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IIA – New York Conference Fraud Detection

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Internal Audit.

Today's Discussion Topics

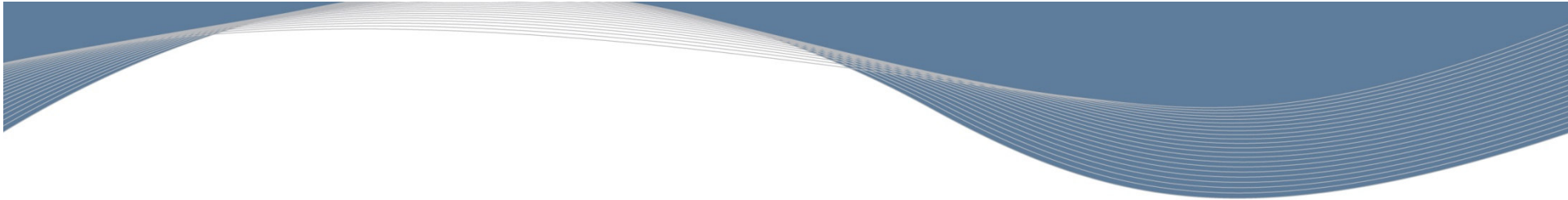
- Fraud Risk in Today's Economy
 - What's emerging
 - How are CAE's approaching fraud risk assessment
- Internal Audit's Role with Respect to Identification of Fraud Risk
- Detecting Red Flags
- Computer-Assisted Audit Techniques
- Fraud Risk Considerations in Internal Audit Planning

Occupational Fraud: A Study of the Impact of An Economic Recession

Association of Certified Fraud Examiners (2009)

1. Level of fraud has increased since beginning of economic crisis.
2. Current increase in fraud stems from intense pressure faced by so many individuals.
3. Employees pose greatest threat to organizational resources in current economy.
4. Fraud levels expected to continue rising.
5. Organizations need to take seriously the threat posed by employees.
6. Fraud thrives in times of economic turmoil.
7. Even while facing budget reductions, companies have not cut spending on fraud-related controls.
8. Layoffs are pervasive and are leaving holes in organizations' internal control systems.





Identification of Fraud Risk: Role of Internal Audit

Changes to the IIA Standards (Effective 1/1/09)

2120.A2 (NEW) – The internal audit activity must evaluate the potential for the occurrence of fraud and how the organization manages fraud risk.

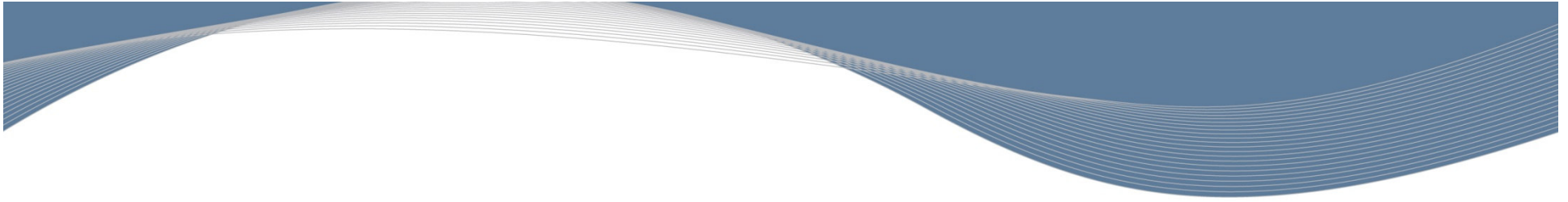
- Focus on fraud risk assessment
- Additional component includes evaluation of fraud risk management

1210.A2 – Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.

- “Must” instead of “should”

Be Skeptical!

- Always request originals.
- Ask yourself whether transactions make sense.
- Have documents been altered?
- Look to see where the documents are maintained.
- Do employees have close personal relationships with vendors?
- Is there a lack of supporting documentation?
- Do background checks identify related parties and DBAs?
- Does an answer not make sense?
- Are you avoided more than usual?
- When asking a relatively simple question, are you unexpectedly referred to someone high up in the organization?
- Go with your gut!



Detecting Red Flags

What is Fraud Auditing?

Combination of tools and techniques used to detect indicators of fraud and misconduct, including:

- Anomalies
- Exceptions
- Irregularities
- Oddities
- Patterns



Ask these Questions...

- Where are the weakest links in the system's controls?
- What deviations from conventional good accounting practices are possible?
- How are off-line transactions handled and who has the ability to authorize these transactions?
- What would be the simplest way to compromise the system?
- What control features in the system can be bypassed by higher authorities?
- What is the nature of the work environment?

Red Flags / Key Indicators – Entity Level

- Internal control gaps, deficiencies, weaknesses
- Business results that continually outperform expectations
- Management override of controls
- Rapid or significant turnover of resources
 - Senior management
 - Key financial positions
 - Key employees
- Inadequate segregation of duties
 - Turnover
 - Cut-backs / lay-offs

Red Flags / Key Indicators – Entity Level (cont'd)

- Unusual end-of-month or end-of-quarter journal entries or topside entries
- High-level of related-party transactions
- Employee, customer or vendor complaints
- Repeated changes of independent public accountants
- Disclosures
 - Investigations
 - Suspicion of illegal activities

Process Level – Red Flags

Cash

- High volume of manually prepared checks
- Unrestricted access to blank checks, signature plates, and check signing equipment
- Improper segregation of duties
- Improper authorization or weak controls over wire transfers
- Unexplained items when preparing bank reconciliation
- Excessive number of unexplained voided checks
- Excessive number of bank accounts and activity between these accounts as to make it difficult to follow the flow of funds

Process Level – Red Flags

Accounts Receivable Process

- Lack of accountability for invoice numbers issued
- Lack of segregation of duties between the following:
 - Processing of accounts receivable invoices and posting to subledger
 - Posting to accounts receivable subledger and cash receipts
- Lack of policies and procedures regarding write-offs
- Frequent undocumented and/or unapproved adjustments, credits, and write-off's
- Low turnover or slow collection cycle
- Dramatic increase in allowance for doubtful accounts
- No reconciliation of AR subledger to GL control account
- Insufficient supervisory review of AR activity and AR aging
- Unrestricted access to subledgers and general ledger

Process Level – Red Flags

Inventory/Production Process

- Credit balances in inventory accounts
- Consistent fluctuations in inventory accounts between months
- Excessive inventory write-offs without documentation or approvals
- Unusual volume of adjustments, write-offs, and disposal of material, inventory, or fixed assets
- Unrestricted access to inventory storage areas
- Significant weaknesses in inventory cut-off procedures
- No policy regarding identification, sale, and disposal of obsolete and surplus materials
- FG inventory turnover rate does not correlate with operating cycle
- No segregation of duties between:
 - Receipt of inventory and issuing of materials
 - Recording of inventory accounts and ordering materials
 - Identification of obsolete and surplus materials and sale and disposal of such materials



Process Level – Red Flags

Distribution

- Substantial cash payments, price discounts, rebates, or other concessions to distributors to induce continued buying as well as promise not to return goods
- Payments or concessions to distributors that are recorded as expenses rather than reductions in revenue
- Inventory sent to distributors include rights of return
- Distributors sell goods on consignment but revenue is recognized immediately
- Recognizing revenue before the risk of loss has passed to the customer
- Distributors are nothing more than warehouses where inventory is stored but sale is recorded

Process Level – Red Flags

Fixed Assets

- Expenses are inappropriately capitalized
- Leased assets are recorded as fixed assets
- Incorrectly classified assets (short-term vs. long-term)
- Fixed assets classified at market value rather than historical cost
- Unexplained discrepancies between the fixed asset register and the general ledger

Process Level – Red Flags

Accounts Payable

- Recurring identical amounts from the same vendor
- PO Boxes or multiple remittance addresses for the same vendor
- Sequential invoice numbers from the same vendor or invoice numbers with an alpha suffix
- Lack of segregation of duties
- Processing AP invoices and updating vendor master file
- Preparing checks and posting to vendor accounts
- Preparing and mailing signed checks
- No proper documentation of changes to vendor master file
- Suspicious/excessive adjustments for returned goods

Process Level – Red Flags

Purchasing

- Turnover among buyers within the purchasing department significantly exceeds attrition rates throughout the organization
- Purchase order proficiency rates fluctuate significantly among buyers within comparable workload levels
- Dramatic increase in purchase volume per certain vendor(s) not justified by competitive bidding or changes in production specifications
- Unaccounted purchase order numbers or physical loss of purchase orders
- Rise in the cost of routine purchases beyond the inflation rate
- Unusual purchases not consistent with the categories identified by prior trends or operating budget

Process Level – Red Flags

Bidding Process

- Costs for work performed by certain contractors are coded differently (e.g. by an unusual project number or general ledger account) than for similar work performed by other contractors
- Certain contractors are typically allowed to overrun their bid amount without proper authorization or change order documentation
- Existence of conflicts of interest (e.g. a company employee having a financial interest in a contractor's business)
- Contractor who consistently submits the lowest bid after all other bids have been submitted
- Inappropriate interaction between purchasing department personnel and contractors
- Background checks indicate that the contractor has numerous DBAs and those other companies compete against the contractor during the bidding process

Process Level – Red Flags

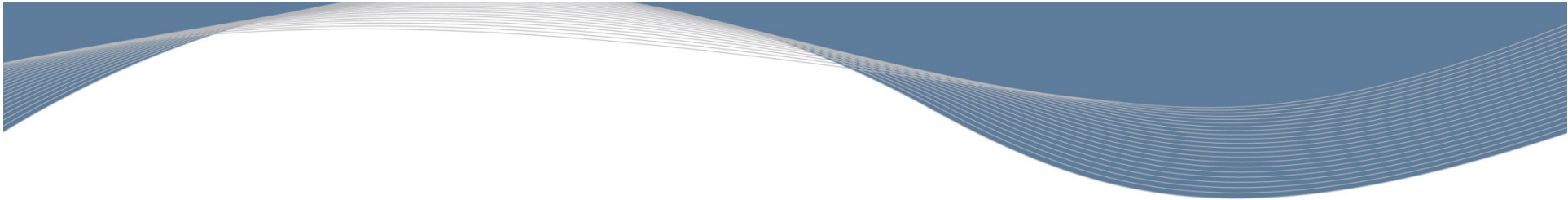
Payroll

- Dramatic increase in labor force or overtime not justified by production or sales volume
- Turnover within the payroll department significantly exceeds attrition rates throughout the organization
- Missing or easy access to blank checks, facsimile, and manual check preparation machine
- Tax deposits are substantially less than those required by current payroll expenses
- High volume of manually prepared payroll checks

Process Level – Red Flags

Finance Process

- Significant adjustments to accrued liabilities, accounts receivable, contingencies, and other accounts prior to acquisition of new financing
- Dramatic change in key leverage, operating, and profitability ratios prior to obtaining financing
- Adopting a change in accounting principle or revising an accounting estimate prior to obtaining financing
- Increase in short-term cash and a decrease in receivables while sales are increasing prior to seeking new financing
- A change in external activities, legal counsel, or treasury department head prior to obtaining new financing
- A delay in issuance of monthly, quarterly, or annual financial reports prior to seeking new financing



Computer-Assisted Audit Techniques



Use Technology:

- Search for duplicate payments
- Analyze voids and refunds by employee, using passwords or employee ID numbers
- Search for duplicate addresses within files: Payroll, Vendor, Accounts Receivable Write-offs
- Analyze use of override transactions
- Analyze file maintenance on employee accounts
- Look for patterns
- List large payments to individuals

Data Mining and Analysis

- Leverage existing electronic data for purposes of identifying anomalies and red flags to better understand potential risk of fraud and misconduct
- All types of electronic data can be collected and analyzed, such as:
 - Financial / accounting systems
 - Public exchange systems (PBX) / v:mail systems
 - Network files
 - E:mail / instant messenger
 - Time and expense reports
 - Employee files / HR data

Numbers speak.

What are they saying about your organization?

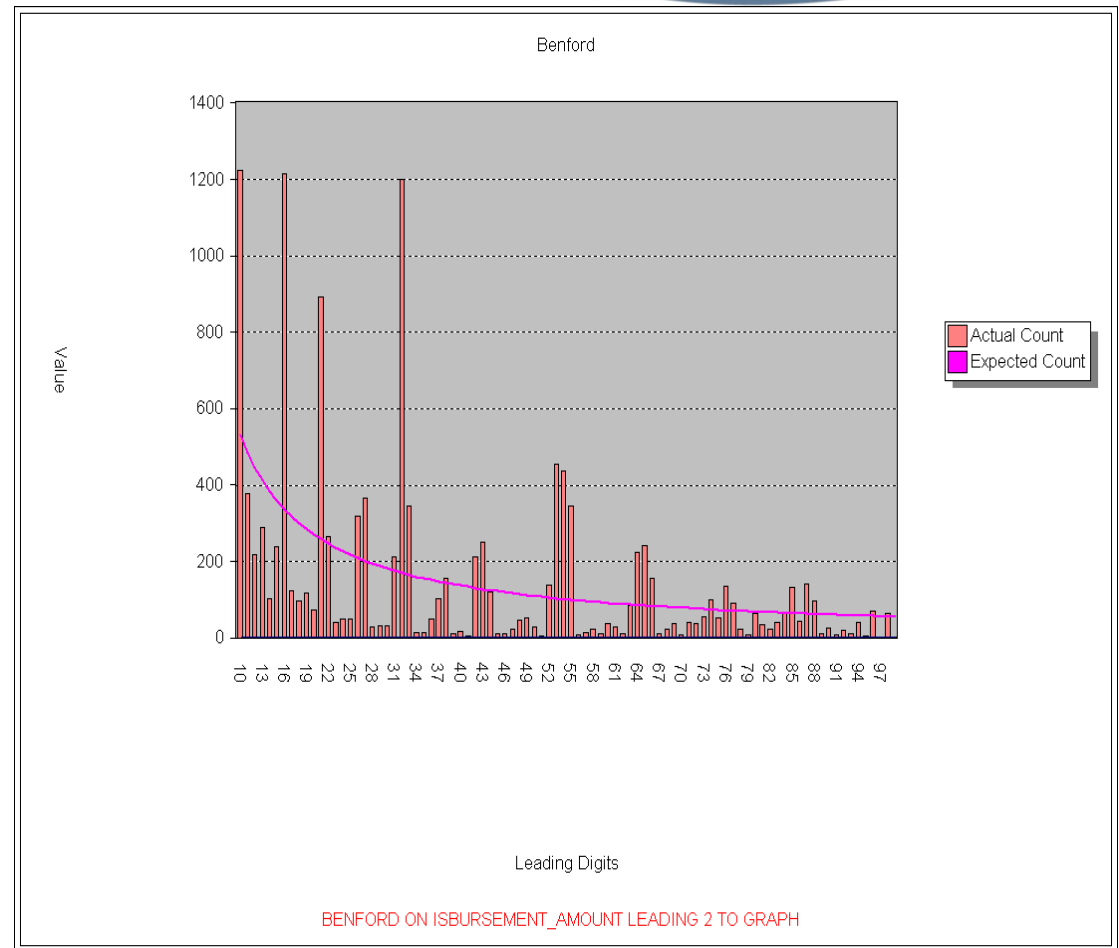
Data Mining and Analysis (cont'd)

Electronic data routines help detect anomalies that may indicate red flags for fraud and misconduct, such as, but not limited to:

Anomaly	Red Flag for:
After-hours / weekend transactions	Fraudulent transactions
Duplicate Social Security Number(s)	Ghost employees
Duplicate Tax IDs for single vendor	Vendor fraud
Employee / vendor address comparison	Collusion Related-party transactions
Transactions outside prescribed policy	Waste / abuse

Fraud Auditing: Benford's Law

- **Helps identify potential errors, fraud, waste and abuse**
- **Low first digits occur more frequently**
- **Expected frequencies can be calculated in tabulated data**





Consideration of Fraud Risk In Internal Audit Planning

Fraud Auditing: Planning Considerations

- Objectives
 - Identify issue to be addressed
 - Identify indicators or red flags
 - Sample selection and testing
 - Continuous monitoring
- Availability of electronic data
 - Identify data sources
 - Areas or issues of focus
 - Collect or gather data
 - Prepare data (“data normalization”)
 - Interpret data
 - Identify issues for further research or investigation
 - Monitor results

What Are Others Doing In This Area?

- Results of fraud risk assessment incorporated within audit planning
 - Areas of focus
 - Priorities
- Fraud audits to address high risk issues or accounts investigation
- Incorporation of fraud risk considerations within each process-level audit
- AFPC assessment used to evaluate overall fraud risk management strategy / infrastructure

Fraud Auditing: Planning Considerations (cont'd)

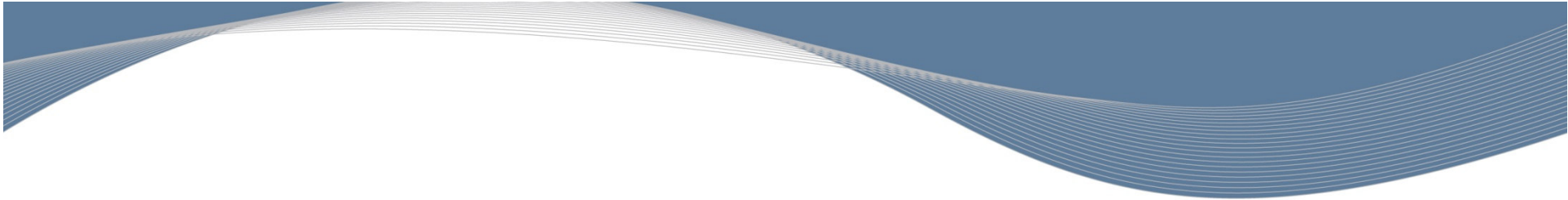
- **Internal resources / skillsets**
 - Availability
 - Fraud awareness / education
- **Tools**
 - Leverage investment in existing tools
 - Microsoft Access
 - ACL / Idea
 - Supplemental training
 - New initiatives
- **Audit vs. Investigation**
 - What to do and when to do it



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Q&A

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