

Fraudulent substance over legitimate form

September 19th, 2009

 **ERNST & YOUNG**
Quality In Everything We Do

Introduction

Six fraud myths

“Our people would not commit fraud.”

- ▶ *Fact: you cannot vouch for all of your employees*

“Fraud could not happen to us – we are a stable organisation.”

- ▶ *Fact: fraud risks are everywhere*

“We would know if fraud occurred – we watch vulnerable areas.”

- ▶ *Fact: fraud prevention activities often are not aligned with risks that matter*

“If fraud occurred, it would be discovered quickly.”

- ▶ *Fact: individual fraud detection mechanisms have limitations*

“Damage would not be significant – we can deal with it.”

- ▶ *Fact: the impact of fraud cascades*

“We are covered on fraud through SOX compliance.”

- ▶ *Fact: Sarbanes-Oxley projects address financial reporting risks*

The current environment

The Stanford case

- The SEC accused Mr. Stanford of executing a “massive Ponzi scheme” over the last decade, in which he misappropriated funds and made more than \$1.6 billion in “bogus” loans.
- He is also accused of falsifying financial statements to investors who bought \$8 billion worth of certificates of deposit whose large returns turned out too good to be true.

Money Manager ran \$370 Million Ponzi Scheme

- Nicholas Cosmo, the owner of a New York investment firm, Agape World Inc, ran a 370 Million Ponzi Scheme, luring in clients with promises of astronomical returns while secretly blowing tens of millions of dollars on bad trades and conspicuous spending

India's Biggest Fraud

- Satyam Computer's founder B. Ramalinga Raju admitted to inflating the cash balance by nearly \$1 billion, incurred a liability of \$253 million on funds arranged by him personally, and overstated quarterly revenues by 76% and profits by 97%.

The Justice Department accused Siemens of making bribes and trying to falsify its corporate books from 2001 to 2007.

- Siemens AG, settled allegations of corruption of public officials with total fines and penalties of approximately € 1 billion.

Parmalat, one of the world's largest dairy manufacturers, defaults on a €150 million bond

- Before investigators could announce that Parmalat overstated its 2003 Earnings by 530%, and understated its liabilities by €1.8 billion, the company declared that €7 billion in liquid assets, believed to exist in a Bank of America account, did not exist at all. By the end of January 2004, Parmalat filed for bankruptcy, with an audit classifying its debt near €14.5 billion.

Société Générale loses \$7 billion in trading fraud

- One of the largest banks in Europe, revealed that a rogue employee had executed a series of elaborate, fictitious transactions that cost the company more than \$7 billion, the biggest loss ever recorded in the financial industry by a single trader.

The Shell Oil Reserves Scandal

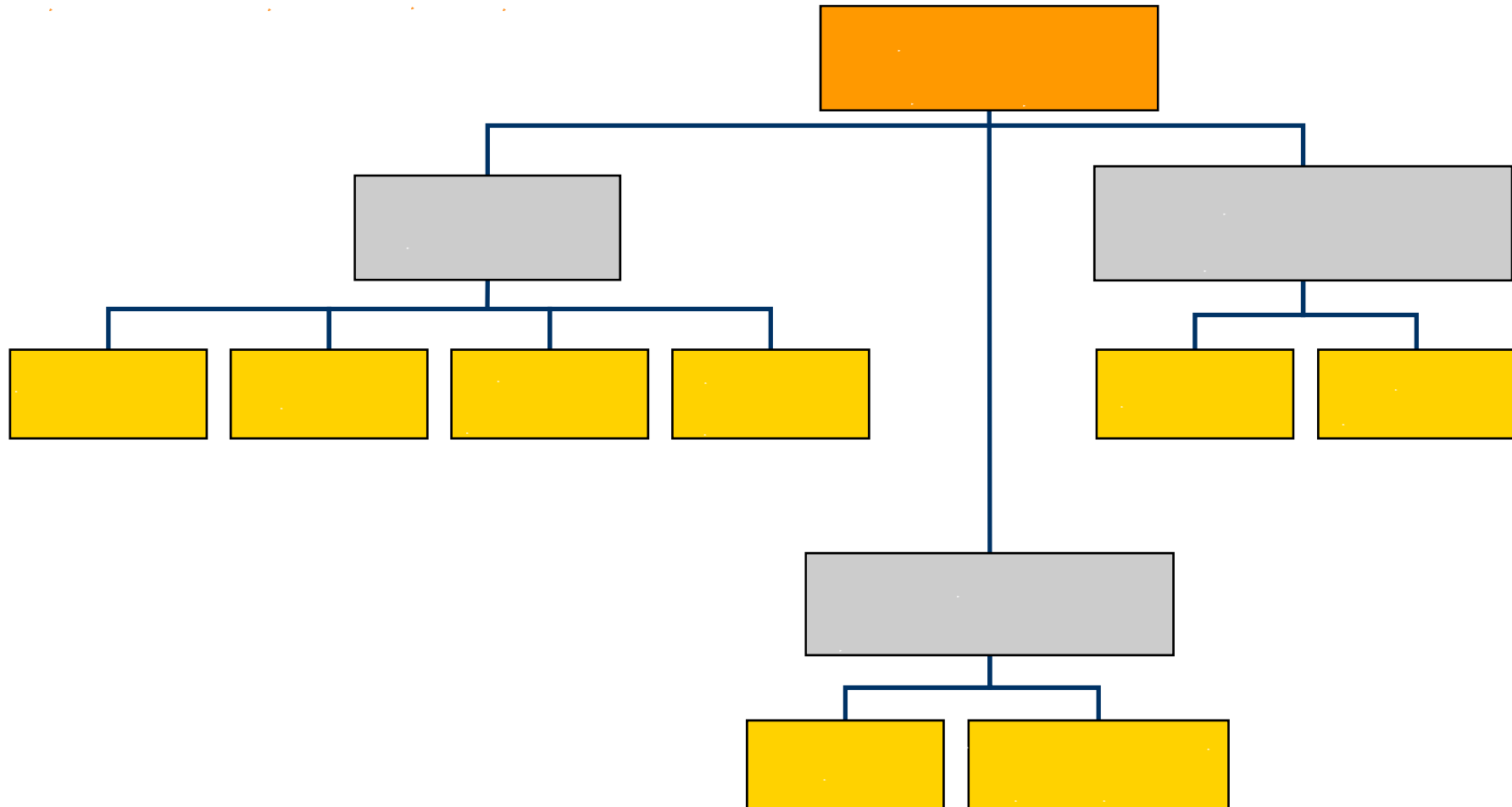
- The oil industry has been gripped by scandal since Royal Dutch/Shell, one of the giants, twice in 2004 downgraded its proven oil reserves by 20 percent, or nearly 4 billion barrels.

What fraud is...


No legal definition of fraud, but common denominators (SAS 99 – ISA 240)

An intentional behavior	INTENTION (planned to favor the fraudster)	Intent for the misrepresentation to be acted upon.
The deceptive intention from the perpetrator	MISREPRESENTATION (words, conduct, failure to disclose)	Intentional material false statements or willful omission of a material fact, either orally or in writing.
An advantage for the fraudster	PREJUDICE (actual or potential loss)	Reliance by the victim on the statements made to the detriment or to the benefice of the organization (financial loss or gain).
A reference frame (law, policy, procedure)	UNLAWFULNESS (against law and customs)	Knowledge by the perpetrator that the statements or omissions are false and misleading.

What fraud is... ⇒ Typology of fraud according to ACFE

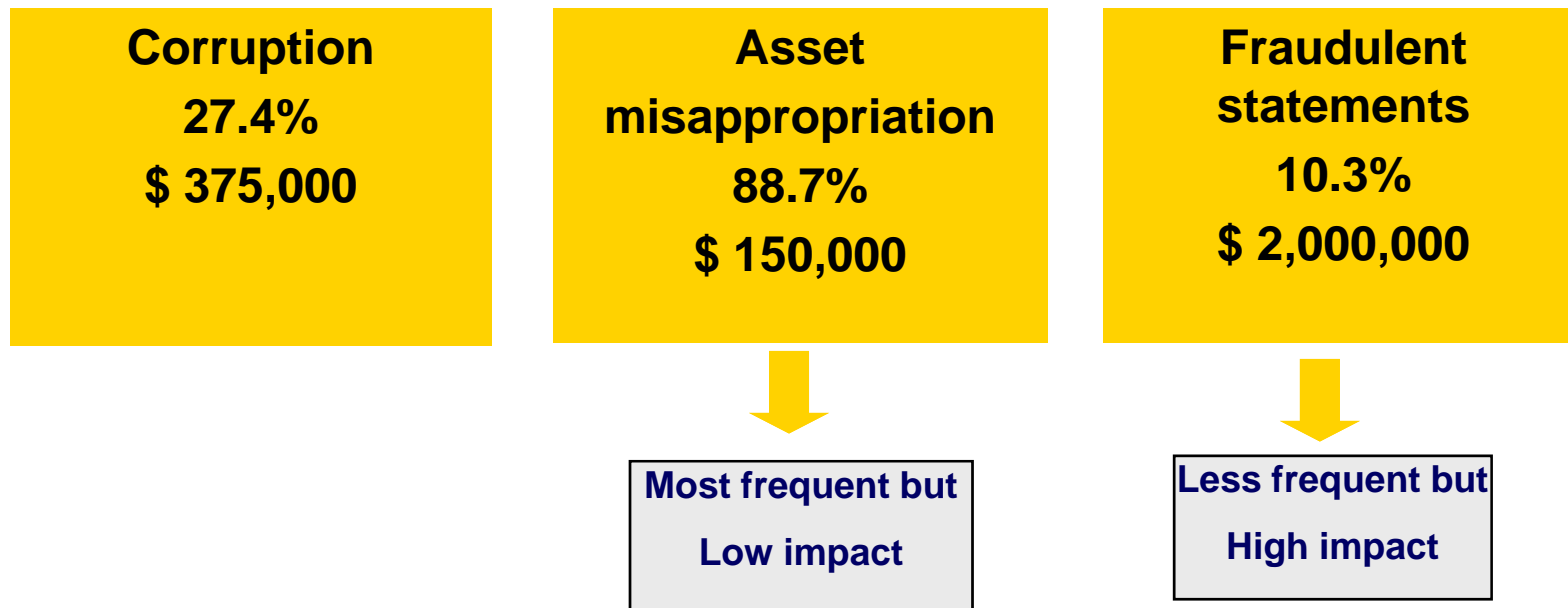


What fraud is... ⇨ Statistics

- “According to research conducted by the Association of Certified Fraud Examiners (ACFE), U.S. organizations lose an estimated **7 % of annual** revenues to fraud. Based on the projected U.S. Gross Domestic Product for 2008, this percentage indicates a staggering estimate of losses around \$994 billion among organizations, despite increased emphasis on anti-fraud controls and recent legislation to combat fraud.
 - All sectors are affected with fraud:
 - ▶ Telecommunication (\$800,000)
 - ▶ Agriculture/forestry/Fishing/Hunting (\$450,000)
 - ▶ Manufacturing (\$441,000)
 - ▶ Technology (\$405,000)
 - ▶ Construction (\$330,000)
 - ▶ Banking and financial services (\$250,000)
 - ▶ Oil and Gas (\$250,000)
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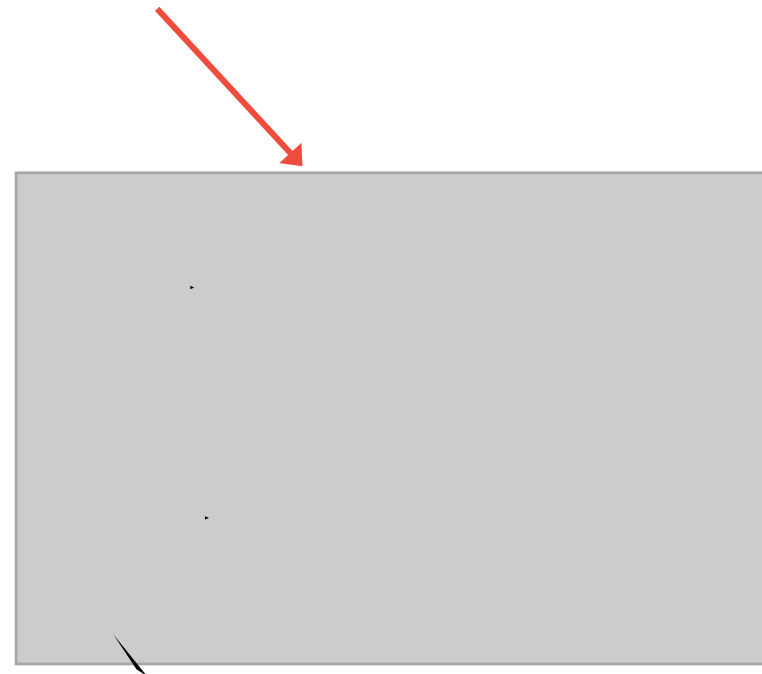
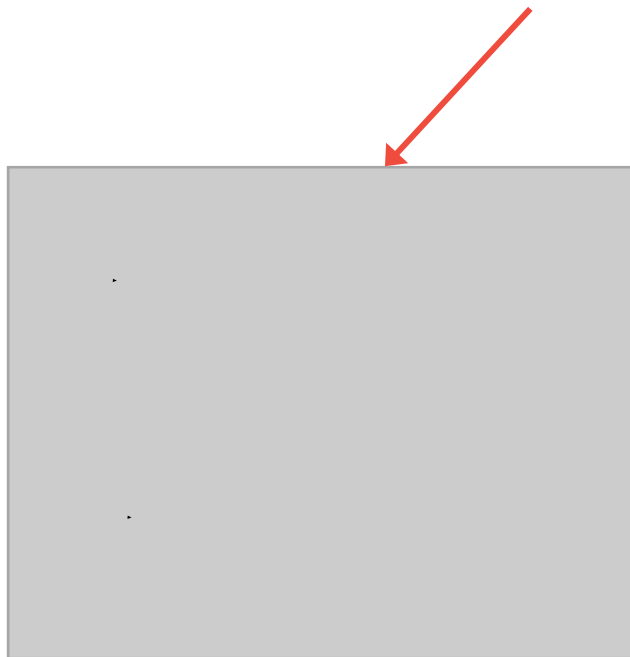
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What fraud is ... ⇒ Average loss by fraud category



Source : « , ... report to the .ation ».

What fraud is... ⇨ How fraud can damage your company



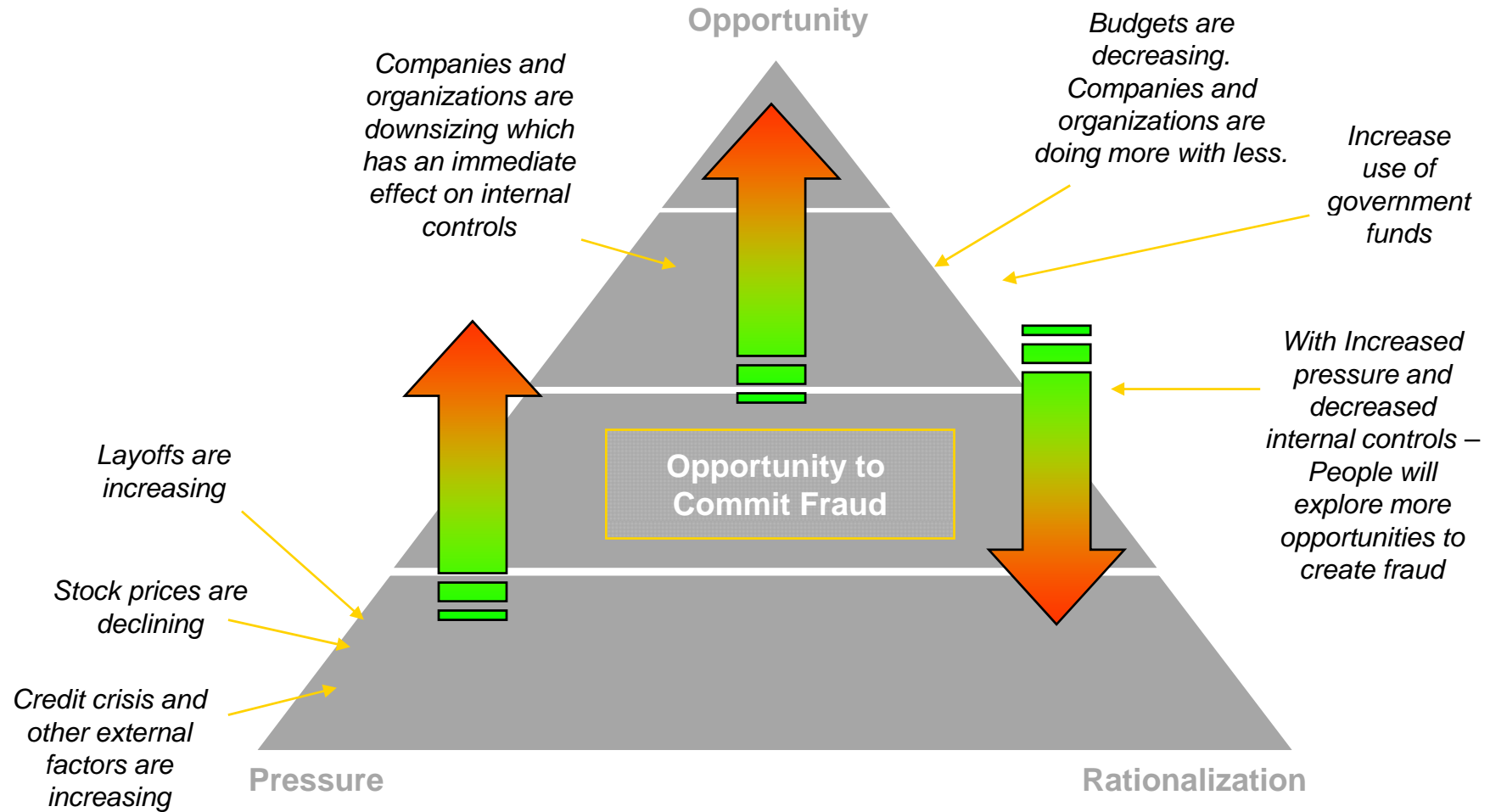
What fraud is... ⇒ Indirect financial consequences



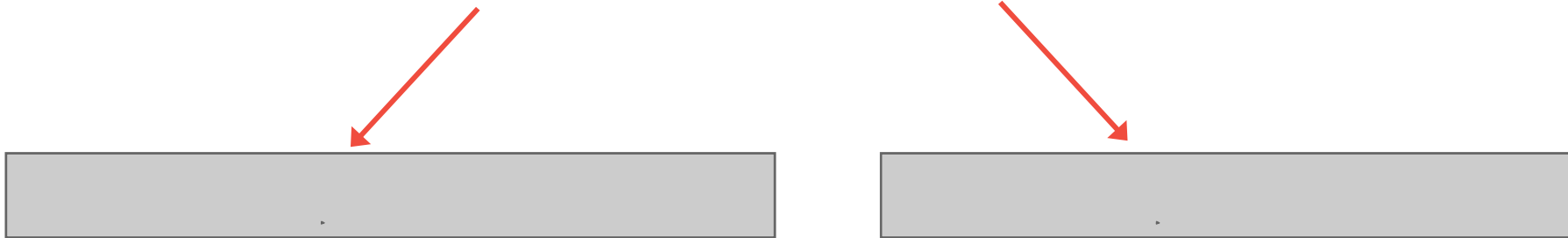
Industry thoughts – Statistics and trends

- The FBI is bracing for a **wave of fraud and corruption cases** stemming from the government's multitrillion-dollar effort to get the economy moving again, the agency's chief told congress (Washington Reuters, March 25, 2009).
- According to a study by the Mortgage Asset Research Institute, the number of **mortgage fraud** reports among loans made last year **grew 28% from a year earlier** (Associated Press March 17, 2009).
- **Economic crisis exposes financial crime.** Industry experts estimate fraud cases on an increase because of the global economic meltdown (Finance News March 14, 2009).
- Top FBI and Justice official said they believed mortgage fraud and other types of corporate criminal behavior has contributed to the economic tailspin. And they said they already have **more than 2,300 open investigations into suspected illegal financial activity** - including 38 probes specifically linked to the crises. (Los Angeles Times February 11, 2009).

The Perfect Storm is Brewing

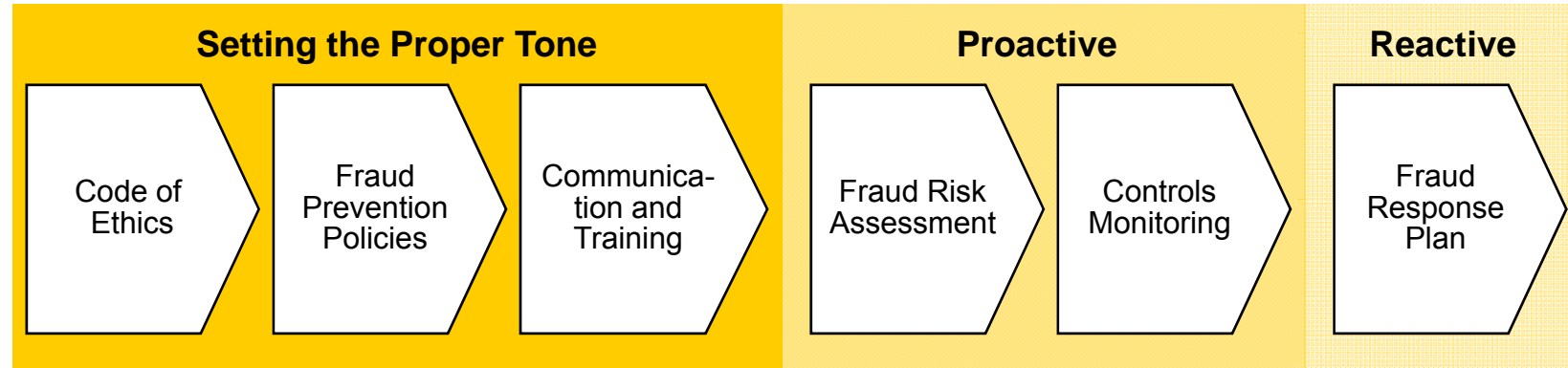


Prevent an protect



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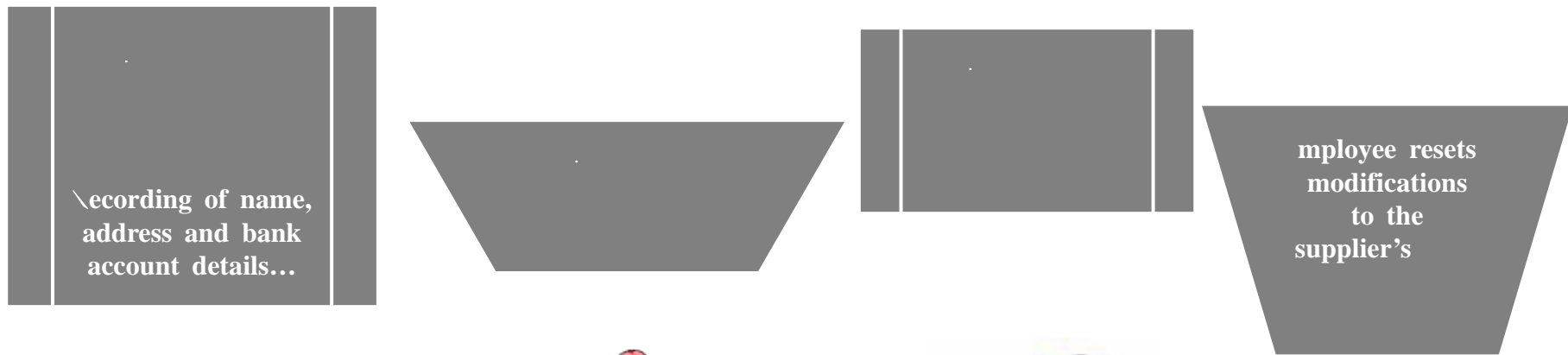
Mitigating fraud risk – Ernst & Young Methodology



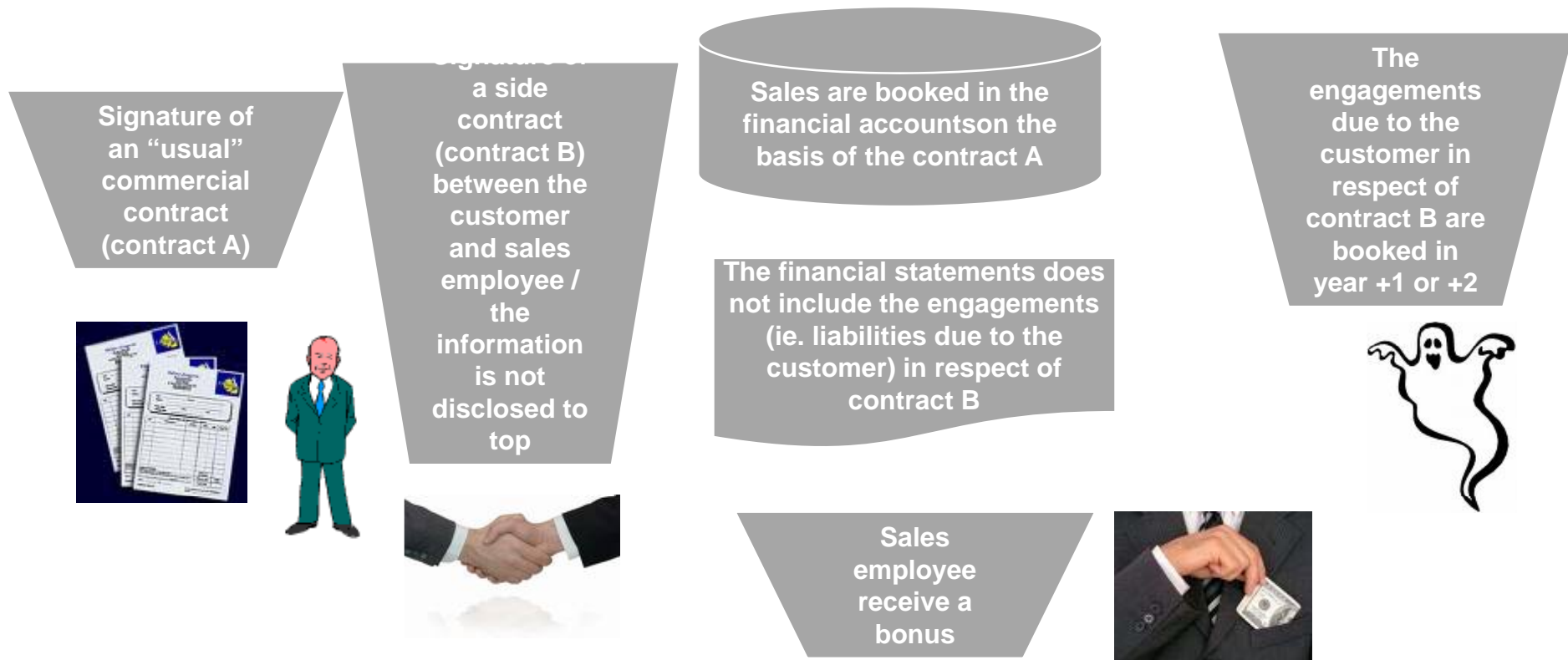
Short examples of fraud schemes

Purchasing process ⇒ Modification of sensitive data

Access rights to sensitive data are insufficiently monitored (access code to master files, tables, types of operations ...)



Sales process ⇨ Side contracts

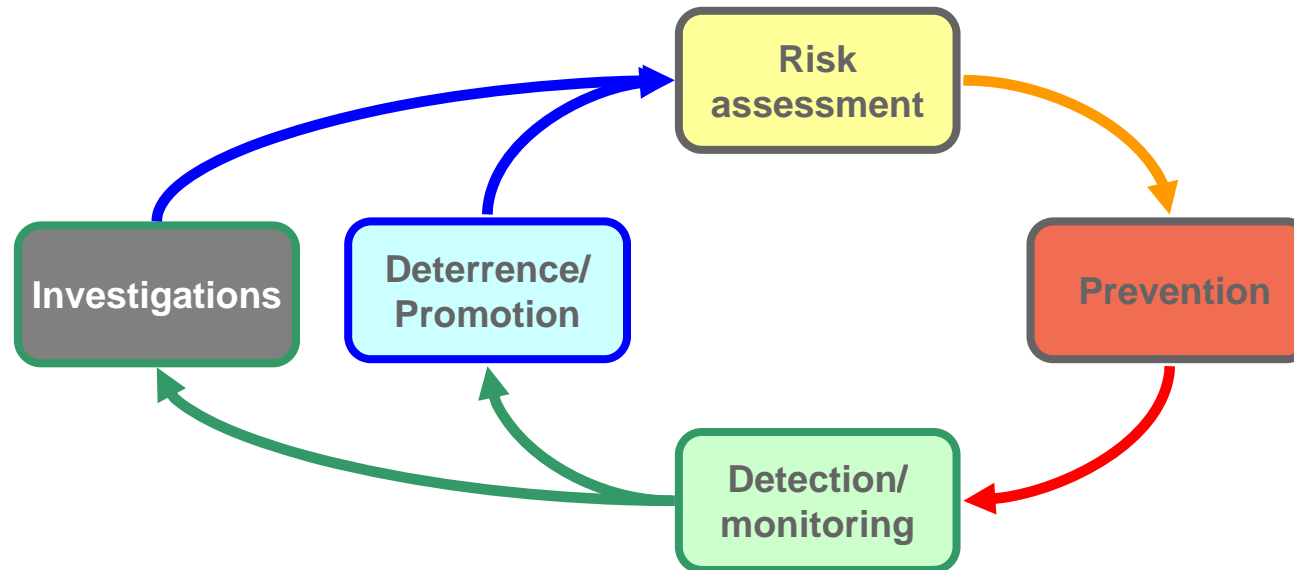


Other processes ⇨ Fictitious employee

Creation of a fictitious employee, whose wages will be paid to the fraudster's own (or its accomplice's)



Fraud Response Plan ⇔ Forensic competencies /skills and methodology



not the ideal investigator; hire external experts: lawyers, , forensic, accounting...

9 Key Questions to Board Members

Prevent	Detect	React
<ul style="list-style-type: none">▶ Do you have a strategy to handle media/regulator interest in the event of fraud to demonstrate you are taking robust, independent and positive action?▶ Do all employees receive regular and relevant anti-fraud training?▶ How does your company demonstrate the effectiveness of your anti-fraud program to shareholders, employees and regulators?	<ul style="list-style-type: none">▶ Do you know what kind of fraud your organization is susceptible to within specific business functions or locations?▶ Is the audit committee keeping a watching brief on the ongoing risks the organization is exposed to?▶ Are you happy that controls are still working effectively post-implementation of any redundancies or consolidation that has occurred in your organisation?	<ul style="list-style-type: none">▶ Are you happy that the company would be adequately resourced and know how to respond in the event of a significant fraud coming to light?▶ Are you happy that the company would be adequately resourced and know how to respond in the event of a significant fraud coming to light?▶ Has the company kept a focus on fraud following identified incident?



What is the Board doing to manage the anticipated increased risks of fraud during the economic downturn?



Thank you for your attention!

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