Fraud is much more than Numbers – it is a behavioral Issues – greed and deception and so the Jigsaw puzzle

Concealment is a cornerstone of fraud

Books and Records do not commit fraud – people do!!
CONDUCTING A FRAUD RISK ASSESSMENT
*Discussion Agenda*

- Why Conduct a Fraud Risk Assessment
- An Approach to Conducting a Fraud Risk Assessment
- Common Pitfalls in Conducting Fraud Risk Assessments
- Recommendations in Conducting Fraud Risk Assessments
Fraud Defined

• Intentional false representation
  • Lying
  • Hiding the truth

• Deception and cover-up to prevent detection
  • Internal controls ineffective or overridden

• Illicit gain achieved or innocent victim harmed
  • Stock prices inflated
  • Bonuses inflated
  • Assets used for personal gain
Fraud Defined

Acts committed on the organization or by the organization or for the organization. The acts are committed by internal or external sources and are intentional and concealed.

The acts are typically illegal or denote wrongdoing, such as the case of: financial misstatement, policy violation, ethical lapse, or a perception issue. The acts cause a loss of company funds, company value, or company reputation, or any unauthorized benefit whether received personally or by others.

Fraud Risk Assessment, by Leonard W. Vona
WHY CONDUCT A FRAUD RISK ASSESSMENT
Why Conduct a Fraud Risk Assessment

• Legal duty of care to shareholders
• Professional Standards
  – ACFE
  – IIA
  – AICPA
• Regulatory Compliance
• Indirect & direct costs of fraud
• Identify exposure where the internal control environment may have limitations, i.e. collusion
• Fraud is a business risk to be managed, not just a compliance issue
• Public Company Accounting Oversight Board - PCAOB AS5
• IIA Practice Advisory 1210-A2-1: Auditor’s responsibilities Related to Fraud Risk Assessment, Prevention and Detection
• COSO for Small Business: Principle 10-Fraud Risk
• SAS No 99, Consideration of Fraud in a Financial Statement Audit
• ISA No 240
• 2007 SEC Guidance to Management
Why Conduct a Fraud Risk Assessment

• Traditional risk assessments link risks to the organization’s key objectives. Fraud can be overlooked during this type of review if it is not considered a core company objective.
• A fraud risk assessment expands upon traditional risk assessment. It is scheme and scenario based rather than based on control risk or inherent risk.
• Assessment teams must be able to identify the potential schemes and scenarios impacting the industries and geographic markets in which the organization conducts business.

KEY APPROACH
• Evaluate fraud risk factors - Identify possible fraud schemes & Scenarios
  • Prioritize identified fraud risks
  • Evaluate whether mitigating controls exist or are effective
  • Document the risk assessment process & conclusions
  • Conduct periodic reviews and updates
Guidance

- **Managing the Business Risk of Fraud: A Practical Guide**
- Joint project of
  - IIA
  - AICPA
  - ACFE
Guidance

• Sections:
  – Fraud Risk Governance
  – Fraud Risk Assessment
  – Fraud Prevention
  – Fraud Detection
  – Fraud Investigations and Corrective Actions
INTERNAL AUDITING AND FRAUD

DECEMBER 2009

The Institute of Internal Auditors
Fraud Risk Assessment

• “A good plan executed today is better than a perfect plan executed at some indefinite point in the future.”

• “Make your plans to fit the circumstances”.
  • General George S. Patton
Planning the Fraud Risk Assessment

**Pitfalls**

- Management does not take responsibility for the FRA
- The FRA is not risk-based
- The FRA is too broadly based

**Recommendations**

- Management should own the FRA and have significant input into the FRA. Educate the Board and External Auditors on the FRA – get their support/buy-in
- The FRA should be risk-based
- The FRA should be focused on the higher risk areas
Planning the Fraud Risk Assessment

Pitfalls
• The planned approach is contrary to the organizational culture
• The organization does not have the necessary skill sets to perform the FRA
• The FRA process does not include the appropriate people
• The FRA is not systematic and recurring

Recommendations
• The planned approach should fit into the organizational culture – consider a mixed approach, e.g., interviews and group brainstorms
• Hire in the necessary skill sets (employees/consultants)
• Consider who should be involved as part of the planning process
• The FRA should be systematic and recurring
Who Should be Involved

C – Suite Officer
- CEO
- CFO
- CIO
- General Counsel
- Chief Compliance Officer

Management
- Business Unit Managers
- Sales
- Marketing
- Human Resources
Who Should be Involved

Accounting
• Controller
• Accounting Manager
• Accounting Supervisors

Oversight
• Internal Audit
• Board of Directors
• Audit Committee
• External Auditors
Conducting the FRA – Step 1

Identify and Evaluate Fraud Risk Factors

1. Schedule interviews and develop approach
2. Identify fraud risk factors at the entity level, significant locations, significant accounts and business process level. Consider whether each fraud risk factor indicates the existence of an incentive / pressure, opportunity or attitudes / rationalizations.
3. For each identified fraud risk factor, identify the account balances and potential errors that may be affected and assess the fraud risks.
1. Identify and Evaluate Fraud Risk Factors

**Pitfalls**
- Fraud Risk Factors are not considered
- Existing controls are considered
- The potential for management override of controls is not considered
- Interviews are not value-added

**Recommendations**
- Use the Fraud Triangle to explain the significance of fraud risk factors and to initiate thinking
- Do not consider controls EXCEPT when considering the potential for management override
- Develop interview approach that matches area and culture
1. Identify and Evaluate Fraud Risk Factors

Identify fraud risk factors at the entity level, significant location, significant account and business process level. Consider whether each fraud risk factor indicates the existence of an incentive, pressure, opportunity or attitude and rationalization.

- Identify incentives / pressures to commit fraud, opportunities to commit fraud, or attitudes / rationalizations to justify fraud.
- Personnel from various levels of the organization should be involved in the process.
- Consider internal and external (e.g., regulatory, industry) influences.

- Where could the fraud occur?
- What would the fraud look like?
- What type of fraud is the area susceptible to?
- What are the effects on the books and records?
- When could the fraud occur?
## 1. Identify and Evaluate Fraud Risk Factors

<table>
<thead>
<tr>
<th>Fraud Risk Factor</th>
<th>Account Balance(s) Affected</th>
<th>Fraud Risk</th>
<th>Fraud Schemes/Scenarios</th>
<th>Potential Person(s) Involved</th>
<th>Type</th>
<th>Persuasiveness</th>
<th>Likelihood</th>
<th>Significance</th>
<th>Inherent Risk</th>
<th>Control Activities</th>
<th>CRR</th>
<th>Residual Risk</th>
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<tbody>
<tr>
<td>Public Company / Unrealistic Earnings Expectations</td>
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1. Identify and Evaluate Fraud Risk Factors

For each identified fraud risk factor, identify the account balances and potential errors that may be affected and assess the fraud risks.

Example FRA Documentation

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<tr>
<td>Public Company / Unrealistic Earnings Expectations</td>
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Conducting the FRA – Step 2

Key Steps

1. Identify fraud risks and determine if the fraud risks are pervasive or specific.
2. Brainstorm specific fraud schemes that could result from the specific risks identified.
3. For each fraud scheme, identify internal and external parties who could be involved with reference to incentives / pressure, opportunities, attitudes & rationalizations.
2. Identify Possible Fraud Risk

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<thead>
<tr>
<th>Fraud Risk Factor</th>
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<th>Control Activities</th>
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</table>
| Public Company / Unrealistic Earnings Expectations | • Revenue  
• Accounts receivable | Overstatement of Sales - "Roundtrip" Transactions | | | | S | | | | |

<table>
<thead>
<tr>
<th>Control Type</th>
<th>CRR</th>
<th>Residual Risk</th>
</tr>
</thead>
</table>
2. Identify Possible Fraud Risk

Pitfalls

• The schemes are too general, not allowing for sufficient consideration of risks and preventing appropriate level of mapping to controls
• The schemes do not consider the potential for management override of controls
• The schemes do not consider the potential for collusion
• Brainstorming ineffective

Recommendations

• Detail the schemes by considering:
  – Why?
  – Who?
  – What? (Assets, financial reporting)
  – Where (locations, accounts)
  – When?
  – How?
## 2. Identify Possible Fraud Schemes

<table>
<thead>
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Conducting the FRA – Step 3

Prioritize Identified Fraud Risks

Key Steps

• Evaluate possible fraud schemes by:
  - Type
  - Likelihood
  - Significance
  - Pervasiveness

• Consider Inherent Risk Rating (IRR)
3. Prioritize Identified Fraud Risks

**Pitfalls**
- All fraud risks are considered equally important

**Recommendations**
- Prioritize the identified fraud
- risks based on likelihood and
- significance
3. Prioritize Identified Fraud Risks

*Evaluate possible fraud schemes by type, likelihood, significance and pervasiveness. Arrive at inherent risk level for each scheme.*

<table>
<thead>
<tr>
<th>Likelihood</th>
<th>Significance</th>
<th>Pervasiveness</th>
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</thead>
<tbody>
<tr>
<td>Remote</td>
<td>Inconsequential</td>
<td>Not Pervasive</td>
</tr>
<tr>
<td>More than Remote</td>
<td>More than Inconsequential</td>
<td>Pervasive</td>
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<tr>
<td>Likely</td>
<td>Material</td>
<td></td>
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</tbody>
</table>

**Inherent Risk Rating***

*Factor of likelihood and Significance*
3. Prioritize Identified Fraud Risks

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Control Activities

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| | | |

30
Conducting the FRA – Step 4

Evaluate Whether Existing Controls Exist/ Are effective

Key Steps
1. Link fraud schemes to mitigating controls. Assess whether each mapped or linked control activity is preventative or detective in nature.
2. Evaluate the effectiveness of controls to determine if they sufficiently mitigate the risk of the identified fraud schemes (control gap analysis).
3. Evaluate the residual fraud risk
4. Evaluate Mitigating Controls

- Antifraud control activities can be preventative or detective in nature

  - Preventative controls are designed to mitigate specific fraud risks and can deter frauds from occurring
  
  - Detective control activities are designed to identify fraud if it occurs. Detective controls can also be used as a monitoring activity to assess the effectiveness of antifraud controls and may provide additional evidence of the effectiveness of antifraud programs and controls.
4. Evaluate Mitigating Controls

• Special consideration should be given to the risk of override of controls by management.
• Some programs and controls that deal with management override include:
  – active oversight from the audit committee
  – whistle-blower programs and a system to receive and investigate anonymous complaints; and
  – reviewing journal entries and other adjustments for evidence of possible material misstatement due to fraud.
4. Evaluate Mitigating Controls

Pitfalls

• Where gaps are identified, no remediation efforts are made
• Future changes in risk are not incorporated into the FRA and remediation is not performed
• Effectiveness of controls is not evaluated
• Mapping is done inefficiently and without consideration of existing controls and documentation

Recommendations

• Design and implement controls to close identified gaps
• The FRA should be iterative and should be reassessed at least annually as well as when there is a significant change in the control environment
• Evaluating the effectiveness of the controls
• Only map those controls identified as significant
• Identify entity level controls that will assist in mitigating remaining residual risk
• Leverage off existing efforts and controls
4. Evaluate Mitigating Controls

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Control Risk Rating

• *Evaluate the Control Risk Rating*
  – Evaluate controls to determine if they sufficiently mitigate the Identified fraud risks and schemes or if additional emphasis should be placed on existing controls or new controls are required
  – Consider both the design and the implementation of the control in mitigating the fraud risk *(Note: fraud controls can be tricky!)*
  – Consider possible management override of controls

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<tr>
<th>CONTROL RISK RATING</th>
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<tr>
<td>Effective</td>
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<tr>
<td>Partial Effective</td>
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<td>Ineffective</td>
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Establish Residual Risk Rating

- Residual risk is the risk remaining after factoring the inherent risk rating and control effectiveness rating for each identified fraud risk.
- A “High” rating would indicate immediate action is required and that item should be included in a fraud risk action plan.
- A “Medium” rating would indicate that attention is required to the fraud risk and control and that item may be included in a fraud risk action plan, depending on the control effectiveness rating.
- A “Low” rating would indicate that the item should be factored into ongoing monitoring plans.
Establish Residual Risk Rating

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<td>22.1.1.2 - Standard Contract Review Checklist - Is such review documented in the standard contract review checklist and signed off Sales Accounting management (or local equivalent) for all contracts?</td>
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<td>22.1.1.3 - Revenue Recognition Review - contracts &gt; $1M - Prior to booking, are contracts with either a gross value of greater than $1 million or have non standard terms reviewed for revenue recognition considerations by the revenue recognition senior manager? Is such review and approval documented? (Such review is typically done in the proposal stage) (Corporate)</td>
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</tbody>
</table>

Residual Risk
Chart Residual Risk Rating

- **Inherent Risk Rating**
  - 0
  - 5
  - High 10

- **Control Risk Rating**
  - 5

- **Legend**
  - A - Overstating Sales "Roundtrip Transactions"
Conducting the FRA – Step 4

Risk Treatment

Key Steps
1. Prepare a Fraud Risk Action Plan to treat and mitigate fraud risk schemes requiring attention.
5. Risk Treatment

Prepare a Fraud Risk Action Plan to treat and mitigate fraud risk schemes requiring attention.

- Controls should be implemented or enhanced for identified fraud schemes where controls are not already present, inadequately designed or poorly implemented.
- Ensure overall responsibility is assigned to a senior manager to monitor control implementation as detailed in the Fraud Risk Action Plan.
- This responsibility could be defined in the Fraud Control Policy of the entity or specified elsewhere.
- The Audit Committee should oversee the entire process.
Documenting the Fraud Risk Assessment

• Documentation may include:
  – Spreadsheet listing identified risks, controls and evaluations
  – “Heat map” summary of key risks
  – Process narrative
  – Minutes of fraud brainstorm sessions
  – Copies of instructions and reference materials provided to participants
  – E-mail and other correspondence related to the process
  – Minutes of audit committee meetings during which management’s fraud risk assessment was presented / reviewed / discussed / approved
Monitoring The Fraud Risk Assessment

• Need to keep FRA and documentation current
  – Conduct quarterly updates
  – Imbed on-going FRA in 404 efforts
  – Re-visit FRA as part of ERM activities
• Report changes and updates to Sr. Team and Board on a quarterly basis
• Update FRA for changes in the business and/or business environment (economy, industry, changes in competitor businesses)
• Use the FRA to refine and focus internal audit testing
## Conducting the Fraud Risk Assessment

<table>
<thead>
<tr>
<th>Step</th>
<th>Approach</th>
<th>Output</th>
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<tbody>
<tr>
<td>1</td>
<td>Identify &amp; Evaluate Fraud Risk Factors</td>
<td>Identify fraud risk factors</td>
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<td>Identify account balances and potential errors related to each fraud risk</td>
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<td>Schedule of fraud risk factors</td>
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<td></td>
<td></td>
<td>Identify account balances and potential errors related to each fraud risk</td>
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<td>2</td>
<td>Identify Possible Fraud Risks, Schemes &amp; Scenarios</td>
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<td>Identify specific fraud schemes</td>
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<td>Pervasive &amp; specific fraud risks</td>
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<td></td>
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<td>Identify specific fraud schemes</td>
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<td>Prioritize Identified Fraud Risks</td>
<td>Analyze the likelihood and significance of possible fraud schemes</td>
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<tr>
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<td>Evaluate Whether Existing Controls Exist / Are Effective</td>
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<td>Risk Treatment</td>
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QUESTIONS & ANSWERS
Contract info

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Responding to Fraud Risks