

Fraud Risk Universe: Are you Identifying all the Fraud Risks Threatening your Organization

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Speaker



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Mr. Vona is the author of three books published by Wiley, *Fraud Risk Assessment: Building a Fraud Audit Program* and *The Fraud Audit: Responding to the Risk of Fraud in Core Business Systems*, *Fraud Data Analytics Methodology: The Fraud Scenario Approach to Uncovering Fraud*.

Wiley has referred to Mr. Vona as a worldwide renowned authority on internal fraud risk.

Mr. Vona's trial experience is extensive, including appearances in federal and state courts. He is qualified as an expert witness, as a CPA and a CFE, and is cited in West Law for the successful use of circumstantial evidence.

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What this Class is About



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Our approach to transferring knowledge

- Lecture via power point presentation
- Redundancy in presentation of key items
- Thought provoking questions though out presentation
- Class exercises which reinforce the lecture material
- Real life examples

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Learning Objectives

- **Starting point: Your strategic fraud audit plan**
- Using the fraud universe methodology
- How to define the scope of your fraud project
- Step by step approach to fraud risk identification
- How to create a comprehensive list of fraud risk statements

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Could This Happen to You?

- 63 million theft loss to a false billing scheme.
- Price fixing conspiracy involving three largest canned seafood suppliers in the United States, CEO goes to prison & 125 million in fines.
- Fraudsters are leveraging the high volume of unemployment insurance claims and money mules to submit fraudulent claims using consumers' stolen personally identifiable information. The funds are transmitted by the states into financial accounts controlled by money mules who are either willing or unknowing participants in this crime.
- How would you explain this to your Audit Committee?

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Your Strategic Plan Thought Provoking Words

- Five key words I want you think about!
 - Differently
 - Logic
 - Linked
 - Superior knowledge
 - Methodology

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Differently

- **Fraud risk identification needs to be logic driven versus professional experience driven**
- The statement has five elements
 - Person committing the scheme
 - Type of entity: master file data
 - Fraud action statement: transactional data
 - Fraud impact
 - Fraud conversion
- Logic first, professional experience in using the logic

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Logic

- **You can compute the number of fraud risk statements in your scope with mathematical precision**
- By understanding permutation fraud analysis:
 - I may not know what the perpetrator is doing, but I know everything the perpetrator can do!
- The goal of logic analysis is threefold:
 - Understand your audit scope
 - Understand what you are looking for
 - Know what it looks like

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Linked

- **The fraud risk statement is what drives the fraud data analytics plan and the fraud audit procedure**
 - Person committing
 - Type of entity
 - Fraud action statement
- By understanding what you are looking for; building the audit program become obvious

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Superior Knowledge

- Understanding fraud risk from the:
 - Audit perspective
 - Data perspective
 - Industry perspective
 - Fraud perspective

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Superior Knowledge of Addresses

- Street address
- US Mail P.O. Box
- Mailbox service address
 - Public company
 - Private company
- Virtual offices
 - Public company
 - Private company
- Mailbox forwarding address
- Redirect address
- Professional service provider address

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There is a Methodology

- The fraud risk universe
- What: Fraud risk statement
- How: Fraud scenario
- Each statement has five components
- Use of permutation analysis
- Calibrate for the sophistication of concealment

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Thought Question #1

Should internal auditors be responsible for fraud detection?

- True
- False
- I'm not sure

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Expression: Professional Skepticism

- The Key: Educated Skepticism
- Knowledge through study; what I call the science of fraud risk and fraud auditing
- Knowledge through experience; what I call the art of fraud risk and fraud auditing

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Building Your Road Map to Become a Master of Fraud Risk

- Science of Fraud Risk and Fraud Auditing:
 - Understanding the fraud universe
 - Knowledge of fraud audit theory
 - Knowledge of sufficiency of audit evidence
 - Understanding sophistication of concealment theory
- Art of Fraud Risk and Fraud Auditing:
 - How to create a fraud audit program
 - Calibrate your audit program for sophistication of concealment
 - Sufficiency of audit evidence
 - Degree of certainty to arrive at a conclusion

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Due Professional Care

- Certified Fraud Examiners shall exercise due professional care in the performance of their services. Due professional care requires diligence, critical analysis, and **professional skepticism** in discharging professional responsibilities.

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Elements of Professional Skepticism

- A component of the auditor's general duty of care that applies throughout the audit.
- An attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence.
- Comprises three elements—auditor attributes, mindset, and actions.

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Cooley on Torts, a legal treatise, describes the obligation for due care as follows:

“Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where **peculiar skill** is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill **commonly possessed** by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession.

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Cooley on Torts, continued:

“But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.” —D. Haggard, *Cooley on Torts*, 472 (4th ed., 1932)

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History of Change

- SAS No. 99 became effective for periods beginning on or after December 15, 2002.
- “Managing the Business Risk of Fraud: A Practical Guide” was issued in 2008.
- IPPF “Internal Auditing and Fraud” was issued December 2009.
- IIA “Internal Audit Competency Framework” was issued in 2020.
- What is the auditor’s responsibility to detect fraud?

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Considering Fraud as Part of Every Audit

Have we identified the fraud risks impacting organizational goals?

- Historical: Known fraud risk statements or fraud scenarios
- Future: Anticipate new fraud scenarios

Have we identified all the fraud risks impacting our organization?

Have we identified the right controls to manage fraud risk?

Let me introduce: The Fraud Universe

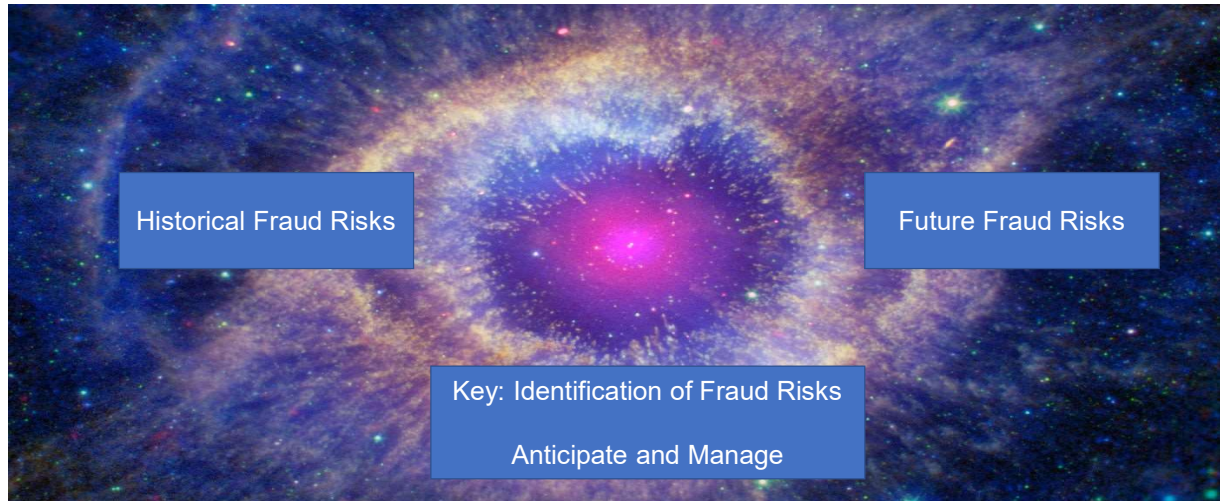
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What Is the Fraud Universe?



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Thought Question #2

What is more important?

- Discipline approach to fraud risk identification
- Life experience approach to fraud risk identification
- I'm not sure

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What is Fraud?

- Blacks Law Dictionary Eight Edition:
- A knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment

- The elements of Fraud, therefore, includes:
 - An act or omission (failure to act)
 - Deceit or concealment, made intentionally
 - A victim who suffers a loss while the perpetrator gains a personal or business advantage

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COSO Definition of Fraud

- COSO defines Fraud as “any intentional act or omission designed to deceive others, resulting in the victim suffering a loss and/or the perpetrator achieving a gain.”
- The IIA defines Fraud as “any illegal act characterized by deceit, concealment or violation of trust... not dependent on the threat of violence or physical force... perpetrated by parties... to obtain money, property or services; to avoid payment or loss of services; or to secure personal or business advantage.
- Yellow Book defines fraud as “A type of illegal act involving the obtaining of something of value through willful misrepresentation.”

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Threats, Vulnerabilities, and Fraud Risks

- **Fraud Risk: An intentional and concealed threat designed to cause harm to the organization by exploiting the natural vulnerabilities that exist within our overall internal control structure.**
 - **Vulnerabilities:** Points in the internal control structure that can be exploited
 - **Threats:** Possible danger that someone might exploit a vulnerability in our internal control structure, thereby causing monetary or non-monetary harm
 - **Risk:** Threat, probability, and business impact

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My View of the Fraud Risk Universe



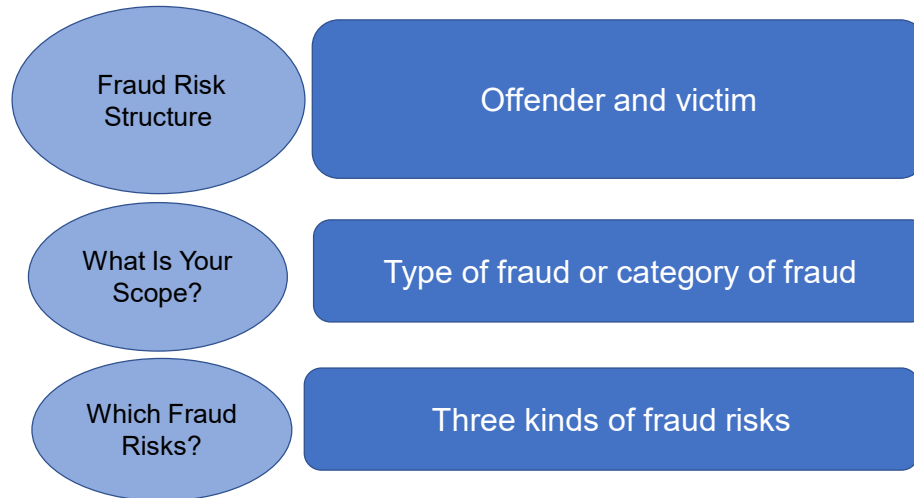
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Methodology: Fraud Risk Universe



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Offender and Victim Analysis

- There are two parties to every fraud transaction
 - Victim
 - Perpetrator
- The first question you must ask: Who are these parties
- Now that we have identified the actors, are we considering fraud committed by an individual or are we considering: collusion; management override or opportunity created by an internal control weakness?

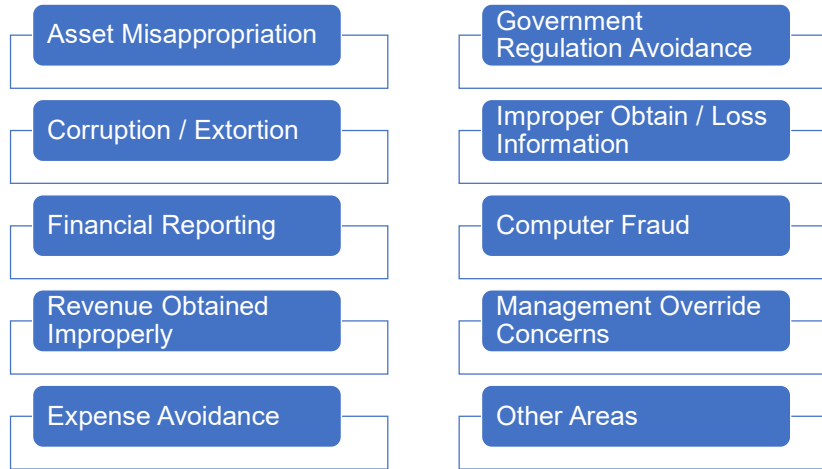
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Knowing what Type of Fraud is in Your Scope



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Definitions Of Major Categories

- **Asset misappropriation:** application of another's property or money dishonestly to ones own use (source Blacks Law Dictionary)
- **Corruption:** is the use of entrusted power for personal gain (source Transparency international) Conceptually, corruption is a form of behaviour which departs from ethics, morality, tradition, law and civic virtue.
- **Financial reporting:** Financial statement fraud is the process of intentionally misleading the reader of the financial statements. It is the deliberate misrepresentation, misstatement, or omission of financial data to provide the impression that the organization is financially sound.

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Secondary Fraud Risk Categories

Asset Misappropriation

- Theft of monetary funds
- Theft of tangible asset
- Misuse of assets
- Lack of business purpose
- Related party/conflict of interest
- Dispose of asset below FMV
- Acquire of asset above FMV

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Secondary Fraud Risk Categories

Corruption

- **Start with person committing**
- Internal collusion
- External collusion
- Internal and external collusion
- **Next the business system**
- Identify the decisions
- Link person to decisions

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Secondary Fraud Risk Categories

Financial Reporting

- False transaction
- Improper recognition of transaction
- Improper accounting treatment for class of transactions
- Failure to record or write-off

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Secondary Fraud Risk Categories

Financial Reporting Assertions

- Class of transactions or events:
- *Occurrence*
- *Completeness*
- *Accuracy*
- *Cutoff*
- *Classification*

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Secondary Fraud Risk Categories

Financial Reporting Assertions

- Account balances at year end:
- Evidence
- Rights and obligations
- Completeness
- Valuation and allocation

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Secondary Fraud Risk Categories

Financial Reporting Assertions

- Presentation and disclosure:
- Occurrence and rights and obligations
- Completeness
- Classification and understandability
- Accuracy and valuation

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Fraud Risk for Auditors

Inherent Fraud Risk

- Generic or high level
- Entity / action
- Easy to understand

Fraud Risk Statement

- Description of a threat facing the organization that has an element of deceit or concealment
- Five components
- Drives the audit program

Fraud Scenario

- How someone would perpetrate a fraud risk statement against your organization
- Five components
- Internal control vulnerability

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Illustration of Fraud Risk for Auditors

- Inherent fraud scheme
 - False Entity / False Billing
- Fraud risk statement (what)
 - Budget owner acting alone cause a shell company to be set up on the vendor master file process a contract and approves a fake invoice for goods or services not received causing the diversion of company funds
- Fraud scenario (how)
 - Budget owner submits invoice for services not provided within their approval authority to accounts payable, I/C weaknesses same person receives, accepts, retains and approves

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Inherent Fraud Scheme for Disbursements / accounts payable

- False entity: vendor
 - False billing: receive no goods or services
 - Pass Through billing: receive goods or services
- Real entity: vendor
 - Over billing: over pay on some aspect or some way
 - Disguised expenditure: personal or theft conversion
- **THE PREDICTABLE PHASE**

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Elements of a fraud risk statement

- What are the combinations? What is your primary element?
- Permutation analysis
 - **Opportunity:** person committing or job title or department
 - **Entity:** Vendor, employee, customer or intangible
 - False: Created or assumed
 - Real: Complicit or not complicit
 - **Fraud action statement:** the fraud threat or fraud risk statement
 - **Impact statement:** Monetary or non-monetary
 - **Fraud conversion statement:** How person committing financial benefits from the fraud action statement

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Levels of Fraud Action Statement

- Follow the step-down process starting with a generic description of the fraud action statement to the eventual specific description:
- Product substitution refers to the knowing and willful substitution, without the purchaser's knowledge or consent.
- Highest (generic) level: Vendor overbills the company
- Second level: Vendor commits a product substitution scheme
- Third Level, Perpetrated by Supplier:
- Third Level, Perpetrated by Manufacturer:
- Third Level, Perpetrated by a Counterfeiter
- Fourth Level, Expenditure specific

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Third Level, Perpetrated by Supplier:

- **Supplier alone (or in collusion with an internal person) commits a product substitution scheme (or provided expired goods) resulting in warranty issues (or internal person receives a bribe for accepting expired goods).**
- Fitness issue
- Knock off scheme
- Obsolete or expired scheme
- Used, surplus, or outdated materials or components
- Materials that do not conform to contract requirements

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Third Level, Perpetrated by Manufacturer:

- **Manufacturer alone intentionally misstates the chemical composition of their goods resulting in potential legal liabilities costs.**
- Chemical composition
- Country of origin
- False testing statements
- False specifications

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Third Level, Perpetrated by a Counterfeiter

- **Counterfeiter sells to your company refurbished components resulting in a damages to company reputation.**
- Parts which do not contain the proper internal construction (die, manufacturer, wire bonding, etc.) consistent with the ordered part
- Parts which have been used, refurbished, or reclaimed, but represented as a new product.
- Parts which have a different package style or surface plating/finish than the ordered parts.

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Fourth Level; Expenditure Specific

- Let's assume you are preparing a fraud risk assessment for the purchase of seafood. The following illustrates a more specific fraud risk statement.
 - Supplier operating alone mislabels seafood as wild catch versus raised in a farm resulting in potential reputation risk.
 - Fisherman (Manufacturer) mislabels sea bass or snapper when the actual fish is a less desirable fish resulting in an intentional product substitution scheme.
 - Restaurant or grocery store intentionally mislabels a less desirable fish as sea bass or snapper resulting in mischarging of consumers.

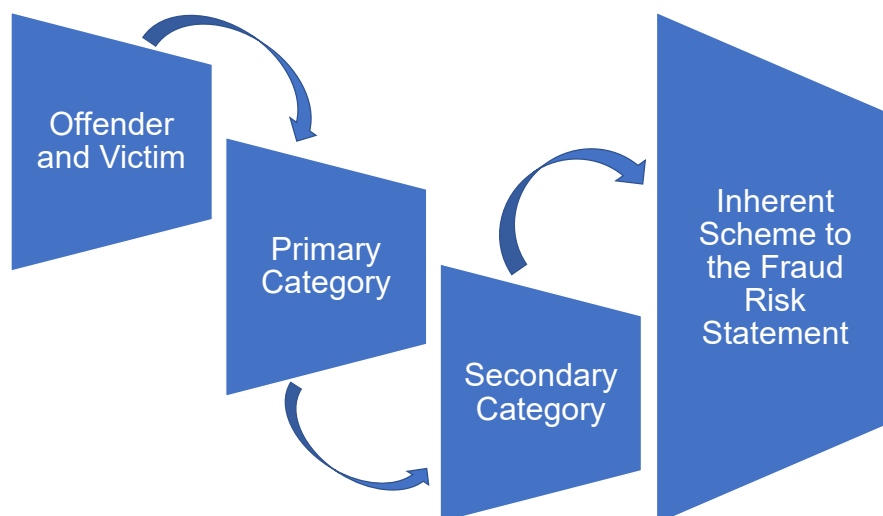
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Fraud Risk Structure



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True of False

- I can compute the number of fraud risk statements with mathematical precession?
- Number of fraud risk statements = 's Person x entity x action
- Fraud is logical

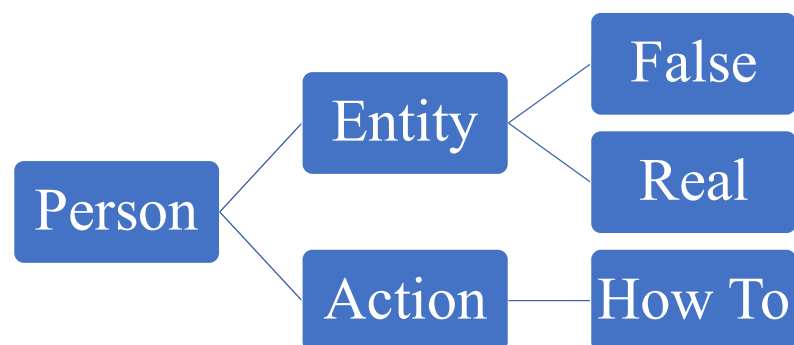
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Just A Different Look At Fraud Risk



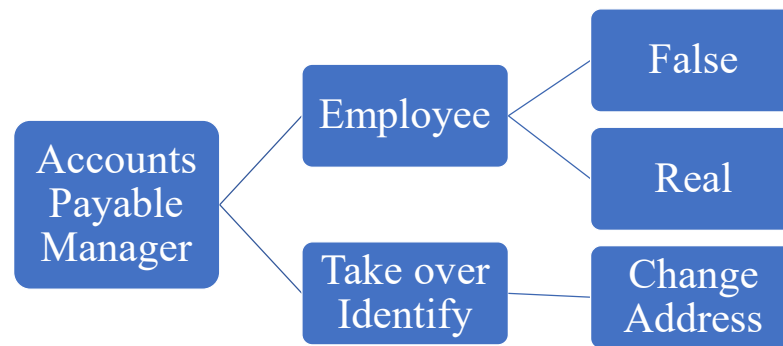
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Just A Different Look At Fraud Risk



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Types of fraud risk statements

- Common to all business systems
- Company specific
- Industry specific
- Unauthorized access
- Internal control inhibitor

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Nuances by Type of Fraud Scheme

- Asset misappropriation (Theft of asset)
 - Primary element varies by scheme
 - Conversion cycle varies by scheme
- Corruption (decision / bribe)
 - Opportunity is always collusion
 - Entity is almost always one element of opportunity
- Financial Reporting (misstatement)
 - Direction of misstatement
 - GAAP Implication

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Quandary: Risk Statement or Fraud Scenario

- Unlike the fraud risk statement, the number of fraud scenarios should be viewed as infinite. While I do not believe the number is infinite, I am sure that we can not count or identify all the fraud scenarios. This is why at that phase; I classify fraud scenario into three categories:
 - Historical methods that should be anticipated
 - Unknown methods that could be anticipated
 - Unknown / unknown methods that would not be anticipated but could occur
- The goal of this phase is to understand how the perpetrator would commit the fraud risk statement, pierce your internal controls, and create the illusion that the transaction is proper.

Thank you Donald Rumsfeld

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Thought Question #3

Fraud risk statements can occur and comply with all of your internal controls.

- True
- False
- I'm not sure

So, what is your strategy?

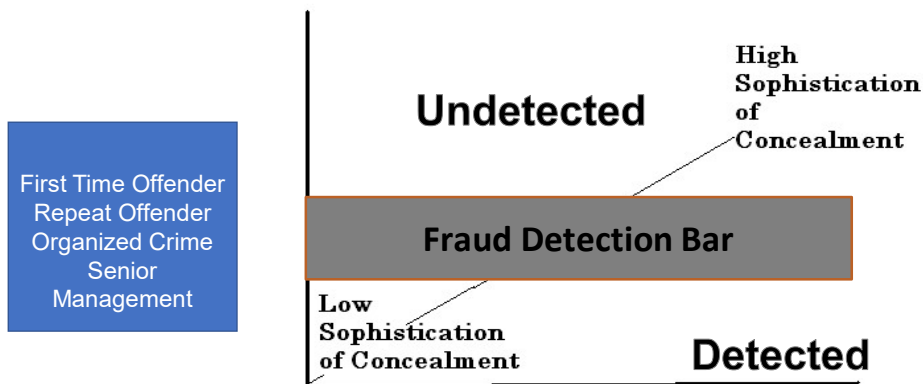
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Calibrate the Fraud Risk Statement for the Sophistication of Concealment Principle



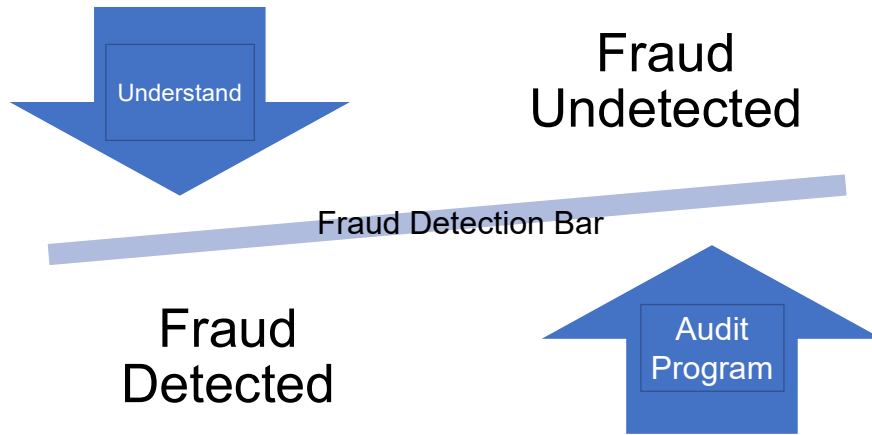
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Fraud Detection Dilemma: How to Calibrate the Detection Process



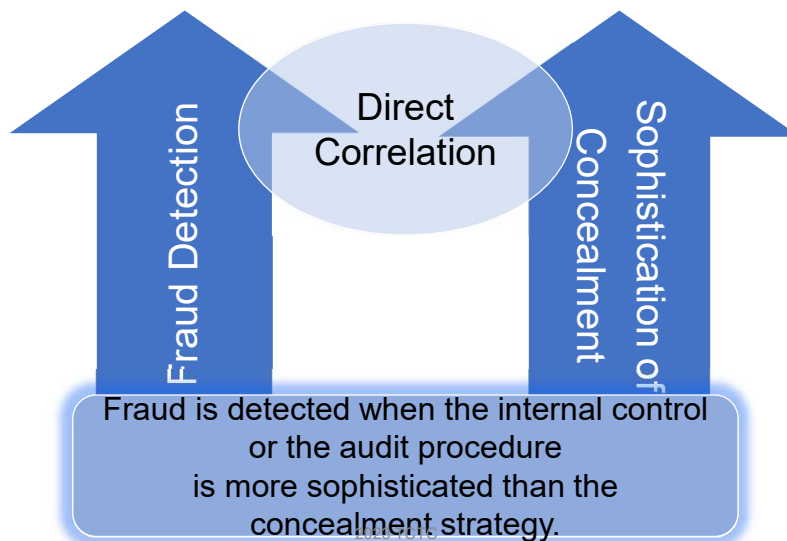
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Sophistication of Fraud Concealment



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How to Define the Audit Scope for Fraud Risk

- Start with the actors
- Identify the primary and secondary type of fraud risk
- Identify entity structures: false or real
- Identify the permutations of your entity structure
- Identify the fraud action statements
- Identify the permutations of your fraud action statements
- Create the fraud risk statements
- Purpose of your audit program

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Purpose of Your Audit Program

1. Perform a **fraud risk assessment** with the fraud scenario approach. There is no change to the field work stage. The focus is on the adequacy of the design of internal controls to mitigate a fraud scenario. The fieldwork methodology follows the traditional internal control approach.
2. Use the **red flag approach** combined with a fraud risk statement approach. The sampling phase is random, but the audit program includes document red flags or control red flags associated with the fraud risk statement.
3. **Integrate** fraud test procedure within the internal control approach. The sampling is random, but a fraud test procedure is added to the test of internal controls.
4. Use the **fraud audit approach** driven by the fraud risk statement. The sampling is based on fraud data analytics, and the test procedure uses a fraud audit test procedure. There is no testing of internal controls.

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Learning Objectives

- Starting point: Your strategic fraud audit plan
- Using the fraud universe methodology
- How to define the scope of your fraud project
- **Step by step approach to fraud risk identification**
- **How to create a comprehensive list of fraud risk statements**

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Thought Question #4

The key to managing fraud risk is a comprehensive fraud risk methodology.

- True
- False
- I'm not sure

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How to Create a Comprehensive List of Fraud Risk Statements

- Start with the scope of your audit program
- Believe it or not: How detailed do you want your fraud risk statement?
- Should I be using fraud risk statements or fraud scenarios
- How will the fraud risk statements be used
 - Fraud risk management
 - Audit program development
 - Experience of the team

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Practical Example: Payroll Fraud

- Operating management remote location to corporate payroll
- Asset misappropriation / theft of monetary assets
- False entity (known as a ghost employee)
 - Fictitious / Real but not complicit / Real but complicit
 - Permanent or Temporary
- Paid for services not performed
- Theft for profit / Pay a bribe
- Use the **fraud audit approach** driven by the fraud risk statement. The sampling is based on fraud data analytics, and the test procedure uses a fraud audit test procedure. There is no testing of internal controls.

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What a fraud risk statement looks like: Simple

- Real supplier acting **alone** overbills the company by increasing the prices or cost of the invoice and the company employee approving the increase based on a false pretense causing the diversion of company funds.
- Real supplier acting **in collusion** with company employee overbills the company by increasing the prices or cost of the invoice and the company employee intentionally approving the increase (management override) based on a false pretense causing the diversion of company funds.

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What a fraud risk statement looks like: Complex

- A budget owner or a senior member of management provides a real complicit supplier / with advance information on future changes to the purchase requirements listed on the bid documents providing the real complicit supplier an unfair competitive advantage in the bidding process. After the purchase order is issued to the complicit vendor, the budget owner or senior member of management / allow or cause changes to the original purchase commitment which may or may not cause a change to the purchase order total amount. / The changes allow the real complicit supplier to invoice for items with higher margins than originally stated in the bid response by the budget owner and:
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What a fraud risk statement looks like: Complex

- Change line item quantities with no change to the original purchase order amount.
- Change the items purchased allowing the supplier to provide inflated prices on the changed item (product mix) within the original purchase order amount.
- Change line item quantities and increase the purchase order amount.
- Change product mix and increase the purchase order amount.
- The complicit vendor provides a kickback to the budget owner in consideration of the advance communication of information which results in a corruption scheme and an overbilling fraud scheme.

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Illustration: Fraud Risk Register

1. Budget owner causes a **fictitious person** to be set up on the employee master file, the budget owner or payroll submits time and attendance records for the fictitious person causing the diversion of funds.
2. Senior manager causes a **fictitious person** to be set up on the employee master file, the senior manager submits time and attendance records for the fictitious person causing the payment of a bribe
3. Budget owner causes a **real non-complicit person** to be set up on the employee master file, the budget owner submits time and attendance records for the real non-complicit person for work not performed causing the diversion of funds.

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Illustration: Fraud Risk Register

4. Budget owner or payroll function in collusion with a "temporary employee" causes the temporary employee to be placed on the employee master file submits time and attendance records for services not performed causing the diversion of company funds.
5. Senior management causes a **real complicit person** to be set up on the employee master file; either the senior manager submits time and attendance records for the real complicit person or causes the time and attendance records to be submitted for work not performed by the real complicit person causing the payment of a bribe.
6. Budget owner causes a real non-complicit employee that terminates employment not to be removed from the payroll for a temporary period of time and the budget owner or payroll submits time and attendance records for the terminated employee and either changes the bank account for direct deposit or diverts the paper check causing the diversion of funds.

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Illustration: Fraud Risk Register

7. Budget owner causes a **real non-complicit** employee that terminates employment not to be removed from the payroll for a permanent period of time and the budget owner or payroll submits time and attendance records for the terminated employee and either changes the bank account for direct deposit or diverts the paper check causing the diversion of funds.
8. Budget owner or payroll function in collusion with a **real complicit employee** causes the terminated complicit real employee to remain on the payroll master file for a permanent period of time causing the diversion of funds.
9. Budget owner causes a properly terminated non complicit employee to be reactivated on the employee master file, the budget owner submits time and attendance records for the **reactivated** employee and either changes the bank account for direct deposit or diverts the paper check causing the diversion of company funds.

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Thought Question #5

Is fraud the greatest unmanaged cost to an organization?

- True
- False
- I'm not sure

This is why fraud risk management is so important!

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My Parting Thoughts

- Understand the phrase: Considering Fraud as Part of the Audit
- Adopt a methodology to identify fraud risk
- Develop a comprehensive identification of the fraud risk universe
- Know what fraud looks like
- Understand how fraud is concealed
- Improve our understanding of why fraud goes undetected
- Understand what internal controls can do and not do
- Develop your fraud audit detection capabilities

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Thank You

To quote a famous individual:

- “That’s all, folks.”
- Questions: lvona@leonardvona.com
- Please visit my website, Leonardvona.com
- Sign up for my monthly blog
- I promise it’s not a marketing ploy

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