


How to Identify Fraud Risk

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Speaker



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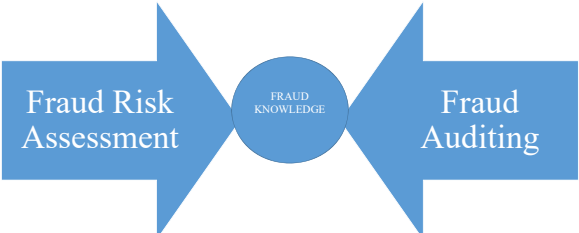
Mr. Vona is the author of three books published by Wiley, *Fraud Risk Assessment: Building a Fraud Audit Program* and *The Fraud Audit: Responding to the Risk of Fraud in Core Business Systems*, *Fraud Data Analytics Methodology: The Fraud Scenario Approach to Uncovering Fraud*.

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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Expression: Professional Skepticism

➤ The Key: Educated Skepticism

- **Knowledge** through the study; what I call the *science of fraud risk and fraud auditing*
- **Knowledge** through experience; what I call *the art of fraud auditing*

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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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Today's Agenda

- **What is fraud risk**
- Understanding the fraud risk universe
- How to create fraud risk statements
- Practical illustrations

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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

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.”

THREATS, VULNERABILITIES AND FRAUD RISKS

- **Fraud Risk: An intentional and concealed threat which is 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

ACFE

Fraud Risk Assessment Process aimed at proactively identifying and addressing an organization's vulnerabilities to internal and external fraud. The objective of a fraud risk assessment is to help an organization identify what makes it most vulnerable to fraud.

Fraud Prevention and Deterrence

- www.acfe.com/uploadedFiles/ACFE_Website/Content/review/examreview/18-fraud-risk-assessment.pdf

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Yellow Book

- 8.71 Auditors should assess the risk of fraud occurring that is significant within the context of the audit objectives. Audit team members should discuss among the team fraud risks, including factors such as individuals' incentives or pressures to commit fraud, the opportunity for fraud to occur, and rationalizations or attitudes that could increase the risk of fraud. Auditors should gather and assess information to identify the risk of fraud that is significant within the scope of the audit objectives or that could affect the findings and conclusions.

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Yellow Book

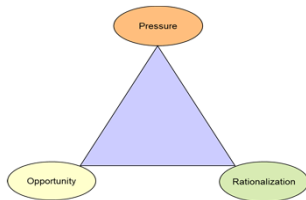
- 8.72 Assessing the risk of fraud is an ongoing process throughout the audit. When information comes to the auditors' attention indicating that fraud, significant within the context of the audit objectives, may have occurred, auditors should extend the audit steps and procedures, as necessary, to (1) determine whether fraud has likely occurred and (2) if so, determine its effect on the audit findings.

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Commonly Accepted Theory For Internal Fraud



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Measuring Fraud

- Founder, Dr. Cressey, felt that the absence of one would not allow an individual to commit fraud
- Three elements co-exist at different levels
- Complex combination of degrees for each element
- Varies based on the individual
- Strength of one element may cause the fraud
- Strength of one element may eliminate the worry of detection
- Considering is easier than measuring

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Pressure To Commit Fraud

- Pressure and motivation similar but different
- Pressures differ by the global fraud scheme
- Pressures maybe caused by internal or external sources
- Pressures should be linked to fraud scheme
- Pressures may be real or perceived

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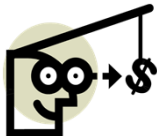
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What Is The Difference?

- Pressure: A constraining influence on the will or mind, as a moral force. (Webster's II Dictionary)
- Motive: Willful desire that leads one to act. (Blacks Law Dictionary)



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Pressures of Fraud Asset Misappropriation

- Financial
- Vices
- Perceived/real
- Change in life situation
- Unexpected crisis



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Rationalization of Fraud

- Subtle
- People rationalize
- Conscious decision
- Ethical decision process
- Confidence factor

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Fraud Opportunity

- Opportunity to commit fraud by virtue of their authority and position.
- Opportunity to conceal fraud by virtue of their position and reputation.

- Each job function has an inherent capability to commit one or more fraud schemes

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Polling Question - 1

- Each professional audit organization defines fraud in the same way?

- True
- False

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Today's Agenda

- What is fraud risk
- **Understanding the fraud risk universe**
- How to create fraud risk statements
- Practical illustrations

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Fraud Risk Universe

The diagram consists of three blue ovals on the left, each connected to a blue rounded rectangle on the right. The top oval is labeled 'Fraud Risk Structure' and points to 'Offender and victim'. The middle oval is labeled 'What is your Scope' and points to 'Type of fraud or category of fraud'. The bottom oval is labeled 'Which Fraud Risks' and points to 'Three kinds of fraud risks'.

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Fraud Risk Universe

The diagram shows four concentric ovals. From the outermost to the innermost, they are labeled: 'PRIMARY FRAUD CLASSIFICATION', 'SECONDARY FRAUD CLASSIFICATION', 'INHERENT FRAUD SCHEME', and 'FRAUD RISK STATEMENT'.

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Offender and the Victim Analysis

- Employee against employer
- Employer against employee
- Vendor against company
- Customer against company
- Company against investors
- Professional crime groups against companies or government
- Starting Point For Fraud Risk Assessment

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Primary Fraud Risk Categories

Asset Misappropriation	Government Regulation Avoidance
Corruption / Extortion	Improper Obtain / Loss Information
Financial Reporting	Computer Fraud
Revenue Obtained Improperly	Management Override Concerns
Expense Avoidance	Other Areas

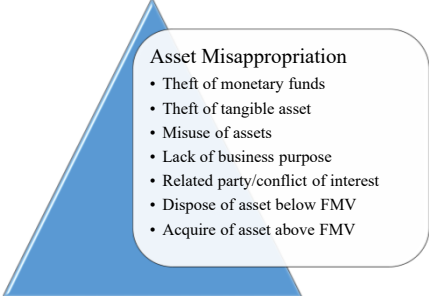
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Definitions Of Major Categories

- **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

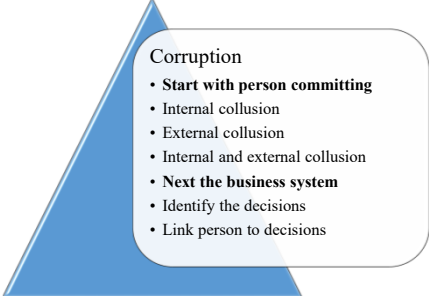


Asset Misappropriation

- 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

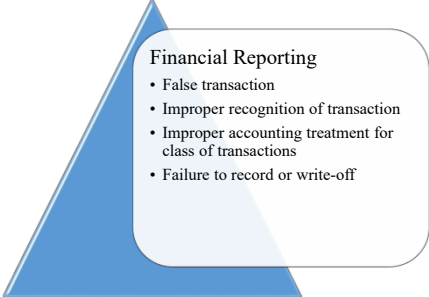


Corruption

- **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

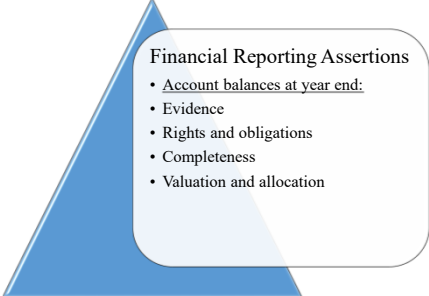


Financial Reporting Assertions

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

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Secondary Fraud Risk Categories

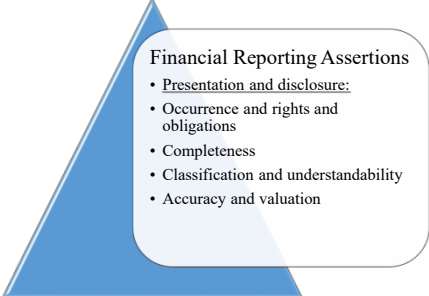


Financial Reporting Assertions

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

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Secondary Fraud Risk Categories

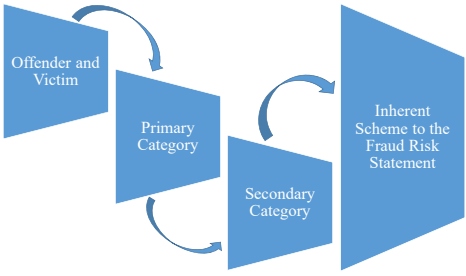


Financial Reporting Assertions

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

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Fraud Risk Structure



```
graph LR; A[Offender and Victim] --> B[Primary Category]; B --> C[Secondary Category]; C --> D[Inherent Scheme to the Fraud Risk Statement];
```

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Three Types of Fraud Risks

- 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 fraud risk assessment / 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

- Inherent fraud scheme
 - False Entity / False Billing
- Fraud risk statement
 - 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
 - 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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Polling Question -2

- The fraud risk universe is larger than our solar system?
- True
- False

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Today's Agenda

- What is fraud risk
- Understanding the fraud risk universe
- **How to create fraud risk statements**
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Elements of a fraud risk statement

- What are the combinations?
- Which permutation is the 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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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

```
graph LR; Person[Person] --> Entity[Entity]; Person --> Action[Action]; Entity --> False[False]; Entity --> Real[Real]; Action --> What[What]
```

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Just A Different Look At Fraud Risk

```
graph LR; APMA[Accounts Payable Manager] --> Vendor[Vendor]; APMA --> TOI[Take over Identify]; Vendor --> False[False]; Vendor --> Real[Real]; TOI --> CA[Change Address]
```

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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

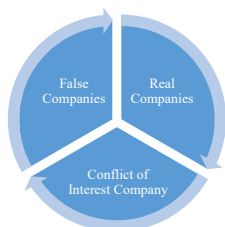
- Asset misappropriation (Theft of asset)
 - Primary element varies by scheme
 - Conversion cycle varies by scheme
- Corruption (decision / bribe)
 - Opportunity is always collusion
 - Entity is almost always one element of opportunity
- Financial Reporting (misstatement)
 - Direction of misstatement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

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Three Types of Vendors

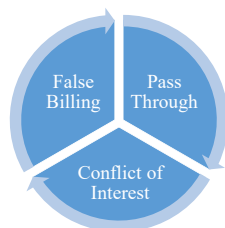


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Three Types of False Company Schemes



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Components of a Fraud Risk Statement Financial Reporting

- Person committing
- Direction of misstatement
- General ledger account
- Type of entity
- Fraud action statement (GAAP)
- Impact Statement

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Person committing

- *Person committing* is less critical for financial statement fraud versus asset misappropriation and corruption. Based on most fraud statistics, financial management or senior management is responsible for most financial statement fraud. Therefore, a simple statement of the controller or senior management would suffice. However, those schemes involving other members of management should identify at the minimum the department or function responsible for committing the fraud scenario.

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Direction of misstatement & General ledger account

- *Direction of misstatement* is whether the general ledger account is overstated or understated. The type of misstatement is critical to understanding which operating year to search for the fraud scenario. This statement also describes when the transaction is recorded to achieve the desired misstatement.
- *General ledger account* is the financial account that is the focus of the audit plan. This tells the fraud auditor where the transaction is recorded or where to search for the concealment technique. Remember, there are two sides of the entry.

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Fraud action Statement Financial Reporting

- Where is the action recorded
- Entity: false or real?
- Transaction: False or real?
- Real transaction: method of improper recognition must be stated
- GAAP Considerations should be stated or understood
- Is transaction recorded thru a source journal?
- Is transaction recorded thru a journal entry?
- Where is the transaction recorded in the financial statements

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Illustration of Fraud Risk Statement

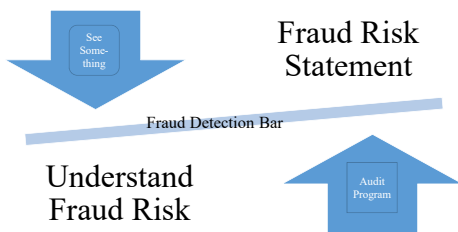
- Controller over states revenue by creating a fictitious customer and records fictitious revenue resulting in the misstatement of revenue and accounts receivable
- Person committing: Controller
- Direction of misstatement Overstatement
- General ledger account: Revenue & Accounts Receivable
- Type of entity: False customer
- Fraud action statement: False revenue
- Impact Statement: Revenue and accounts receivable

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Fraud Detection Dilemma



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How Does The Perpetrator Conceal Fraud?

Strategies used to hide the truth

- False documents
- False representations
- False approvals
- Control inhibitors
- Control avoidance
- Blocking the flow of information
- Below the control "radar"

Each scheme has typical concealment strategies; but how the strategy is implemented varies

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Fraud Sophistication Chart Detection Of Fraud

Undetected

High Sophistication of Concealment

FRAUD DETECTION BAR

Low Sophistication of Concealment

Detected

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Fraud Sophistication Chart Detection Of Fraud

See Something

High Sophistication of Concealment

FRAUD DETECTION BAR

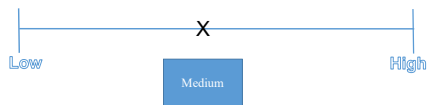
Low Sophistication of Concealment

Audit Proc.

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Sophistication Of Concealment

- Level of sophistication of concealment will vary based on perpetrators' knowledge and/or pressures
- Range of sophistication to conceal



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Fraud Concealment Linkage Master File Data

High Concealment	<ul style="list-style-type: none">• Must use transaction file• No Match
Medium Concealment	<ul style="list-style-type: none">• Limited linkage between vendor and perpetrator• Close Match
Low Concealment	<ul style="list-style-type: none">• Linkage between vendor and perpetrator• Exact Match

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Fraud Concealment Illustration Using a Bank Account Number

High Concealment	<ul style="list-style-type: none">• Different bank• No match
Medium Concealment	<ul style="list-style-type: none">• Same bank, different account number• Close match
Low Concealment	<ul style="list-style-type: none">• Same bank and same account number• Exact match

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Polling Question -3

• Each fraud risk statement has five elements?

- True
- False

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Today's Agenda

- What is fraud risk
- Understanding the fraud risk universe
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- **Practical illustrations**

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Illustration of Fraud Risk Statement: False Billing

• Budget owner acting alone / cause a shell company to be set up on the vendor master file / cause a fake invoice for goods or services to be paid / causing the diversion of company funds

• Now how could this occur in your company?

• The difference between a fraud risk statement and a fraud scenario

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Understand the Fraud Risk Statement: Pass Through Scheme

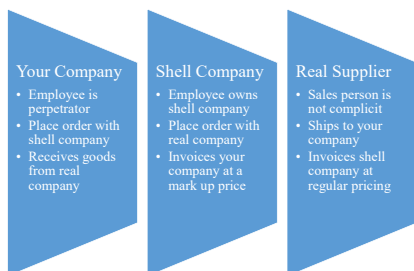
Budget owner acting alone or in collusion with a direct report cause a shell company to be set up on the master file, places orders for goods or services thru the shell company, the shell company places an order with a real supplier, the real supplier ships directly to the budget owner company, the real supplier invoices the shell company and the shell company invoices the budget owner company at an inflated price causing the diversion of company funds.

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Pass Thru Entity Fraud Risk Statement Version One-15

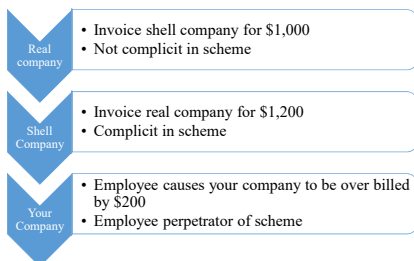


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Pass Thru Entity Fraud Risk Statement Version One



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Understand the Fraud Risk Statement: Conflict of Interest Scheme

Senior member of management creates a real company; senior member of management causes the issuance of a purchase order or contract to their real company for goods and services that are provided without disclosing the conflict of interest

Senior member of management in collusion with an external party creates a real company; senior member of management causes the issuance of a purchase order or contract to their real company for goods and services that are provided without disclosing the conflict of interest.

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Polling Question -4

• Creating fraud risk statements for your audit plan is fun and easy?

- True
- False

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Fraud Scope Questions

- Who is the victim and who is the perpetrator?
- What is the primary type of fraud?
- What is the secondary type of fraud?
- What type of entities is the focus of your audit?
- What is your fraud action statement?
- What is your time period?
- What is the purpose of the audit?

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Thank you

- That's all Folks!
- Questions: lvona@leonardvona.com
- Please visit my web site Leonardvona.com
- Down load my E-Book which will sign you up for automatic monthly blog series
- I promise not a marketing ploy

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