term trends and on comparisons between business units.
- Surprise audits and/or cash counts.
- Implementation of an anonymous, user-friendly tip hotline for use by employees, vendors and customers.
- Data mining using one of the common auditing software applications such as ACL or IDEA.
RED FLAGS IN CASH/ACCOUNTS RECEIVABLE

- Excessive number of voids, discounts and returns
- Unauthorized bank accounts
- Sudden activity in a dormant banking accounts
- Taxpayer complaints that they are receiving non-payment notices
- Discrepancies between bank deposits and posting
- Abnormal number of expense items, supplies, or reimbursement to the employee
- Presence of employee checks in the petty cash for the employee in charge of petty cash
**Red Flags in Payroll**

- *Inconsistent overtime hours for a cost center*
- **Overtime charged during a slack period**
- *Overtime charged for employees who normally would not have overtime wages*
- **Budget variations for payroll by cost center**
- *Employees with duplicate Social Security numbers, names, and addresses*
- **Employees with few or no payroll deductions**
**PERSONNEL RED FLAGS**

- It refer to the employment policies and procedures within a company, including hiring procedures, advancement policies, employee monitoring programs, and disciplinary standards. Company can prevent fraud in this area:
  - *Uses employment screening tools prior to hiring new employees*
  - *Gives employees clear ethical policies by which they are expected to abide*
  - *Properly trains employees so that they are competent in their job functions*
  - *Maintains accurate and up-to-date personnel records*
  - *Treats employees fairly and equitably*
Red Flags in Purchasing/Inventory

- Increasing number of complaints about products or service
- Increase in purchasing inventory but no increase in sales
- Abnormal inventory shrinkage
- Lack of physical security over assets/inventory
- Charges without shipping documents
- Payments to vendors who aren’t on an approved vendor list
- High volume of purchases from new vendors
OTHER FRAUD DANGER SIGNALS

- No supporting documentation for adjusting entries
- Incomplete or untimely bank reconciliations
- Increased customer complaints
- Write-offs of inventory or cash 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
SPECIFIC RED FLAGS

- Complex or unstable organizational structure.
  - Unusually intricate or confusing financial transactions with third-party entities.
  - Sudden or gradual increase in gross margin compared with the company’s prior performance, and with industry averages.
- Cash flows that are negative for the first three quarters and suddenly positive for the fourth quarter—not by just a little, but by more than all losses to date
- Significant sales to companies or individuals whose identity and business track record are questionable.
- Sudden above-average profits for specific quarters.
- Executives or board members have direct personal dependence on the company’s performance.
Once a red flag is identified, one must take action to determine its effect.

- Evaluating the red flag may be accomplished by
  - i. *financial analysis*,
  - ii. *observation*
  - iii. any other *technique* that tests an apparent weakness
Financial analysis has several applications when red flags are present. The most common is to determine what effect it has on the conduct of the local government. For example, what is the potential as well as the historical loss as the result of the red flag? What is the cost to prevent a potential loss from occurring and what will it cost to recoup the identified loss?
NEXT STEPS.... CONT'D.

- Computer programs have been developed that identify a red flag and can even quantify it. Computer red flags that have been used include:
  - Listing that compares actual vs. budgeted expenditures for employee reimbursements to determine unusual patterns
  - Duplicate or non existent Social Security numbers for employees or vendors
  - Taxpayer complaints
  - Unusual patterns of overtime payments
**NEXT STEPS…. CONT'D.**

- Direct observation is the method of choice to determine the effect a red flag has on an organization. For example, if analysis of overtime for an area suggests that one person is falsifying time cards, observing the person’s start and stop times is important.

- Observation is also useful when employee lifestyle changes are noted, or to get an understanding of how an area works. Does the employee in fact drive a new Jaguar on a salary that clearly wouldn’t support it?

- Whether it is fraud or an error, action should be taken to prevent the act from occurring again.
**Red Flags in Gowex Case**

- **GOW’s audit fee is €40,000, which makes sense if Gowex’s actual revenues are only 5%-10% of reported revenue.**

- **Gowex told some investors that New York City was paying them €7.5 million. GOW told Gotham that it is €2 million. The real number was <€200,000 only, according to New York City.**

- **Gowex does not publicly disclose basic metrics, such as hotspot count or wireless revenue segment details.**

- **The 5th June 2014 Mall Plaza press release (in English) made demonstrably false claims. The same was omitted from press release in the native Spanish.**
Drugs, Ranbaxy and lies

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Seven years after the first warning in June 2006 from the U.S. Food and Drug Administration (FDA) and five years after the Department of Justice initiated legal proceedings against the company, Ranbaxy is back in the news for the same wrong reasons. Last fortnight it pleaded guilty to felony charges in the U.S., admitting to selling adulterated drugs with intent to defraud, not reporting that its drugs failed to meet specifications and making intentionally false statements to the government. These are serious charges against any company, not to talk of one from the critical industry of pharmaceuticals, whose products are responsible for curing illnesses and ensuring the well-being of humankind itself. In the event, it is indeed surprising that Ranbaxy managed to get away with a fine of just $500 million. If the charges of the whistle-blower, Dinesh Thakur, are to be believed, Ranbaxy is guilty of not just failing to follow good manufacturing practices as prescribed by the FDA but of outright fraud. The company's actions are a breach of the sacred trust that patients, whether foreign or Indian, place in it when they buy its drugs. The company deserves to be penalised more severely; at its harshest it could even include blacklisting of its drugs pending investigation.
How did you first find out about fraud at Ranbaxy?

- My manager asked me to investigate the extent to which the company had provided "made-up" data to seek the WHO prequalification.

- Very soon we found very large gaps in the data that was submitted to the regulators worldwide by the company; the data needed to secure marketing authorization in many countries across the globe did not exist in the first place.

How did Ranbaxy conduct drug documentation, and how is it supposed to work?

At every step of the way, my investigation found that the company had taken shortcuts, never tested its product before it released it to the market, made up data in the clinic to prove it worked in patients, etc.
How was Ranbaxy able to continue to operate if it was an open secret that it "manipulated almost every aspect of its manufacturing process to quickly produce impressive-looking data that would bolster its bottom line?"

- Until about two years ago, inspectors from the U.S. FDA informed companies like Ranbaxy months ahead of time before they went to India to inspect their manufacturing facilities.

- During an inspection, if the FDA inspector asked for a set of documents to review, the company printed those documents overnight and aged them in specially designed "steam rooms" to make them look old.

- They purchased what are called "innovator samples" — samples of branded drugs from U.S. and European markets — and shipped them in suitcases in violation of the customs laws of many countries that were used in demonstrating quality of their products to regulators like the FDA.
In May 13, Ranbaxy pleaded guilty to seven federal criminal counts of:

1) Selling adulterated drugs with intent to defraud,
2) Failing to report that its drugs didn’t meet specifications, and
3) Making intentionally false statements to the government.

Ranbaxy agreed to pay $500 million in fines, forfeitures, and penalties — the most ever levied against a generic-drug company.
REPORTING FRAUD

- In today’s environment, it is essential that local governments have policies and procedures in place for reporting irregularities and/or suspected fraud.

- These policies and procedures need to be clearly communicated to all employees and reviewed periodically to ensure that they still make sense.

- Must communicate red flags with the appropriate personnel without being concerned for their jobs or some type of retaliation.
CONCLUSION

- Red flags are warnings that something could be or is wrong.
- Auditors, employees, and management need to be aware of red flags in order to monitor the situation and then take corrective action as needed.
- Employees who notice that red flags are ignored may mistakenly believe that it is okay to game the system or that they won't get caught.
- A little fraud soon becomes a large one if left to grow.
CASE STUDY ON GREEN FLAG

- **Name of the Client**: XXX Co. Limited (A MNC Company)
- **Location**: Situated in Industrial Area in a Town
- **Involved into**: Client is involved into manufacture of detergent/cakes. The same is being got manufactured from third party under supervision of their Unit Manager
- **Employee Strength**: 20 office staff and 300+ unskilled staff
- **No. of Shifts**: 3 no.s (24 hours)
- **Assignment**: Internal Audit (once in six months)
- **Year of Audit**: 1994
Case Study on Green Flag - contd.

**Facts of the case:** Was pursuing my CA and was working as Audit officer post completion of training. Conducted the audit twice - first time conducted the assignment along with my principal and second time on my own along with a team member. First time due to inexperience and probably because of the brand perception and considering the experience of the employees and their respect and affection towards us, took the things at Face value. Except some clerical errors could not do much.

Things were looking quite good on the ground and all the records were also partly computerized. The employees were also very cooperative and used to take us for lunch and evening dinners along with Sunday picnic trips. The first assignment was for 15 days i.e seven days with principal and seven days on my own. The second assignment was independent with one reporting junior.

The things looked extremely structured and employees behavior was very cooperative and too friendly especially stores incharge and accounts head.

During second time, also started looking into the things in a normal way and took things at face value. We were conducting the audit smoothly except some minor observations. However, the treatment meted this time was much better as this time was acting as principal. We went for trip to nearest hill station on Sunday by company’s car and they spent good amount of money on the picnic. This was the first trigger point. Then when inquired about the reputation of accounts and stores incharge from few people, came to know that they were quite old in the unit and being third party unit the material also belonged to MNC and their promoters were also not involved in audit.
CASE STUDY ON GREEN FLAG- CONT'D.

The unit Manager of MNC was also coming occasionally and was signing the statements, MIS reports quite casually.

When asked them that want to conduct physical verification of stock, they conveyed that the same was not feasible and used lot of tactics to avoid the same. This was the major trigger and tussle point.

During physical verification found certain obsolete material in stock and shortage of certain items. The next trigger was mismatch of figures while totaling in manual stock registers. When confronted the store manager, he admitted to certain lapses and explained that other teams also had issues. The lab was accepting substandard material and changing the actual reports to suit the requirement. However, was maintain actual data also for each consignment in separate register. When confronted him, he explained who expenses were being exaggerated in accounts deptt and sometimes single invoice was also being entered twice and payment being shown in cash for local purchases.

The consumption reports were also being prepared in a way that the actual consumption and wastage comes within the permitted parameters. The MIS reports being sent to were distorted. The material tank for liquid was also empty against the book records of having substantial quantity.

The excise register were also being managed improperly and glaring things came out.

The weightment receipts for inward material was also being managed in connivance with outside parties.

The production was also being done during night shift by lowering the actual parameters.
Case Study on Green Flag - contd.

Though internal checks and systems were there, however the actual control was with one person i.e Unit Manager.
The people handling various profiles were there in same roles for quite a long time.
Hence, when correlated various points the same, turn out to be fraud of grater magnitude.
Relied on various documents, papers, evidence, cross questioning, threat, physical checks, open mind which helped me to detect fraud of large magnitude and changed my perception about face value.