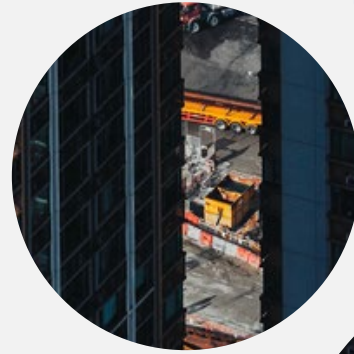# Considering Fraud for Internal Audit

Houston IIA Conference 2023

April 17, 2023

Presented by David Kirtland, CPA, CIA, CFE

Agenda

- Introduction

- Planning an Audit

- Using Analytics

- Discussing Fraud Opportunities with Stakeholders

- What do Fraudsters Look Like?

- Interviewing Auditees

- Evaluating Fraud (Case Studies/Examples)

- Questions

Introduction

Every year, fraud is a major problem for corporations of all sizes. The Association of Certified Fraud Examiners estimates that 5% of REVENUE is lost each year for most organizations.

If this statistic is even remotely accurate, then we have a duty as internal auditors to include it in our procedures so we can better protect our stakeholders.
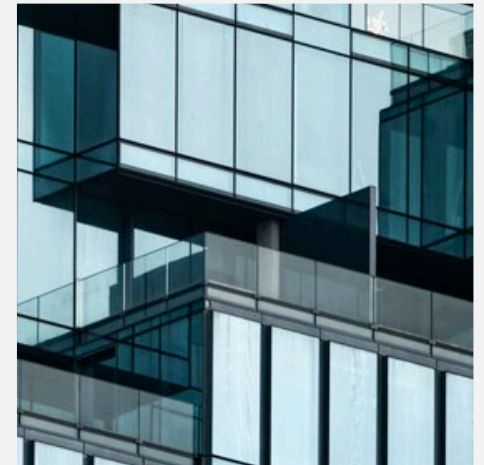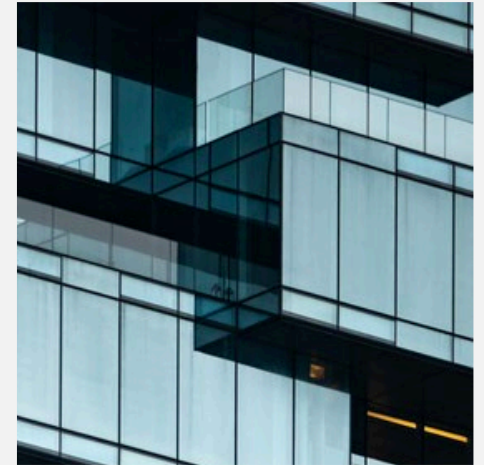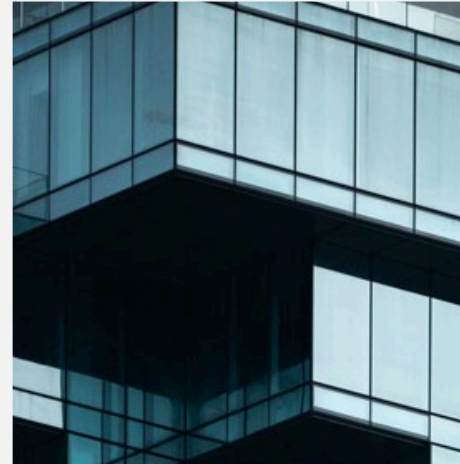
David Kirtland, CPA, CFE

- Head of Internal Audit, JERA Americas

- Houston ACFE Chapter Past President

- Over 22 years of professional experience, 12 of those in Audit

- MBA, Texas A&M University

- BBA & MS Accounting, University of Houston

- Certified Public Accountant

- Certified Fraud Examiner

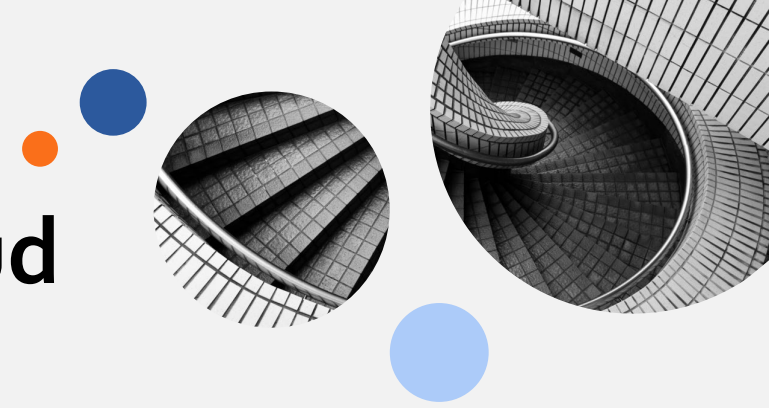- Certified Internal Auditor

- Certified in Risk Management Assurance

How do you plan for an Audit?

Let's dive in!

Planning Steps – **Considering Fraud**

Understanding The Business

- Meeting with Management to understand the process
- Understand the KPIs for the auditee and business unit
- Understand how KPI and other information is communicated out of the business unit
- Understand the users of the information provided by the business unit
- Discuss fraud opportunities (internal & external)

Data Analytics

- Benford's Law (An oldie but a goodie!)
- Understand key financial trends (target 36 months of data)
- Understand dramatic changes in the data
- Understand how the data is pulled or provided
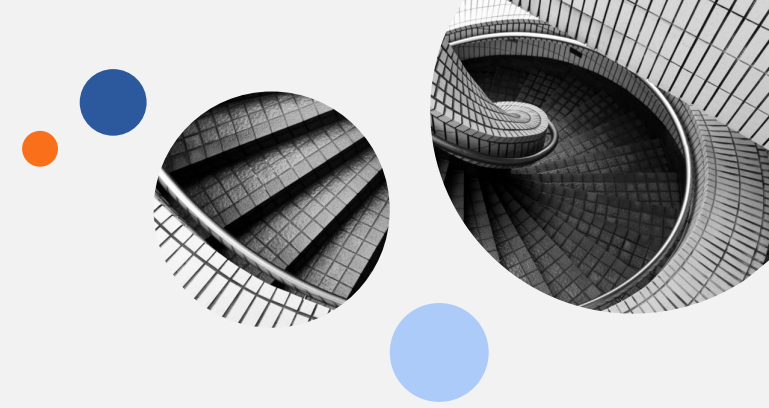- Pull your own data when possible

Using analytics to plan for an Audit

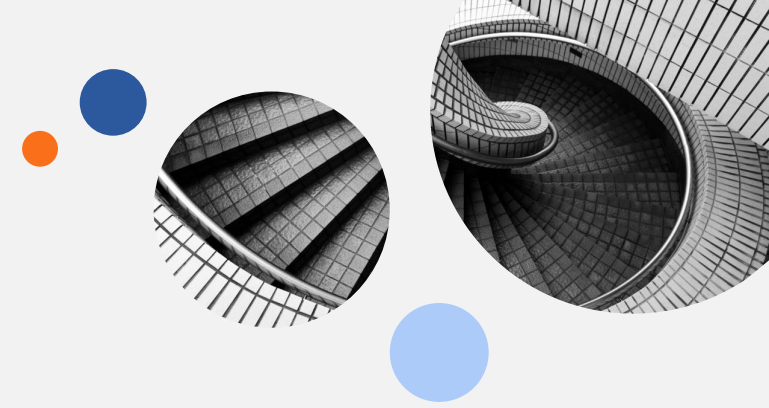**Let's dive in!**

Using Data Analytics

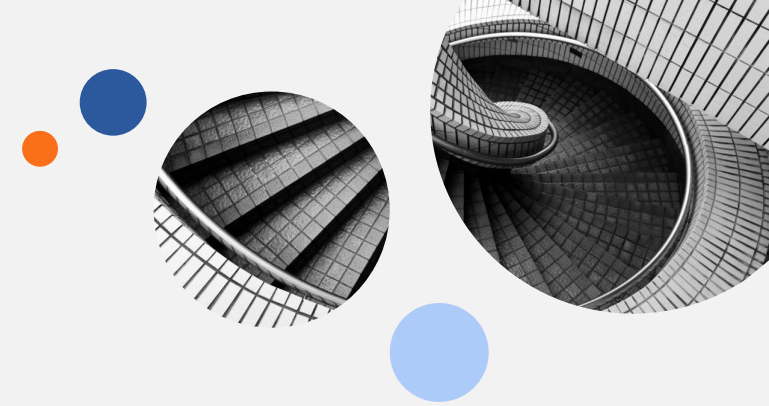What analytics do you currently use when planning an audit?

Using Data Analytics

Common Analytic Procedures

- Benford's Law

Benford's Law

What is Benford's Law

- "The principle that in any large, randomly produced set of natural numbers, such as tables of logarithms or corporate statistics, around 30% will begin with the digit 1, 18% with 2, and so on, with the smallest percentage beginning with 9. The law is applied in analyzing the validity of statistics and financial records." – Dictionary.com
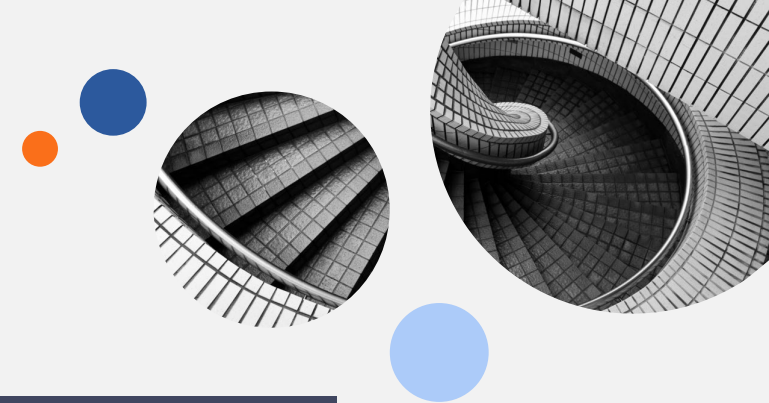
What datasets can I use it on?

- Invoice/payment amounts
- Transactional data
- Expense Reports/P-Card transactions
- Some KPI measurement data sets
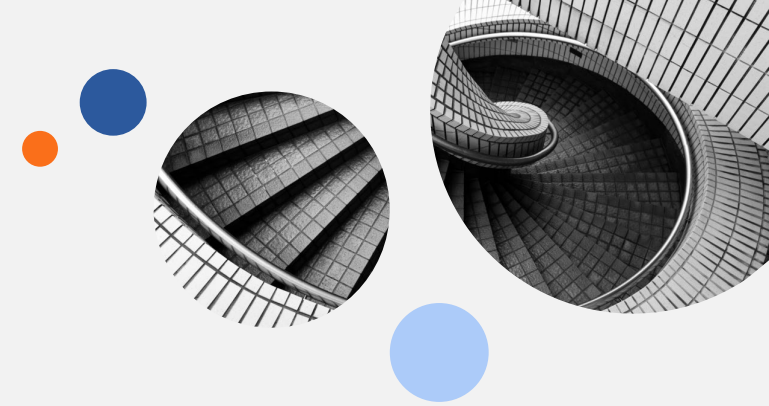
Benford's Law (Example)

Project Summary

- Routine audit over commissions paid to brokers

- Used to identify if there are specific vendors we should look into

- Used to understand the risk of transactions being manipulated by employees

- Used to identify potential fraudulent brokers (Internal & External)

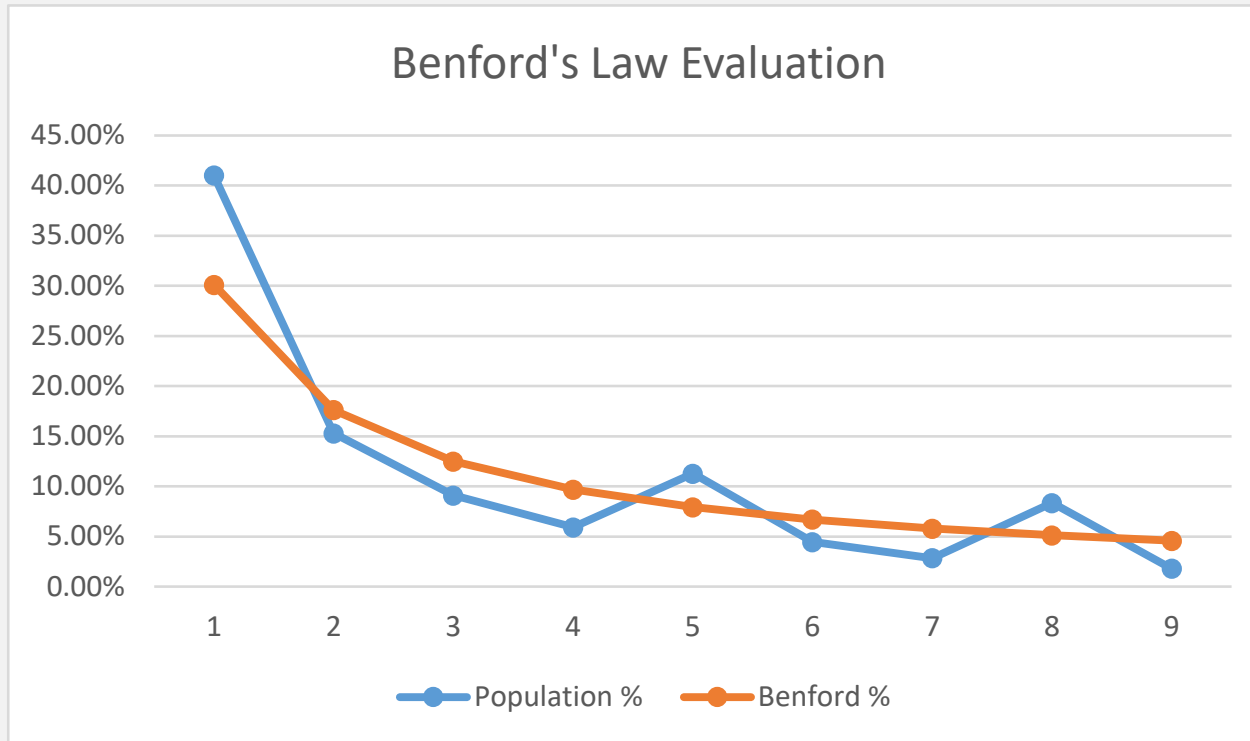- Analyzed 3,799 transactions over 24 month period

First Digit	Probability
1	30.1%
2	17.6%
3	12.5%
4	9.7%
5	7.9%
6	6.7%
7	5.8%
8	5.1%
9	4.6%
Total	100%

Benford's Law (Example)

Initial Review – Upfront Commissions

Benford's Law Evaluation

Chart showing Population % (blue line) and Benford % (orange line) for digits 1–9. Population % starts at ~41% for digit 1, dropping to ~15% at 2, ~9% at 3, ~6% at 4, ~11% at 5, ~4% at 6, ~3% at 7, ~8% at 8, ~2% at 9. Benford % follows the expected curve: ~30%, ~17%, ~12%, ~9%, ~8%, ~6%, ~5%, ~5%, ~4%.

What stands out here?

- WAY more occurrences where the number 1 is used
- Proportion of 5's is disproportionately high
- 8's seem pretty weird too
- There is DEFINITELY something to look into here

Benford's Law (Example)
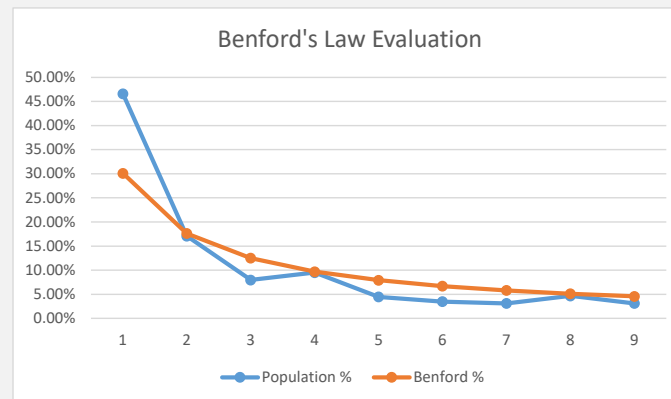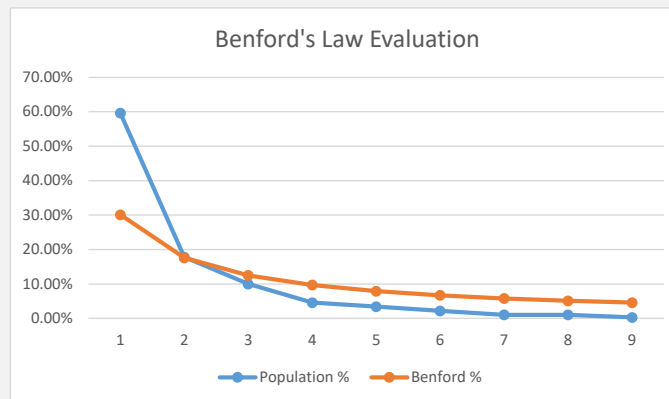
2nd Review – Upfront Commissions
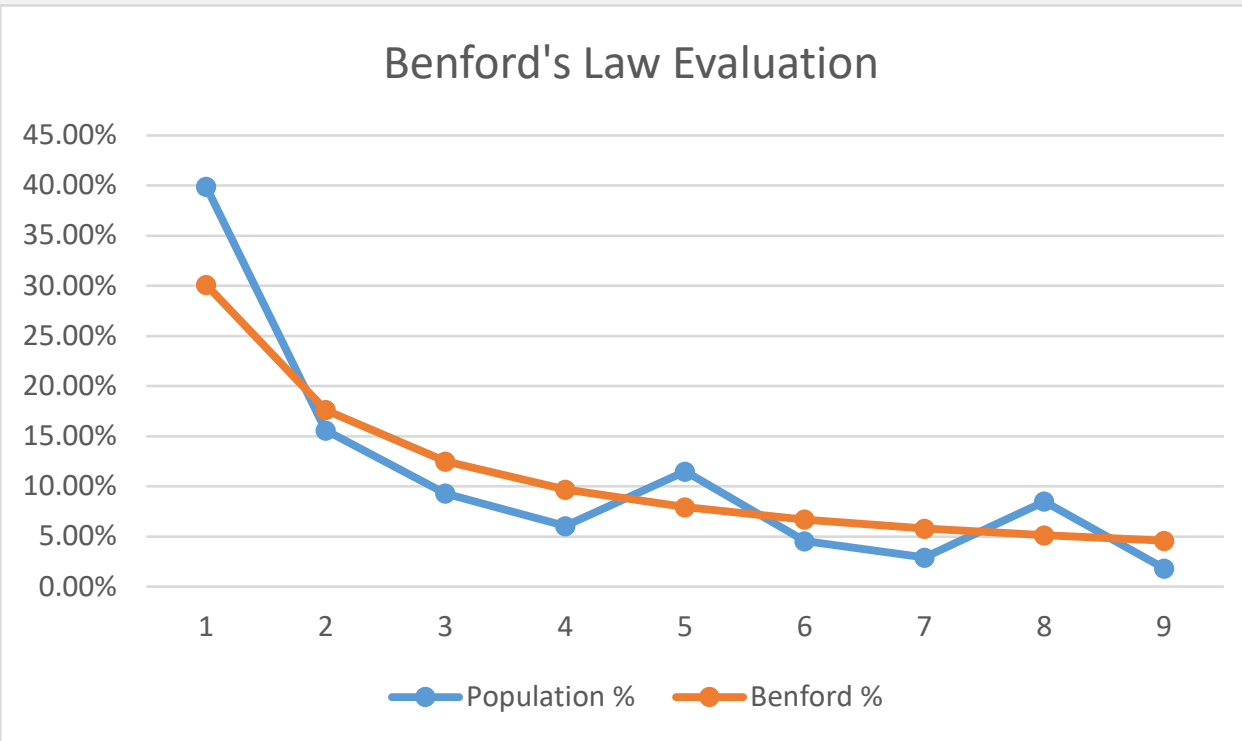
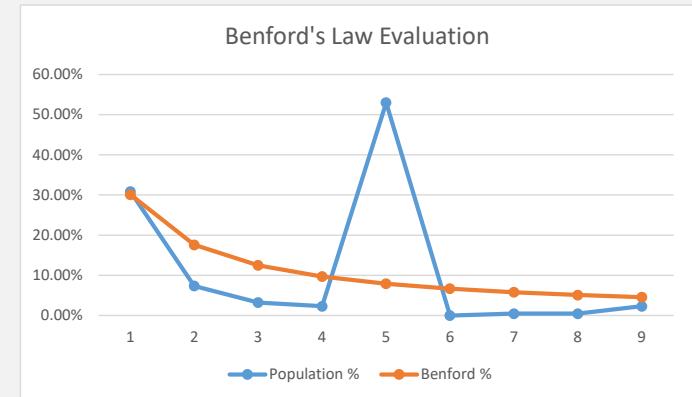Benford's Law Evaluation
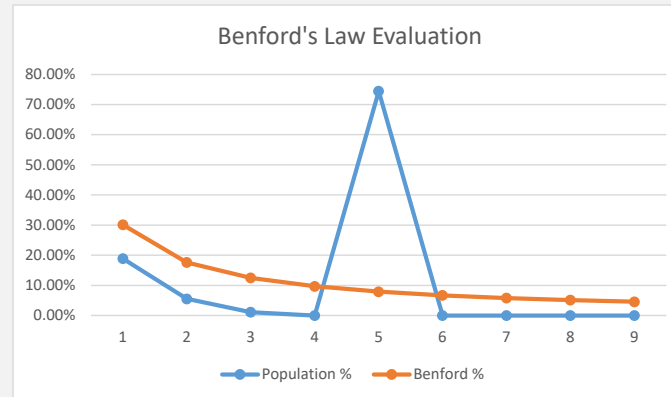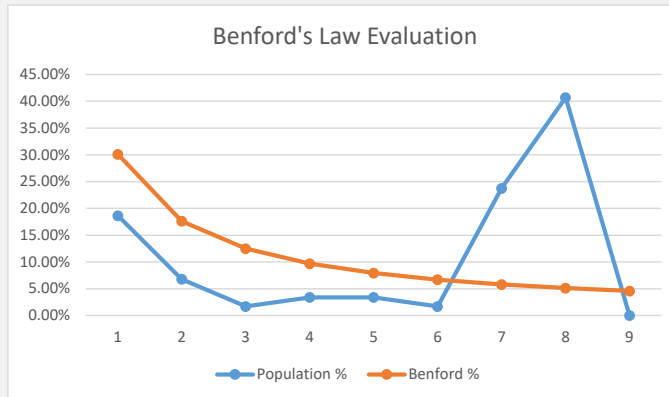
Population % — Benford %

What stands out here?

- WAY more occurrences where the number 1 is used

- Proportion of 5's is disproportionately high

- 8's seem pretty weird too

- There is DEFINITELY STILL something to look into here
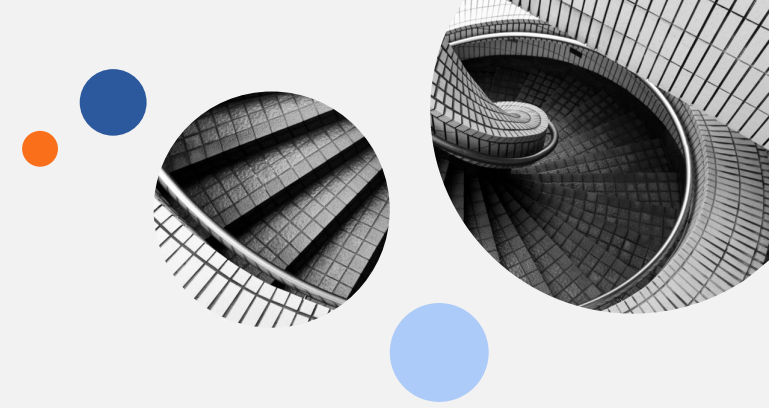
Benford's Law (Example)
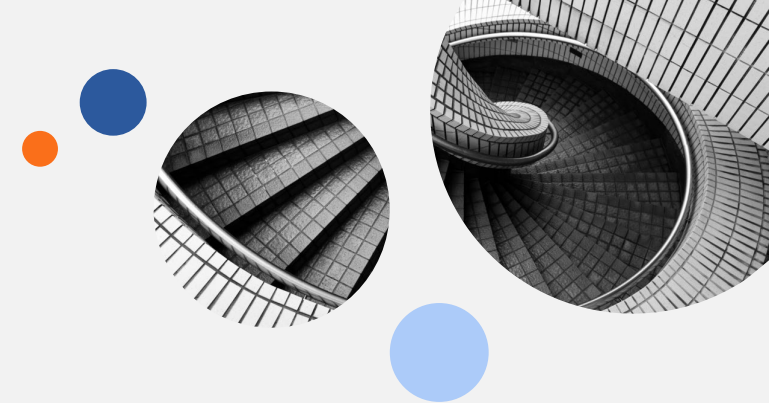
3rd Review – Upfront Commissions

- Our contracts are structured for the following payment amounts:
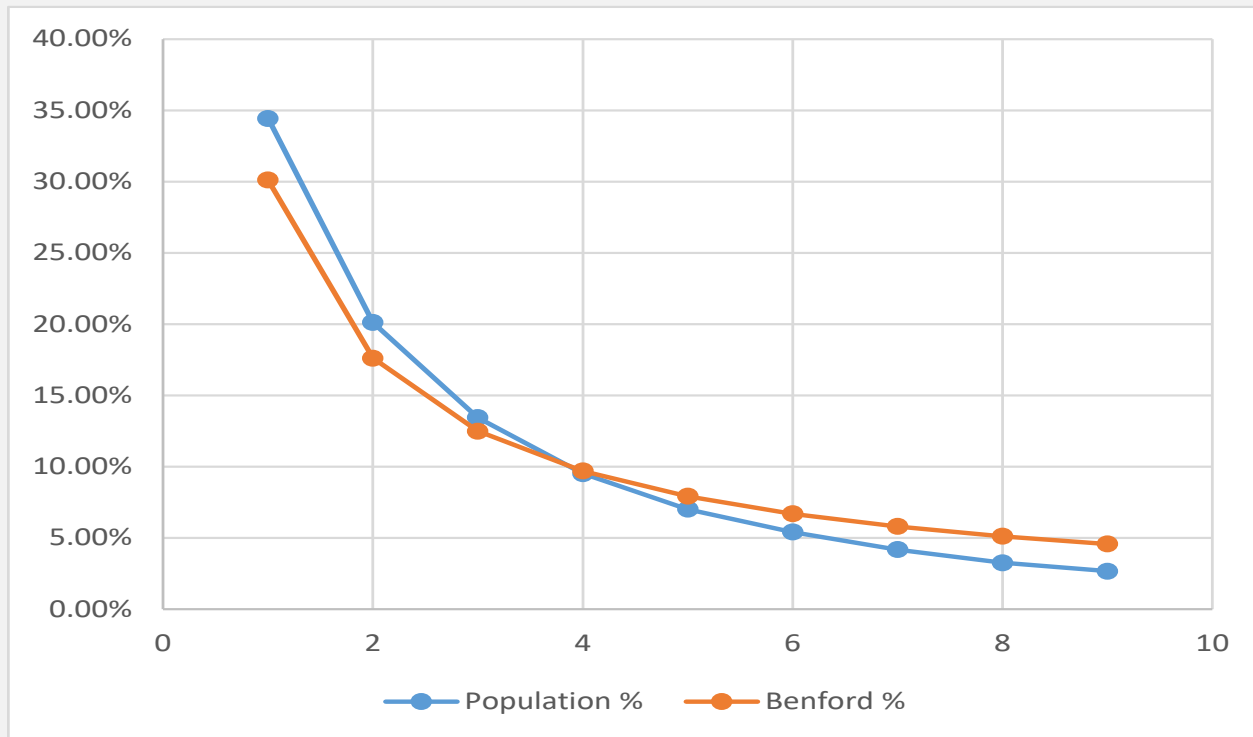 - $50
  - $75
  - $85
  - $100

Benford's Law (Example)

1st Review – Residual Commissions

What stands out here?
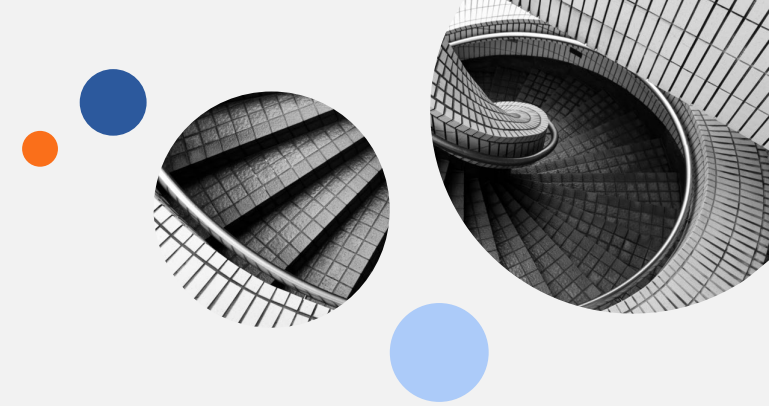
- Looks to be pretty much as expected
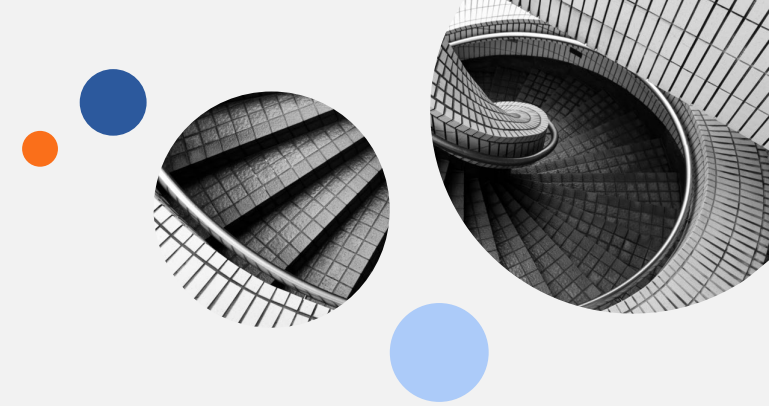
Using Data Analytics

Common Analytic Procedures

- Benford's Law
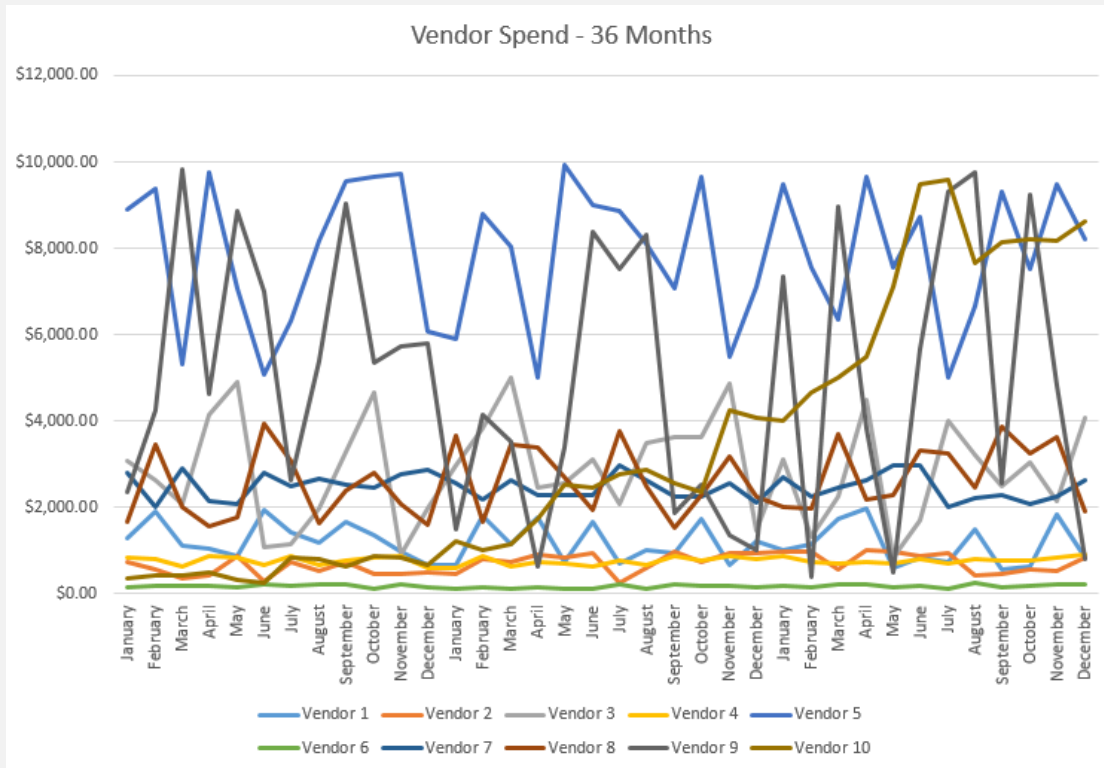- Individual Vendor Spend over time

Vendor Spend (Example)

1st Review – All Vendors

Vendor Spend - 36 Months

What stands out here?

- Looks to be pretty much as expected
- That is hard to read
- Is this guy ever going to show us actual fraud stuff?

Vendor Spend (Example)

2nd Review – Individual Vendors
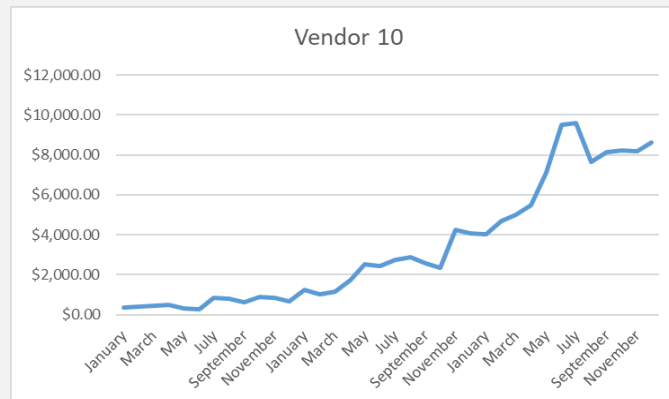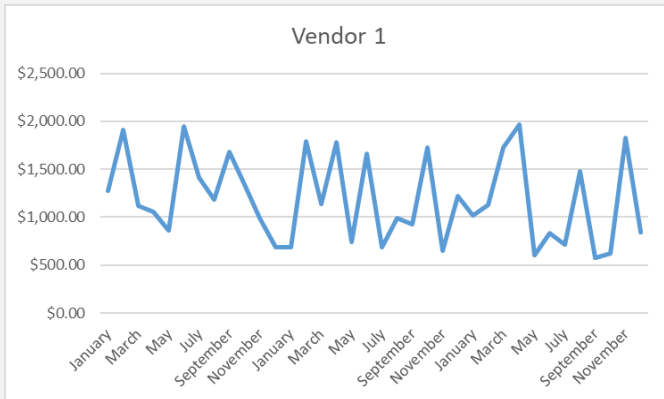
- One of these things are not like the others:
  - Why has vendor 10 spend increased so dramatically?
  - What changed?
  - $80+ million fraud scheme

Using Data Analytics
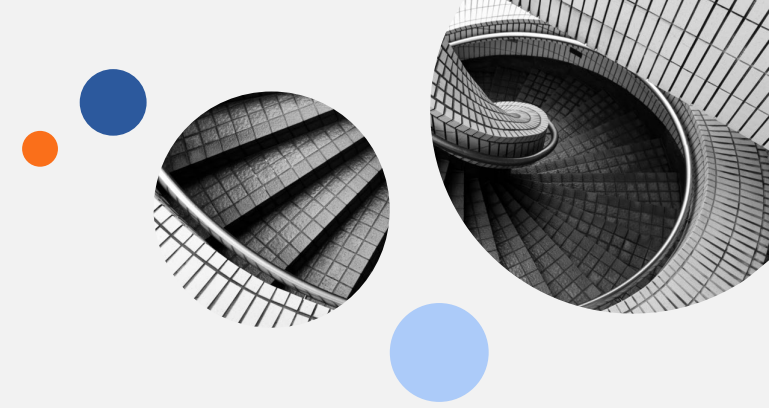
Common Analytic Procedures

- Benford's Law

- Individual Vendor Spend over time

- Duplicate Transactions

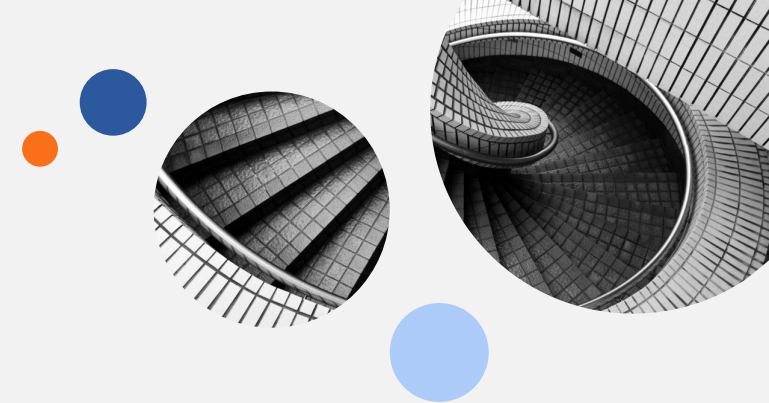- Unusual Transaction Timing

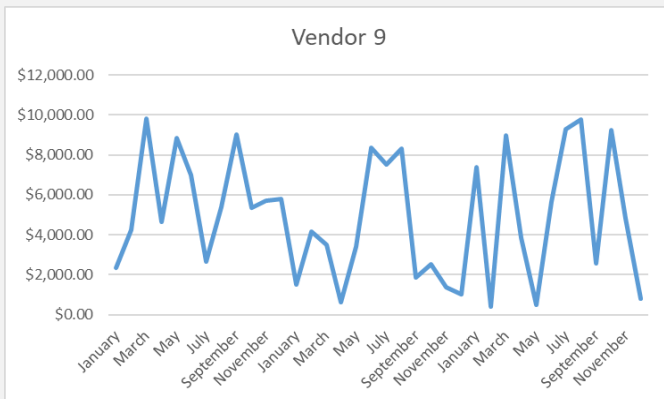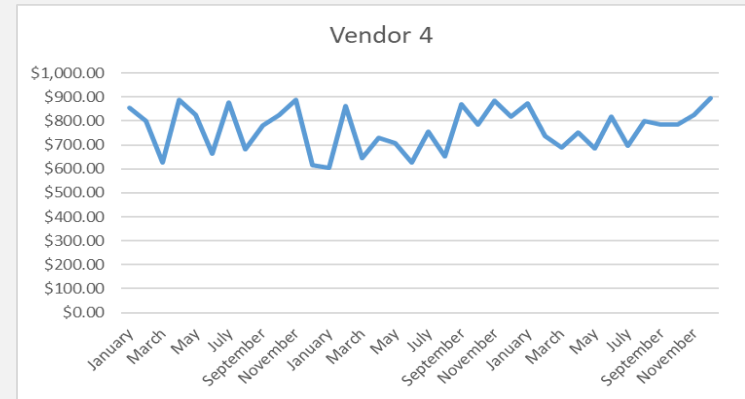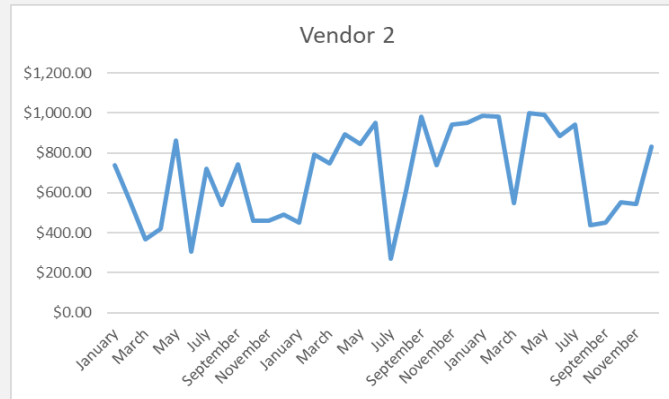- Productivity metrics
  - Time on internet
  - Timecard/log on data
  - PTO Reports/Trends

- Data Outliers

- Transaction proportions
  - Number of transactions
  - Dollar amounts of transactions

- Long Time Gaps in Spend with Vendors

- Changes in Transactions
  - Updates to payment information
  - Updates to addresses
  - Change in Remittance/Payment Type

Discussing Fraud When Planning an Audit

Let's dive in!

Discussing Fraud Opportunities
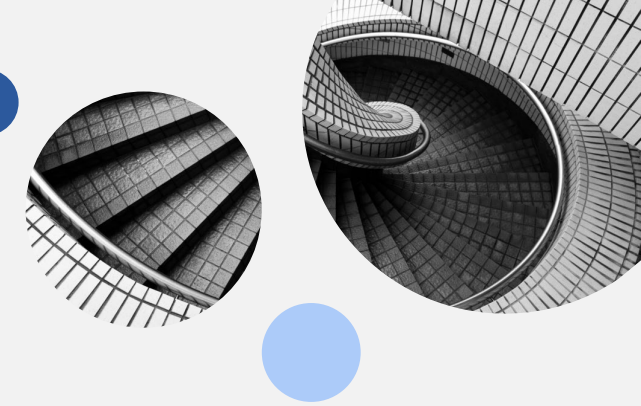
How do we discuss fraud with Management?

- Understand the underlying symptoms of fraud and ask about those
  - Unnecessarily Complex Processes
  - Unexplainable Spend Increases
  - Excessive Inventory Issues
  - KPI Measurement Criteria
  - Highest Performers
  - Grumpy Employees (Who should we stay away from?)
  - Overly Protective Employees

Profile of Fraudsters

Let's dive in!

Profile of Fraudsters

What do Fraudsters look Like?

- Ugly
- Humpback
- Kinda Smelly
- DEFINITELY look Shifty
- Unlikeable
- Dislikes dog/cats for ridiculous reasons

- Uneducated
- Very Grouchy
- Never Heard of Religion
- Doesn't buy girl scout cookies
- Probably looks like David

Profile of Fraudsters
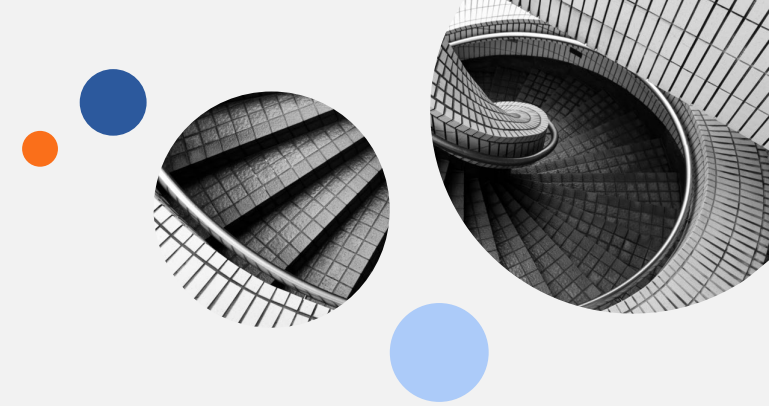
What do Fraudsters look Like?

- Ugly
- Humpback
- Kind Smelly
- DEFINITELY look Sh...
- Unlikeable
- Dislikes dog/cats for ridiculous reasons

- Overweight
- Very Grouchy
- Never Heard of Religion
- Probably look Like David

FALSE

Profile of Fraudsters

What do Fraudsters look Like?

- Majority are College Educated

- Majority are 31 – 50 years old

- 89% have never been charged or convicted of fraud in the past

- 86% have never been punished or terminated for fraud related issues

- Only 42% are living beyond their means

- 15% exhibit no red flags

- Only 26% are having financial difficulties

- 19% have close relationship or association with a vendor or customer

- 13% have control issues

- 12% have family problems/divorce

- 13% are irritable/defensive/act suspiciously

- 13% "Wheeler/Dealer" attitude

Profile of Fraudsters

What do Fraudsters look Like?

Engage in non-fraud related misconduct?

■ Yes ■ No

45%

55%
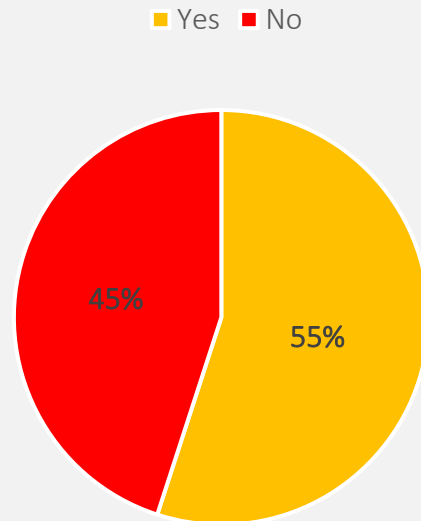
- Bullying/Intimidation - 20%
- Excessive Absenteeism - 13%
- Excessive Tardiness – 12%
- Excessive Internet Browsing – 8%
- Other – 4%
- Sexual Harassment – 3%
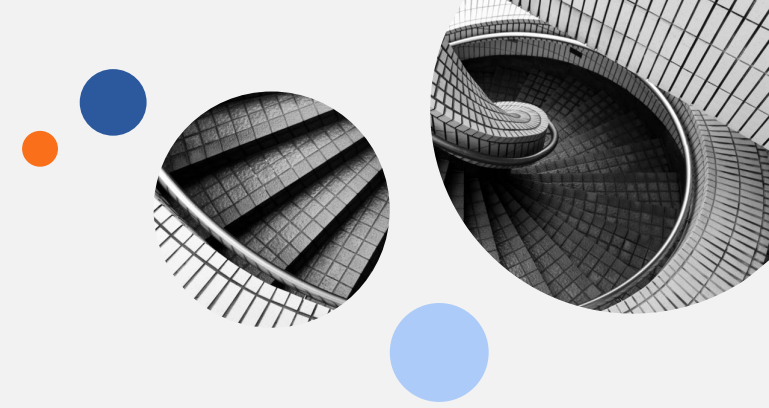- Visiting Inappropriate Internet Sites – 2%

How do you interview Auditees about fraud?
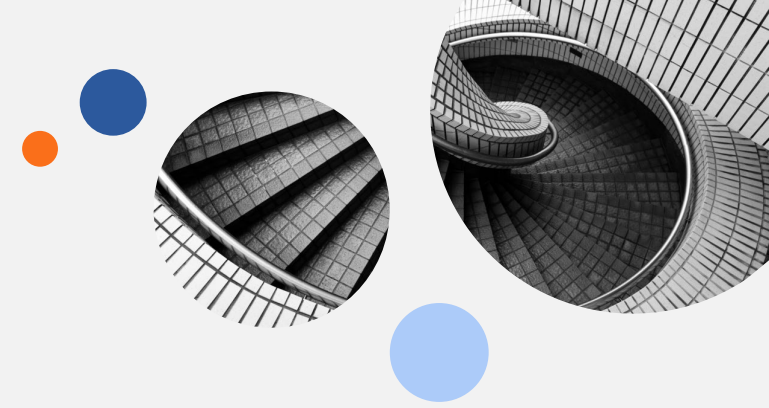
Let's dive in!

Interviewing

How do you Interview for fraud?

What questions do you ask?

What responses do you get?

Interviewing

Why are we asking about fraud?

- It is required
- It is wasteful
- It is unfair to the good managers/employees
- It is unfair to the stakeholders
- It has happened before
- It will happen again
- 5% of revenues are lost annually due to fraud

So, what do we ask?

- Ask about unexplained poor performance
- Ask about high performance that can't be replicated
- Ask about overly complicated processes
- Ask about data outliers
- Ask about specific vendors identified in the data analytics from planning
- Ask about the culture of the business unit

Interviewing
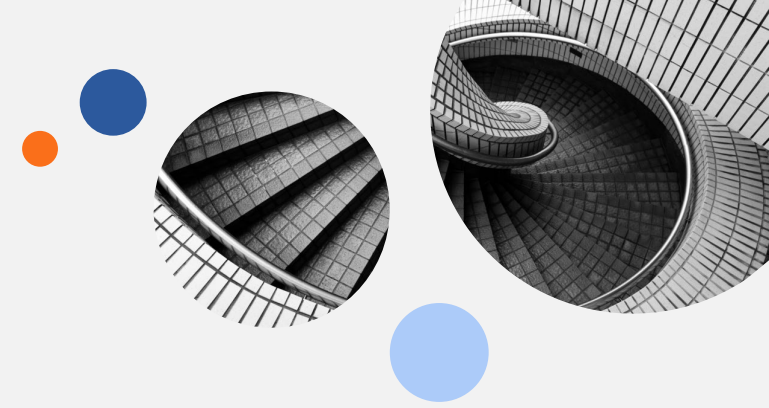
What else do we ask?
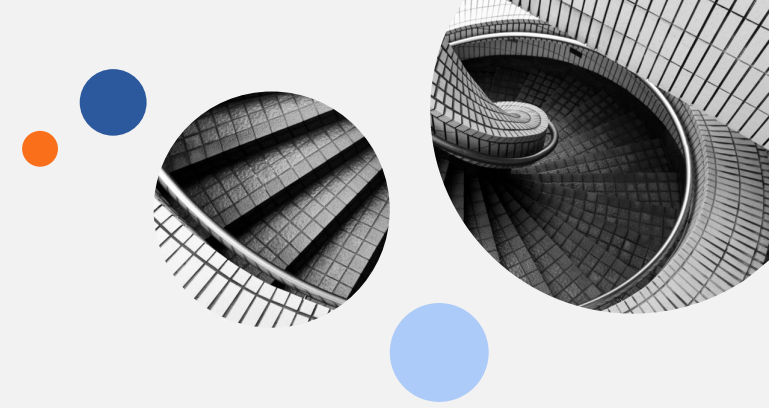
- Ask about employee attendance issues
- Ask about the really hard-working employees who never take time off and make sure everything is exactly done a certain way
- Ask about growth in spend from a specific vendor
- Ask about trends you noted in planning analytics

- Ask about vendor relationships
- Ask about the areas they are better than their peers
- Ask about the areas they are not as good as their peers
- Understand how their success is measured
- Ask what keeps them up at night
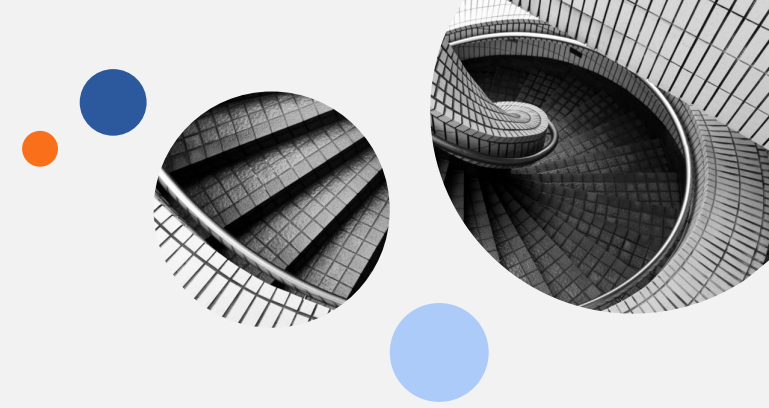- THEN ask them about fraud (obligatory)

Now What?

You just asked a bunch of questions...

But what are you looking for in the responses?

Interviewing - Responses

What are we looking for?

- Identified opportunities

- Identified motivations

- Identified behaviors

- What topics make the manager uncomfortable?

- Do they try to change the subject?

- Are there themes to the responses?

- Do the responses make sense?

- Did anything make their body posture change?

- Did a topic change the tone of the interview?
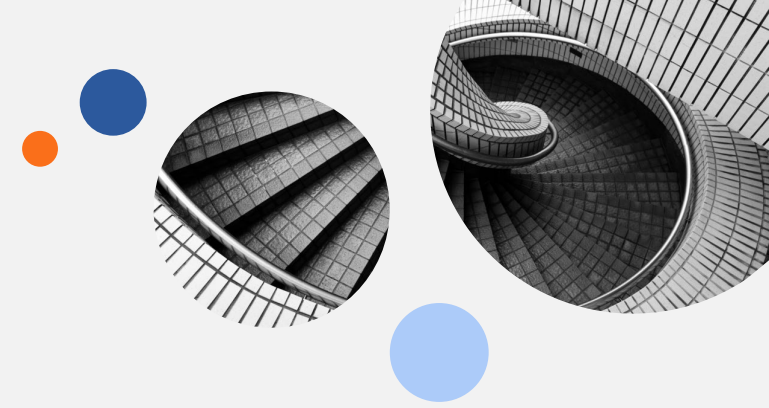
- Did they tell you about fraud?

Evaluating for Fraud Schemes

Let's dive in!

Evaluating Schemes

Ok, we interviewed
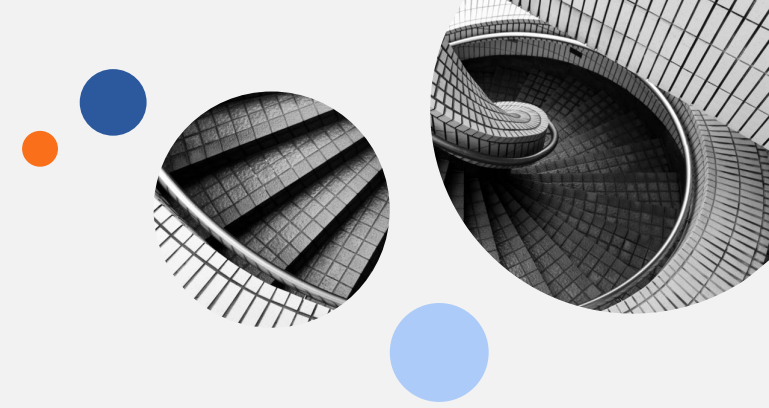Management about fraud, now
how do we find it?

Evaluating Schemes

Understand the Schemes

- There are several types of popular fraud schemes – Which one applies to your audit?
  - Use the information you gathered in the interviews to determine this
  - Use the data analytics you performed in planning
  - Use the typical fraud schemes you understand
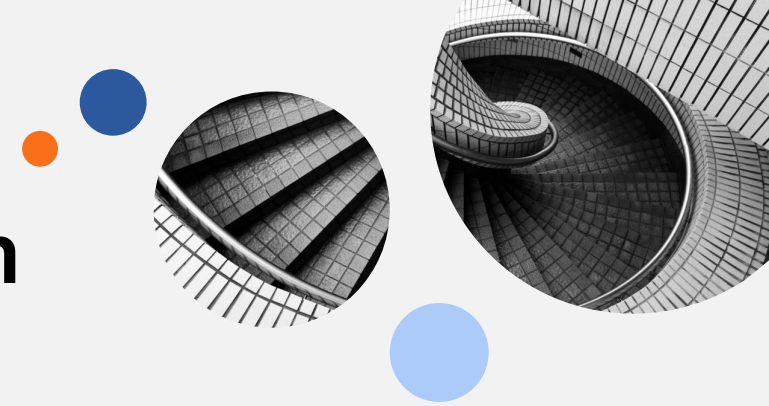 - Where and how would you commit fraud in this business unit?

Evaluating Schemes

What are the popular schemes?

- Corruption – 47%
- Noncash Transactions – 19%
- Billing – 17%
- Expense Reimbursements – 13%
- Cash on Hand – 10%
- Financial Statements – 10%

- Skimming – 9%
- Payroll – 7%
- Check/Payment Tampering – 6%
- Cash Larceny – 6%
- Register Disbursements – 2%

Source: 2020 ACFE Report to the Nations - https://acfepublic.s3-us-west-2.amazonaws.com/2020-Report-to-the-Nations.pdf

Evaluating Schemes - Corruption

## **How do I find corruption?**

- What is Corruption?
  - Bribery
  - Conflicts of Interest
  - Extortion
  - Purchasing Schemes
  - Kickbacks
  - Sales Schemes
  - Bid Rigging
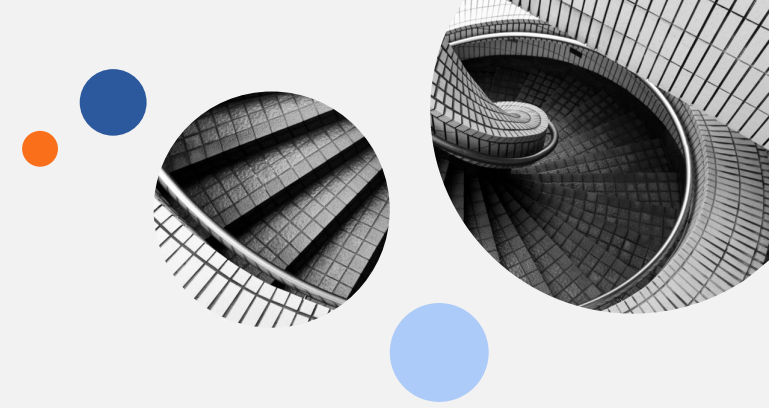- How would we audit for these?

Evaluating Schemes - Skimming

How do I find Skimming?

- What is Skimming?
  - Stealing part or all of:
    - Receivables
    - Sales
    - Unrecorded sales/liabilities
    - Refunds
    - Lapping
    - Unconcealed
- How would we audit for these?
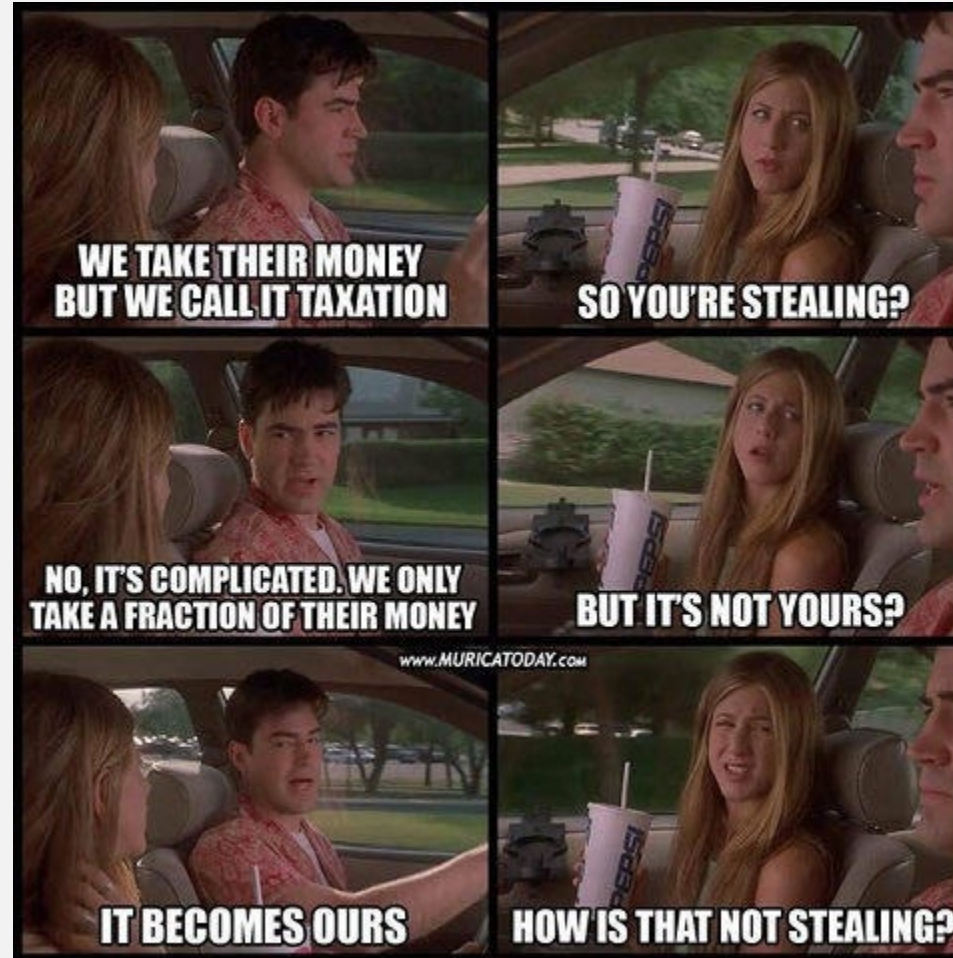
Evaluating Schemes - Expenses

How would expense schemes happen here?

- Employee Steals $8.5 Million After Discovering he had DOA Authority[3]
  - Company acquired by AIG and integrated/centralized
  - Employee inadvertently received DOA as part of system conversion (has counterpart too)
  - Wife got pregnant & he panicked
  - Filed fake invoices/expenses
  - Approved those same expenses using his counterpart's log in and DOA authority
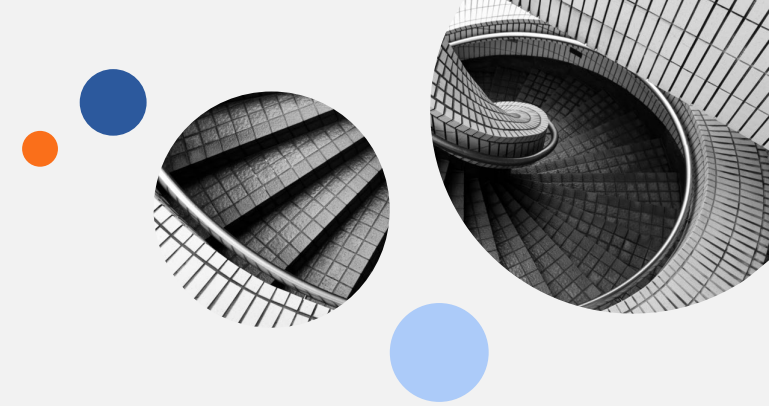
How was it discovered?

- His soon- to be ex-wife
  - He had a girlfriend (also pregnant) and his wife was leaving him
  - His wife met with his counterpart (college buddies) to talk about an intervention for him
  - Counterpart put the pieces together and ran a report on all things she had "approved"

- How would the interviews we discussed earlier have helped find this fraud?

Evaluating Schemes - Basics

Make sure you cover the basics

- Check for Segregation of Duties
- Ask the questions and make the auditee answer them. Don't explain things for them.
- Make sure everything is supported by original documentation
- Look at the documentation
- Check Whistleblower hotline activity
- Check with HR for any issues reported

Questions?