

How to Perform a Fraud Risk Assessment

2021 ALBANY FRAUD
CONFERENCE

Today's Agenda

- Professional Standards
- Fraud Auditing, Inc.: Identifying the fraud risk statements
- Sample fraud risk assessment
- Required elements of a risk assessment
- Linking the internal controls to the fraud risks
- Linking the audit program to the risk assessment

Managing the Business Risk of Fraud: A Practical Guide

- Sponsored by IIA, AICPA AND ACFE
- Key principles for proactively establishing an environment to effectively manage an organization fraud risk include
- Principle 1: As part of an organization's governance structure, a **fraud risk management program** should be in place, including a written policy (or policies) to convey the expectations of the board of directors and senior management regarding managing fraud risk.

Managing the Business Risk of Fraud: A Practical Guide

- Principle 2: **Fraud risk exposure should be assessed periodically by the organization to identify specific potential schemes and events that the organization needs to mitigate.**
- Principle 3: Prevention techniques to avoid potential key fraud risk events should be established, where feasible, to mitigate possible impacts on the organization.
- Principle 4: Detection techniques should be established to uncover fraud events when preventive measures fail or unmitigated risks are realized.

Managing the Business Risk of Fraud: A Practical Guide

- Principle 5: A reporting process should be in place to solicit input on potential fraud, and a coordinated approach to investigation and corrective action should be used to help ensure potential fraud is addressed appropriately and timely.

Fraud Risk Standards

- What Standards are you following?
- Very Important!
 - Statement of Auditing Standards
 - PCAOB
 - IIA
 - ACFE
 - Yellow Book

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

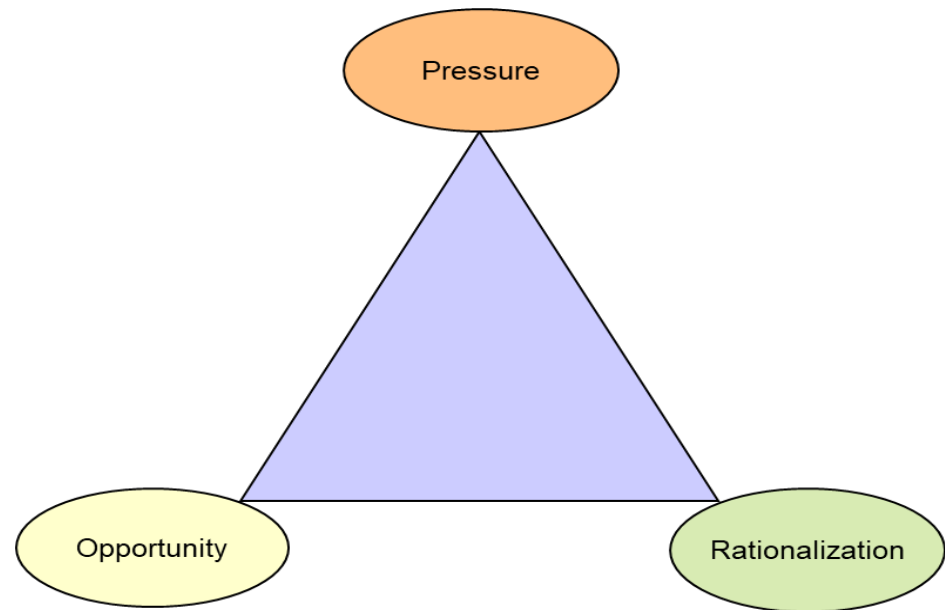
Yellow Book

- 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.

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.

Commonly Accepted Theory For Internal Fraud



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

Pressure To Commit Fraud

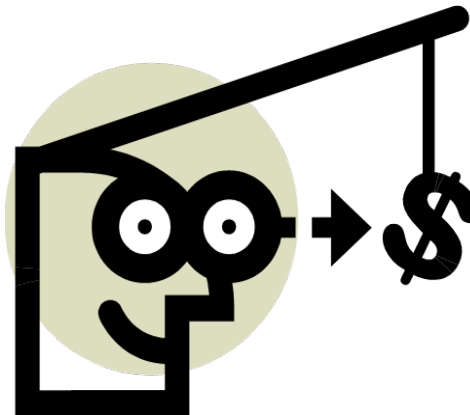
- Pressure and motivation similar but different
- Pressures differ by the global fraud scheme
- Pressures maybe caused by internal or external sources
- Pressures should be linked to fraud scheme
- Pressures may be real or perceived

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)



VS



Pressures of Fraud

Asset Misappropriation

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



Rationalization of Fraud

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

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

Polling Question-1

- Every child wants a fraud triangle for the holidays
- True
- False

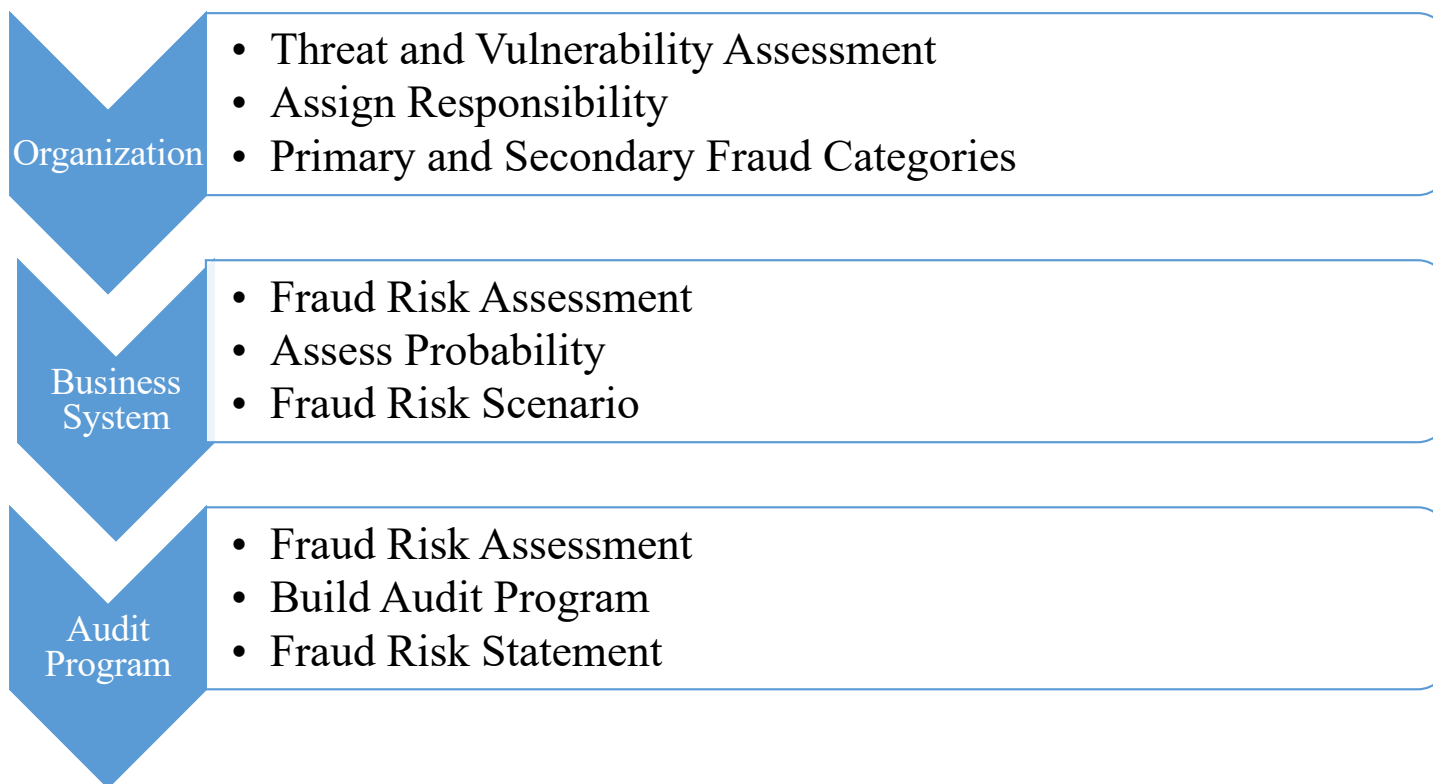
Professional Skepticism

- Applying reason to determine the validity of the claim
 - Critically analyzing all evidence considered
 - Finding a factually supported conclusion
-
- Source ACFE

Educated Professional Skepticism

- Understand the fraud risk universe
- Understand the fraud auditing is both a science and a art
- Understand there is a methodology to assessing fraud risk
- Understand there is a methodology to fraud data analytics, fraud auditing and fraud investigation

Understanding the Progression The Three Levels



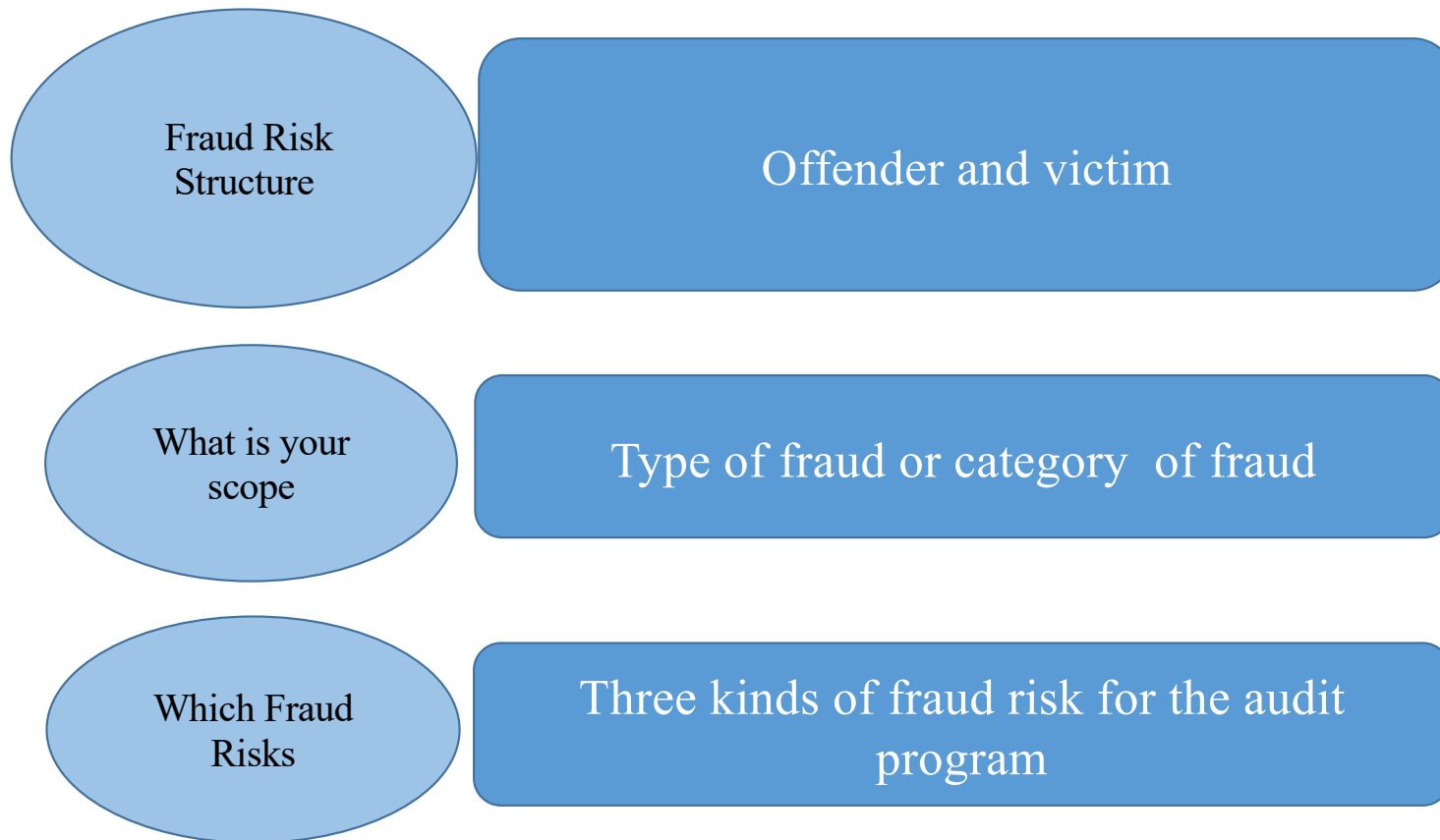
THREATS, VULNERABILITIES AND FRAUD RISKS

- **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

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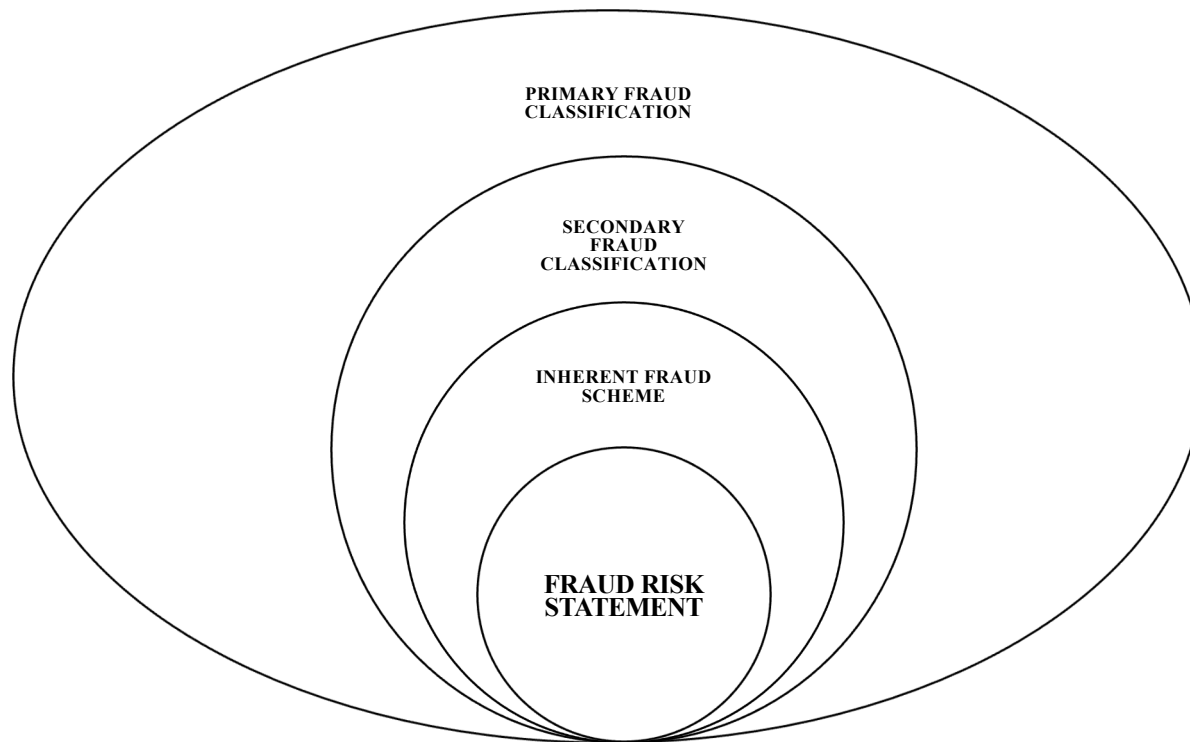
Fraud Risk Universe



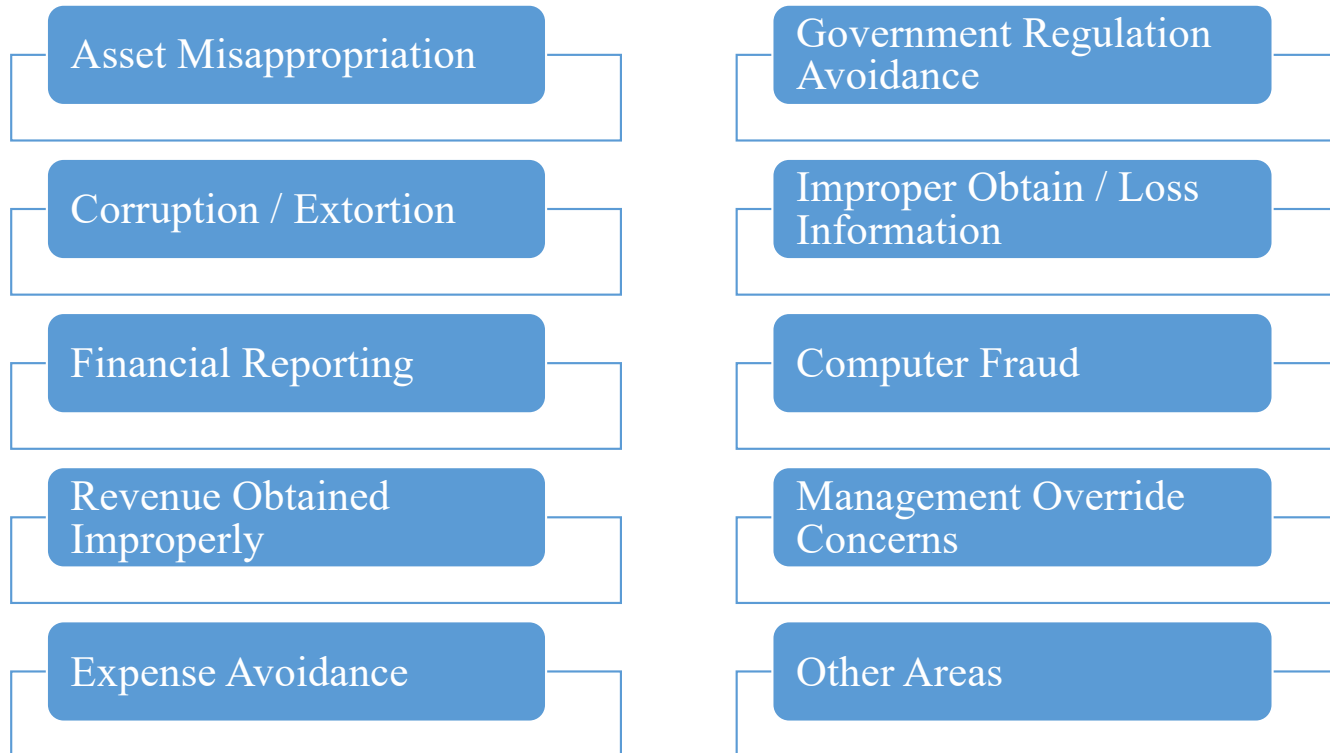
Offender And The Victim

- 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**

What is your audit scope



Primary Fraud Risk Categories



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

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.

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

Elements of a fraud risk statement

- What are the combinations?
- 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

Illustration of Fraud Risk for Auditors

- Inherent fraud scheme
 - False Entity / Paid for Services not performed
- Fraud risk statement
 - Budget owner or payroll function 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.
- Fraud scenario
 - Manager at a fast food restaurant submits a employee action form to payroll department listing a fictitious employee/ The manager prepares, approves and submits a time card for the fictitious employee causing payroll to calculate a pay check and direct deposit the money.

Polling Question-2

- A fraud risk statement is the same as a fraud scenario?
- True
- False

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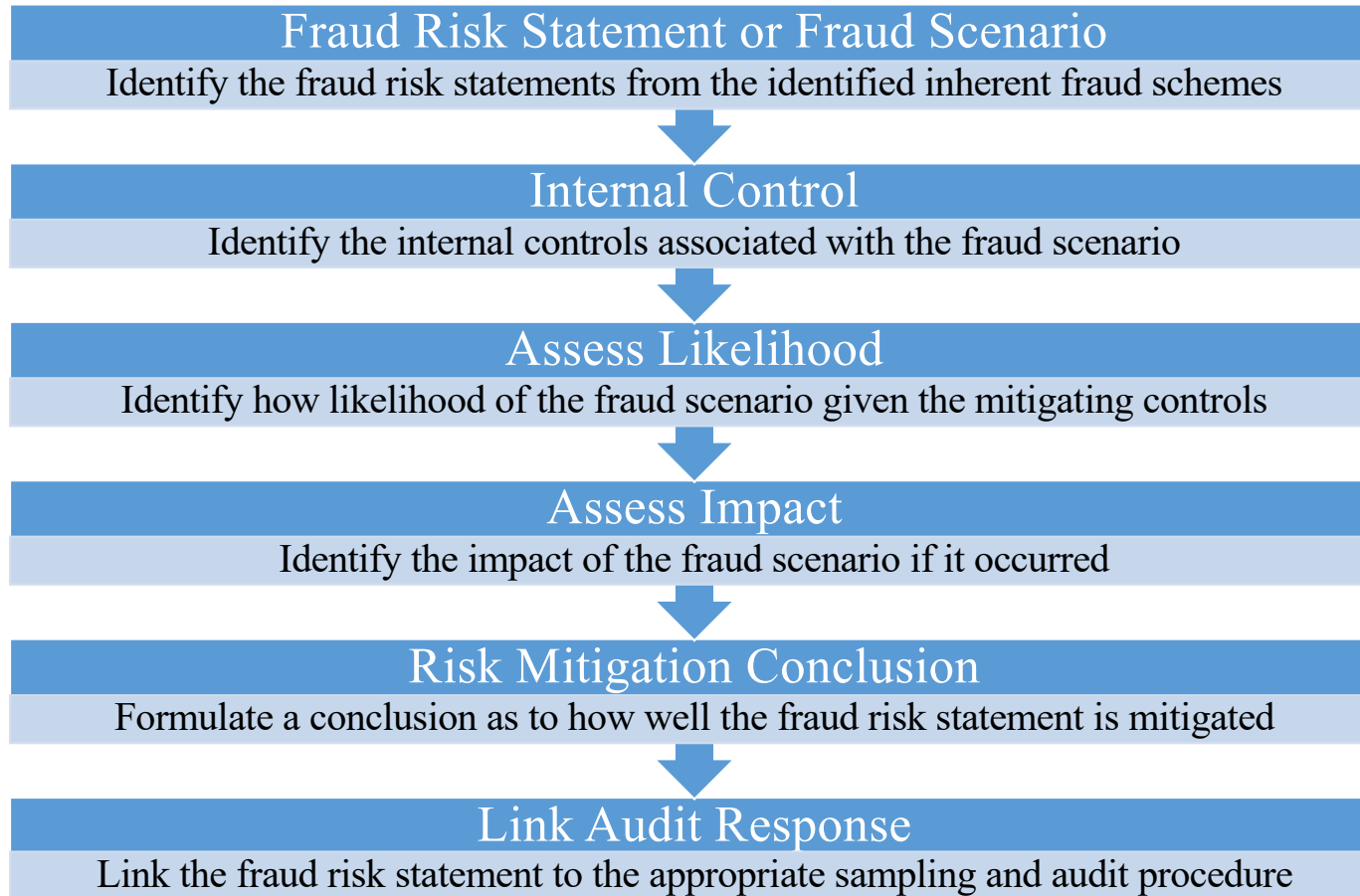
Sample Fraud Risk Assessment

Procurement and payment cycle
 See fraud risk assumption memo
 See system flowchart of internal controls

ILLUSTRATION OF FRAUD RISK ASSESSMENT

ITEM #	PRIMARY FRAUD CATEGORY	COMMON OR LOCAL	TYPE	Internal or External	FRAUD RISK STATEMENT	CONVERSION	INTERNAL CONTROLS	LIKELIHOOD	IMPACT	OVERALL	AUDIT PROGRAM	CONTROLS	RESIDUAL
1	Asset Misappropriation	Common	False Entity Schemes	Internal	Budget owner acting alone or in collusion with a direct report cause a shell company to be set up on the vendor master file, process a contract and approves a fake invoice for goods not received causing the diversion of company funds	Payment to a controlled entity	1. See standard control list 2. New vendor procedures	Medium	High	High	See procedure	High	Medium
2	Asset Misappropriation	Common	False Entity Schemes	Internal	Accounts payable clerk acting alone takes over the identity of a dormant vendor, creates a fake invoice and processes the invoice against a dormant contract for goods not received causing the diversion of company funds	Payment to a controlled entity	1. See standard control list	Low	Medium	Medium	See procedure	High	Low
3	Corruption	Common	Favored Vendor	Internal	Budget owner corruptly influences the bid process by structuring the process to provide a favored vendor with an unfair advantage in the selection process. The selected vendor pays a kickback to the budget owner. The following techniques are commonly used to corrupt the process:	Blank	Blank	Blank	Blank	Blank	Blank	Blank	Blank
4	Corruption	Common	Favored Vendor	Internal	Structuring a series of purchases below the bid threshold thereby avoiding the bid process	High	Review of purchases	High	High	High	See procedure	Medium	High

Business Process Risk Assessment Process



Purpose Of Fraud Risk Assessment

PURPOSE

- Identification and understanding of all fraud scenarios
- Identify the right type of internal control
- Manage the cost of fraud
- Build methodology for allocating resources

OUTCOME

- • Comprehensive listing of all fraud risks
- • Judge the likelihood of fraud occurring
- • Determine the impact if the fraud scenario occurs
- • Link control resources and audit responsibility to the fraud risk

Preparing the fraud risk assumption memo

- Starts with identifying the primary and secondary category of the fraud risk universe
- Identifies the professional standards followed
- Describes the purpose of the fraud risk assessment
- Describes the scope of the fraud risk assessment
- Identifies assumptions in preparing the fraud risk assessment

Examples of Assumptions

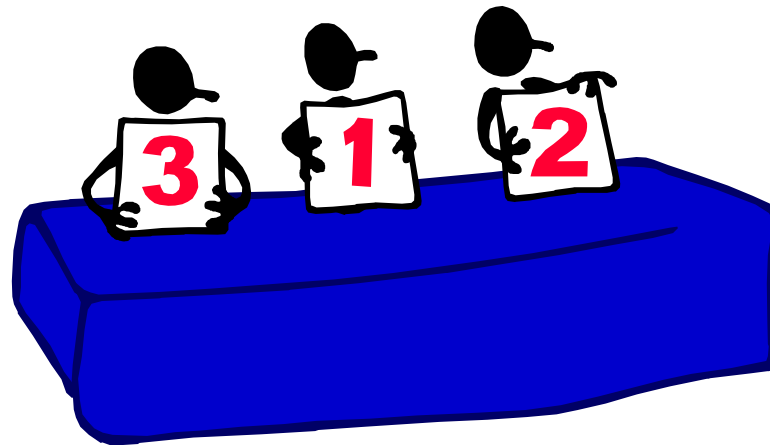
- Collusion is considered in the fraud risk assessment, when the collusion is logical to the scheme. (I.e. Sales person and a customer).
- Collusion amongst three or more parties is not identified in the fraud risk assessment because the likelihood of that level of corruption seems not likely.
- Senior manager is considered in a management override scheme. All fraud risk scenarios involving senior manager are rated as high “impact” due to the visibility factor of the position.

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Assessing Likelihood

- Link fraud control to fraud risk
- Methodology for scoring
- Score each fraud control
- Rate the fraud minimization



How to Assign a Fraud Risk Score

- Not a mathematic solution
- Typically based on the auditors: available evidence; experience and expert judgment
- Fraud triangle is one source of information
- Identify vulnerabilities and predisposing conditions
- Adequacy of internal controls
- Effectiveness of internal controls

Determine Likelihood

- Will the fraud risk statement be initiated or occur
- Characteristics of threat source (fraud opportunity)
 - Internal
 - External
- Natural vulnerabilities that exist in organization
- Prevalence of the fraud risk in the organizations industry

Traditional Risk Ratings

- Risk likelihood
 - Likely, conditions within the business system indicate that an event is expected to occur in most circumstances (3)
 - Possible, an event will probably occur in many circumstances (2)
 - Remote, an event may occur at sometime (1)

Risk Likelihood, another way

- **Low** Indicates the fraud scheme has happened or could happen, but likely only to occur once or twice in a ten-year period.
- **Medium** Indicates the fraud scheme has or might occur, likely, every three to four years.
- **High** Indicates the fraud scheme will and/or has occurred once or more on an annual basis.

Traditional Risk Ratings

- Risk impact
 - High, serious impact on business
 - Medium, significant business
 - Low, minimal impact on business

Determine Impact

- Resulting in adverse impact either monetary or non monetary
- Anticipated severity
- Duration of impact
- Frequency of occurrence
- Who commits the fraud scheme
- Regulatory or legal implications
- Safeguards to impede such events

Overall risk

- Combination of likelihood and impact
- Establish a matrix based on two factors
- I.e. High likelihood and high impact would result in a high overall risk rating

Traditional Risk Ratings

- Residual risk rating
 - Remaining risk after considering control effectiveness
 - Establish a matrix based on overall risk and control effectiveness

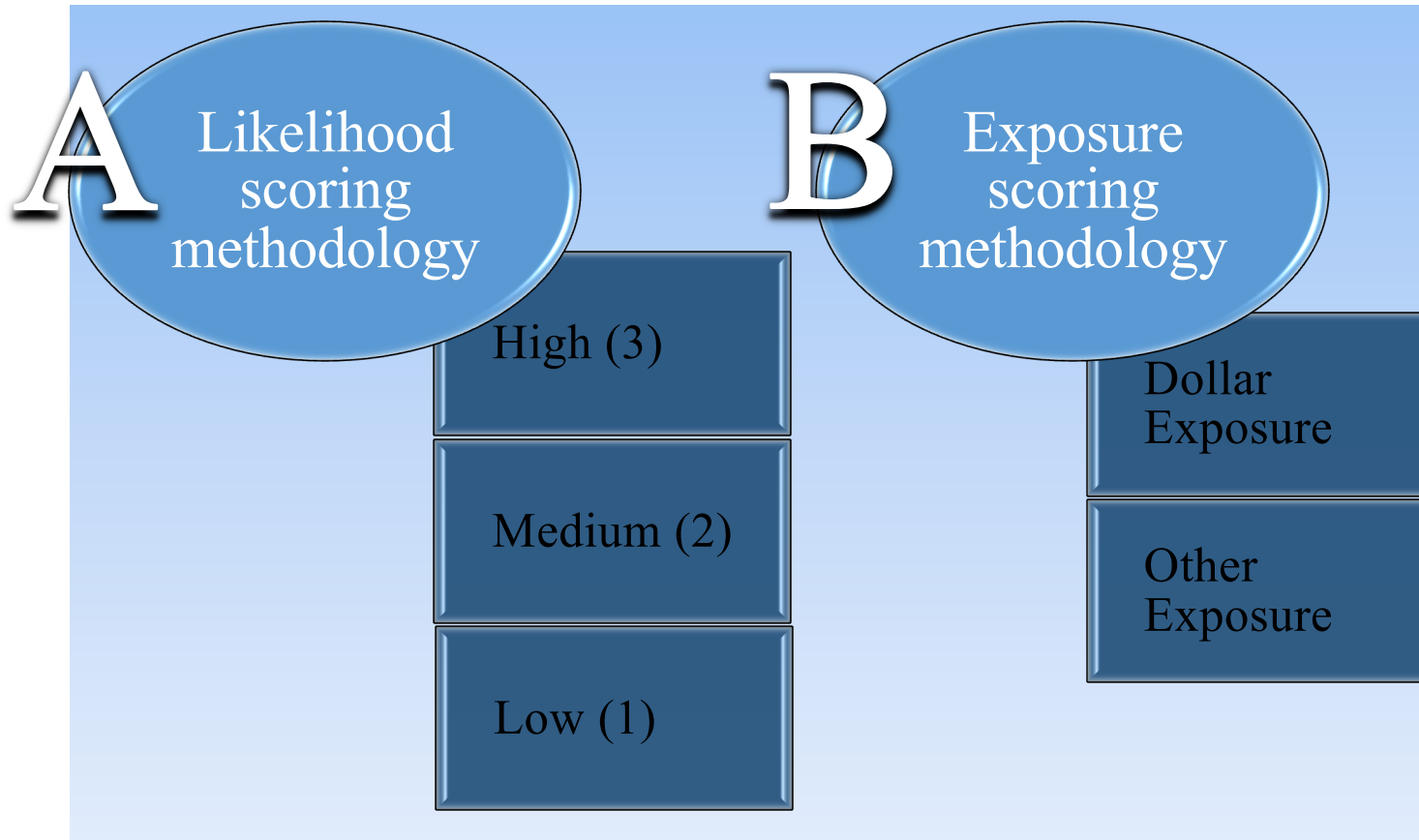
Polling Question-3

- Low residual risk is the goal of every fraud risk assessment
- True
- False

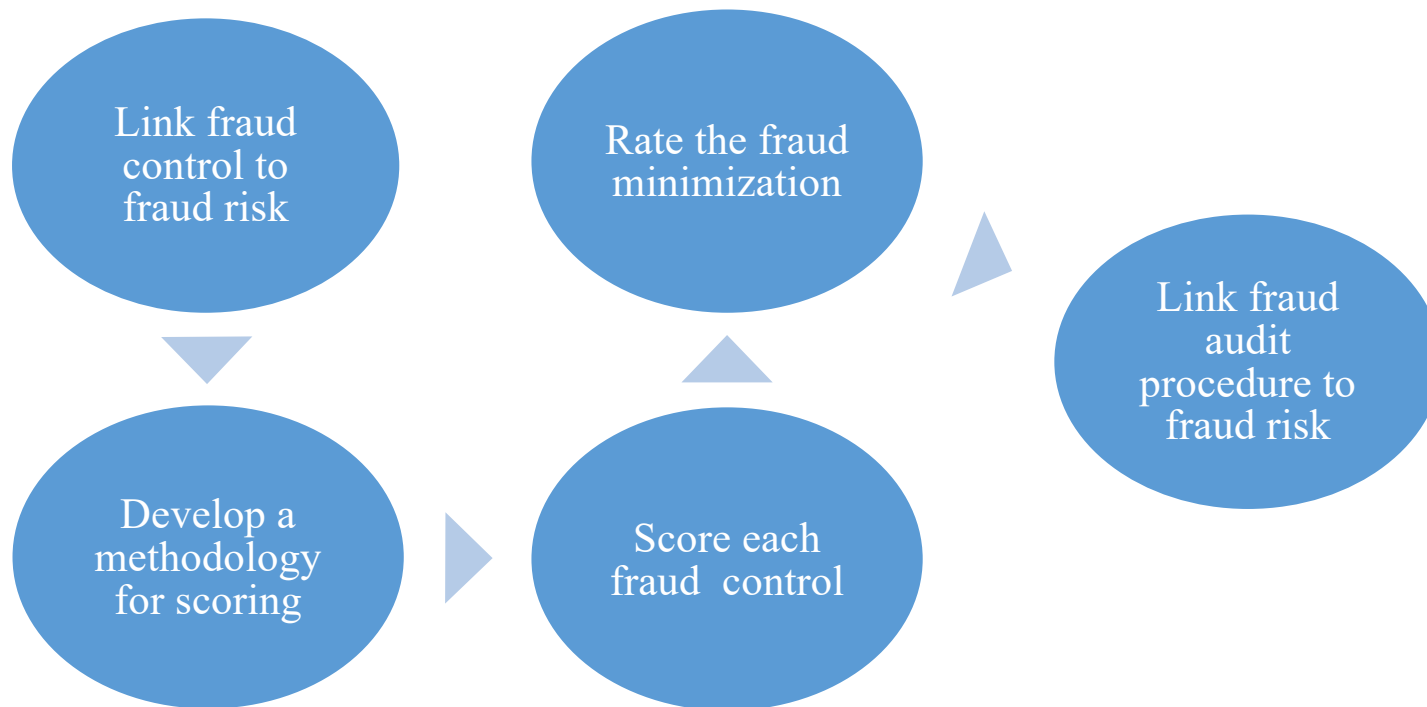
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Fraud Risk Exposure Should Be Assessed Periodically By The Organization



A. Risk Likelihood



Likelihood Methodology

A. FUNDAMENTAL

Focus on the presence of a fraud prevention and detection control

B. CONTROL SCORE

Establishes criteria for the effectiveness of the control procedure to prevent or detect fraud

Discussion Point: Which is more objective?

B. Methodology For Scoring Control Score: Illustration

- Define control activity and establish criteria for control effectiveness
- Establish a score for control effectiveness
- Document control activity
- Assign score based on professional judgment
- Link to COSO

Fraud Prevention Definition

Controls designed to minimize the likelihood of a fraud risk from occurring

Control Activities

- Completeness
- Authorization

Disciplinary Controls

- Separation of duties
- Supervision

Definition For Scoring: Fraud Prevention Illustration



Control design would reasonably minimize the occurrence of the fraud risk plus minimize control inhibitors



Control design would reasonably minimize the occurrence of the fraud risk



Control design would not reasonably minimize the occurrence of the fraud risk

Definition For Scoring: Fraud Prevention - Continued

- Illustration of criteria
 - Fraud prevention performed by someone other than individual with the ability to initiate fraudulent transaction
 - Volume of transaction reviewed is reasonable for individual to adequately review

Fraud Detection Definition

Controls designed to alert management that a fraud risk is occurring

Monitoring and Supervision

Information and Communication
Facilitative
Process

Definition For Scoring: Fraud Detection Illustration



A fraud monitoring report is created for the specific scheme and all instances are investigated



Fraud transaction printed on transaction journal and reviewed



No transaction journal or fraud monitoring report

Definition For Scoring: Fraud Detection - Continued

- Illustration of criteria
 - Fraud monitoring should detect the fraudulent transaction within a specific time period
 - Fraud monitoring performed by someone other than individual with the ability to initiate fraudulent transaction
 - Volume of activity is reasonable for someone to review and detect the fraud

Fraud Likelihood Score

- Total the fraud prevention and detection scores

Fraud Scenario	Prevent Controls	Detect Controls	Total Control Score
False Billing	2	1	3
Pass Through Billing	2	2	4
Conflict of Interest	2	3	5

- Establish ranking for scores
- **5-6** event is likely to occur
- **4** event is more than remote but less than likely
- **2-3** event occurring is slight

Fraud Exposure

1. Gross fraud exposure: if the risk occurs the anticipated maximum loss
 - Monetary
 - Non monetary
2. Link the exposure calculation to the fraud likelihood score
3. Establish the base for the calculation
4. Calculate exposure base on dollar or percentages
5. Identify other exposures

Gross Fraud Exposure

- a. Dollar impact
 - Gross calculation
 - Net calculation
- b. Business impact
 - Adverse publicity
 - Reputation risk
 - Impair conduct of daily business
 - Corporate criminal action
 - Class action lawsuits

GROSS EXPOSURE

Total dollar value of the business system, class of transactions, or account

Discussion Point: Which is more harmful to the organization?

Fraud Exposure Dollars (% Method)

- Use likelihood score to assign a loss percent

Likelihood Score	Fraud Impact
If 2 or 3	Then .5%
If 4	Then 1%
If 5 or 6	Then 5%

Percent's illustrated are arbitrary and for illustration only

- Start with the gross exposure amount
- Multiple gross exposure by the loss percent

Discussion Point: What are the appropriate percentages to use?

Polling Question-4

- Kim does a great job organizing the annual fraud conference
- True
- False

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Methodology for Deciding on Audit Response

- Based on the fraud minimization (likelihood) score

