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Proactive Fraud Audit Techniques for Auditors and Investigators

PRESENTATION

BY

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Introduction

Background

The traditional 'passive philosophy' towards auditor responsibility for fraud detection is well summarised by the Lord Justice Lopes' ruling, in the UK, given in the 1896 Kingston Cotton Mill case (re Kingston Cotton Mill Company (No.2)):*'An auditor is not bound to be a detective, or… to approach his work with suspicion, or with a foregone conclusion that there is something wrong. He is a watchdog, not a bloodhound.'*

ISA 240

Paragraph	Details
2.	Misstatements in the financial statements can arise from either fraud or error. **The distinguishing factor between fraud and error** is whether the underlying action that results in the misstatement of the financial statements is **intentional or unintentional**.
4	The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior which can be reinforced by an active oversight by those charged with governance. Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of analysts as to the entity's performance and profitability.

ISA 240

Paragraph	Details
5.	An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs.
10.	The objectives of the auditor are: (a) To identify and assess the risks of material misstatement of the financial statements due to fraud; (b) To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and (c) To respond appropriately to fraud or suspected fraud identified during the audit.

1200 – Proficiency and Due Professional Care

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.

1210.A3 – Internal auditors must have sufficient knowledge of key information technology risks and controls and available technology-based audit techniques to perform their assigned work. However, not all internal auditors are expected to have the expertise of an internal auditor whose primary responsibility is information technology auditing.

1210.C1 – The chief audit executive must decline the consulting engagement or obtain competent advice and assistance if the internal auditors lack the knowledge, skills, or other competencies needed to perform all or part of the engagement.

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Recognized Investigative

Tools and Techniques Used by

Forensic Specialists/Fraud Examiners

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1. Public Document Reviews and Background Investigations
2. Interviews of Knowledgeable Persons
3. Confidential Sources
4. Laboratory Analysis of Physical and Electronic Evidence

(cont'd)

5. Physical and Electronic Surveillance
6. Undercover Operations
7. Analysis of Financial Transactions

Forensic Tools and Techniques for Internal Auditors

Public Document Reviews and Background Investigations

- Public Databases
- Government Websites
- County Government Databases
- Corporate Records
- Internet

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Public Databases

- Analyse Increasing number of suppliers
- Analyse increasing number of customers
- Analyse increasing number of transactions
- Reliability of data
- What type of data is available?

Forensic Tools and Techniques for Auditors

Government records

- Real Estate records; business registrations; business licences

Corporate Records

- Stock Transfer records; Accounting data; vendors; competitors; customers

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Internet

- Search Engines
- News Sources/Newspapers
- Telephone Numbers and Addresses
- Maps
- Legal Resources
- Government Sites
- Company websites

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Interviews of Knowledgeable Persons

- Interview vs. Interrogation
- Continuous process throughout an investigation
- Gain additional information with each interview
- Evidence from witnesses provides additional leads
- May identify additional witnesses
- Interview the target only after completing the interviews of the peripheral witnesses

Forensic Tools and Techniques for Auditors

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Confidential Sources

- Hotlines
- E-mail
- Letters
- Current Employees
- Former Employees
- Vendors & former vendors
- Customers & former customers

Forensic Tools and Techniques for Auditors

Confidential Sources (cont'd)

Cautions

- Use professional skepticism in assessing information
- Information supplied to discredit or embarrass the target
- Weigh the value of the evidence provided against the possibility that it may be false or cannot be proven
- Validate all evidentiary matter provided
- Do not assure absolute confidentiality

Forensic Tools and Techniques for Auditors

Laboratory Analysis of Physical and Electronic Evidence (cont'd)

- Altered & Fictitious Documents
- physical examination
- fingerprint analysis
- forgeries
- ink sampling
- document dating

Forensic Tools and Techniques for Auditors

Laboratory Analysis of Physical and Electronic Evidence (cont'd)

Computer Forensics

- hard disk imaging
- E-mail analysis
- search for erased files
- analyze use & possible misuse
- computer software to analyze data

Forensic Tools and Techniques for Auditors

Physical and Electronic Surveillance

Physical

- usually done by law enforcement or PI's
- surveillance cameras
- can also be used to verify addresses for vendors, employees, etc.

Electronic

- Internet surveillance
- E-mail

Forensic Tools and Techniques for Auditors

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Undercover Operations

- usually a recommendation to use
- can be done
- best left to professionals

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Analysis of Financial Transactions

- Horizontal/vertical analysis
- Authorization of new vendors & employees
- Comparison of employee & vendor addresses
- Detailed matching of persons approving transactions in finance and procurement.
- Analysis of sales returns & allowance account
- Management override of controls
- Different reviews based on known industry fraud schemes

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Analysis of Financial Transactions

- Purchase prices and Market price comparisons
- Expiry date checks from Manufacturers websites

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Procurement Fraud Symptoms

Supplier Checks

Conduct supplier-to-employee matching. Compare vendor addresses to a clean list of companies, starting with the postal code. “You can use social media to identify undisclosed relationships,” “Also, look for a vendor who is now an employee or someone who is in the system as both a vendor and an employee. Check emergency contact addresses for employees against supplier addresses.”

Look for related party transactions. Research high-risk vendors by obtaining Government records and using the registered agent information to compare those details against employee records.

Supplier Checks

Find suppliers with residential addresses. The suppliers you pay the most money to generally have a physical office. He suggests using a forensic investigator to assist with address verification and cleansing. “By utilizing an address cleansing service you will learn the type of address, whether it’s vacant, seasonal, a commercial mail service, etc.

Review early payment exceptions. “Some fraudulent vendors will request accelerated or expedited payments,”. “Run a report of payments and look for those who are getting quick payments.”

Use third party data sources, such as PIN and VAT matching.

“Use 3rd party data to find bad or black listed vendors,”.

Invoice Red Flags

Invoice Red Flags

There are other areas of the disbursement cycle that can be monitored for suspicious characteristics. Invoices, for instance, are a valuable source of data. “Pull physical invoices and check for red flags,”

Some red flags to look for are:

- Consecutive invoice numbers
- Even Kenya Shilling amounts on invoices
- Outliers, such as very large or unusual amounts
- Amounts that fall outside the pattern predicted by Benford’s Law


Supplier and Staff relationships
Decreasing purchases from other vendors
Increasing Purchases from specific vendors
Poor Quality
Increasing Prices
Documents and records
Large Order Quantities
Analytical Symptoms
All transactions approved by same staff for same suppliers
Ghost Supplies
Poor staff relationships with suppliers
Behavioral Symptoms
kickbacks
Internal Controls
Use of unapproved suppliers
Unexpected change in employee habits
Lifestyle Symptoms
Owning expensive homes
Products quality complaints
Tips and Complaints
Numerous parties and holidays
Staff leaving beyond means
Staff owning expensive Vehicles
Unsuccessful Vendor Complaints
Anonymous tips about suppliers and staff

Digital Analysis using Benford's Law

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Benford's Law works because nature produces more small things than large things. There are more insects than large mammals, more small houses than large ones, and more small lakes than large bodies of water.

Similarly, businesses produce more transactions with small amounts than with large amounts. Benford's Law predicts that amounts will start with the digit 1 more often than the digit 9, and it even provides a mathematical formula describing the law and percentages.

The digit 1 should show up about 30 percent of the time, while the digit 9 should occur less than 5 percent of the time.

Outlier Detection

One of the primary methods of detecting fraud is discovering data values that are outside the normal course of business.

For example, a kickback scheme might be the reason purchases from one supplier are twice as high as similar purchases from another Supplier.

Trending

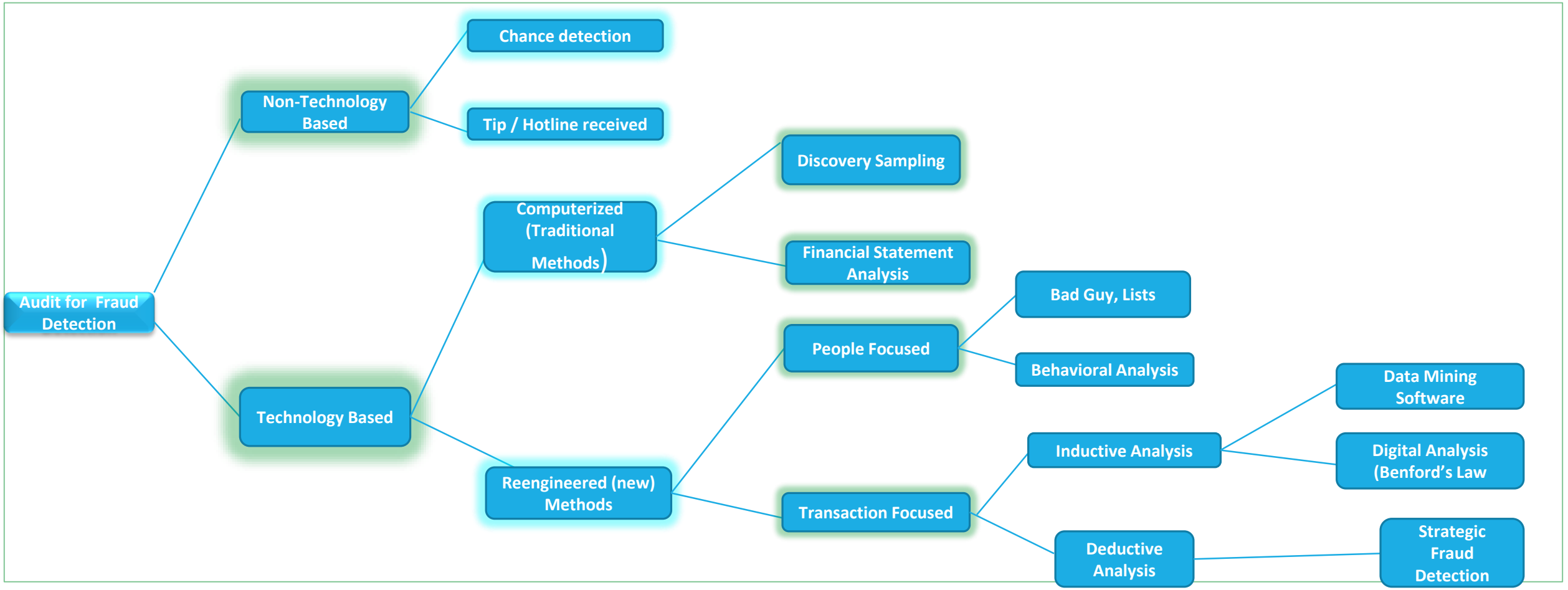
In addition to comparing same period numbers from different vendors, employees, or customers, fraud can be discovered by comparing numbers over time.

Because almost all perpetrators are greedy, fraud increases exponentially over time. Auditors can easily spot an increasing trend on a line chart— computers are not needed if only one item is being audited (one employee, one vendor, etc.).

The need for automation is during the initial phase of a fraud investigation. If auditors do not know which item is increasing, they must look through thousands of graphs to determine which item requires additional investigation.

Trending methods allow the computer to determine which trends are increasing so the auditor can focus on those items. One of the most basic methods of determining an increasing trend is linear regression. Once the computer fits a line to the data, the slope and goodness of fit provide a simple measure of trend.

Fraud Detection Methods



Tools

CCTV

Spread sheets
- Ms-Excel

Audit software's
- IDEA
- ACL

Disk Imaging software
- Encase
- Forensic Tool Kit-(FTK)

Data Analysis & Search Tools

Data Analysis

ACL -http://www.acl.com/products/

- Desktop -"traditional" data analysis tool with various file interoperability, built-in analysis functions, and custom-language scripting / automation abilities
- Exchange -data feeds, functions with custom parameters, documentation acquisition and storage, Microsoft Office integration, and data exception identification and workflow
- Acerno-Excel Add-In for results analysis

IDEA -http://www.caseware.com/products/idea: Data analysis tool with various file interoperability, built-in functions, and custom-language scripting / automation

Active Data/ Active Audit-Excel Add-Ins for data analysis similar to IDEA and ACL

Search Websites

- Craigslist / EBay search: http://www.searchtempest.com/
- Person or Company profiling: http://www.zoominfo.com/
- Address or Phone search: http://www.zabasearch.com/
- Social Media search: http://www.kurrently.com/
- Blog Search: http://technorati.com/

Open Discussion

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Questions

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Thankyou

Services Offered

- Internal audit
- Fraud Risk Assessment
- Forensic Investigations
- Fraud Training & Awareness Programs
- Anti-money Laundering
- Pre-employment Integrity interviews
- Loss Prevention Consulting
- Dispute Advisory
- Due Diligence Investigations
- Background Screenings
- Unclaimed Financial Assets compliance and reporting audits

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The Aftermath of Fraud

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Internal Investigations

Internal investigations can be triggered in a number of ways;

- routine internal audits sometimes reveal anomalies, but more often the trigger will be a whistleblower report (which may in-turn lead to a specific auditing process).
- Other catalysts may be a mass staff defection, a significant reduction in revenue (potentially suggesting a conflict of interest) or staff that have come to notice as living far beyond their apparent means (often indicative of fraud).

Preliminary considerations

The severity of the potential issue should guide you as to what initial action should be taken. An obviously large and serious event could potentially have catastrophic consequences for your company and will be handled very differently from an individual who is suspected of (relatively) small-scale fraud. If the investigation has been triggered by an anonymous whistleblower, try and establish more information on the allegation from the informant, and if you can, persuade the whistleblower to confirm his or her identity (which will help to potentially determine the veracity/accuracy of the information), although this will be difficult if the allegation came in without some method to remain in contact; but do remember your duty to protect the whistleblower.

The Investigation Team

As part of your compliance program that you should already have in place, you will have ideally pre-determined who the key internal core-team members should be for the situation at hand and which individual will manage/lead the team. Depending on how extensive the investigation needs to be, typically the internal team will most likely consist of members from the legal, compliance, risk, audit and HR departments. At this point you will need to decide whether to involve independent specialist consultants to handle the investigation and whether to engage outside legal counsel.

The decision whether to involve independent investigation consultants

The range of typical professional skills and expertise that may be required during an internal investigation may not be available in-house:

1. Acquisition, preservation and review of computer evidence:
2. A review of books and records by *forensic* accountants to identify suspicious transactions etc.
3. Discreet on-ground intelligence inquiries into identified relationships, lifestyle analysis and asset tracing;
4. Appropriately handled interviews of internal staff and third parties: Conducting interviews in support of an investigation is a specialist skill, and a member of your HR department or other designated interviewer may not have the experience to conduct the interviews effectively (as well as potential legal considerations); and
5. Provide remedial action or consulting advice on lessons learned and how to help prevent a repeat of the issue.

As well as the above expertise, the investigation consultant will also conduct the investigation so that any pertinent information identified will be gathered in a legal and ethical way, in accordance with local and international laws, and which would be able to be used in evidence, if necessary, at a later stage.

Privilege and Legal Considerations

Whether you use your in-house counsel only or supplement this with the engagement of outside counsel it is important that you understand the potential for a civil claim or criminal prosecution relating to the issues under investigation. Privilege may also be an issue, particularly for investigations involving a cross-border element.

Outside counsel can bring a higher level of legal experience and expertise, particular if the violation involves overseas operations, and complex legal, data-privacy and cultural issues may be at play, and where the deployment of local counsel may be appropriate. Legal communications will also be protected as privileged (to what extent will depend on the jurisdiction).

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Fraud Investigation

Investigation process

The investigation plan

Whether the investigation is primarily conducted by an internal team or external consultants, the investigation should have a plan. In more complex internal investigations, the investigation plan should be essentially be a ‘living document’ which can be amended/updated as the situation changes or as new evidence or information comes to light.

Investigation considerations

In order to reduce the risk of evidence tampering or collusion, the initial part of the investigation should be handled discreetly. Typical actions in an investigation during this phase may include;

- out of hour's forensic acquisition of computer hard-drives;
- sensitively handled discreet investigations on any pertinent issues (including media and record checks and on-ground fact-finding);
- and a discreet review of books and records by a suitably experienced forensic accountant.

For some elements of this, you will need the support of specific staff in certain departments, for example HR or Finance, so consider this when you formulate your investigations team.

Post investigation – remedial action

Depending on the outcome of the investigation it will be important to determine what remedial actions need to be taken. These actions could include:

- changes to compliance policies and procedures,
- improvements to internal controls, and
- civil or criminal action against employees or involved third parties.

Although often painful and time-consuming, every investigation is an opportunity to learn something new and discover ways to reduce your vulnerabilities.

There may also be a requirement to report the results of the investigation to the appropriate regulatory authorities.

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The criminal justice system

Definition

The criminal justice system is the set of agencies and processes established by governments to control crime and impose penalties on those who violate laws.

System Components

Most criminal justice systems have five components

1. law enforcement,
2. prosecution,
3. defense attorneys,
4. courts, and
5. corrections,

each playing a key role in the criminal justice process.

System Components

Law Enforcement: Law enforcement officers take reports for crimes that happen in their areas. Officers investigate crimes and gather and protect evidence. Law enforcement officers may arrest offenders, give testimony during the court process, and conduct follow-up investigations if needed.

Prosecution: Prosecutors are lawyers who represent the state (not the victim) throughout the court process-from the first appearance of the accused in court until the accused is acquitted or sentenced. Prosecutors review the evidence brought to them by law enforcement to decide whether to file charges or drop the case. Prosecutors present evidence in court, question witnesses, and decide (at any point after charges have been filed) whether to negotiate plea bargains with defendants.

Defense Attorneys: Defense attorneys defend the accused against the government's case. They are ether hired by the defendant or (for defendants who cannot afford an attorney) they are assigned by the court. While the prosecutor represents the state, the defense attorney represents the defendant.

Courts: Courts are run by judges, whose role is to make sure the law is followed and oversee what happens in court. They decide whether to release offenders before the trial. Judges accept or reject plea agreements, oversee trials, and sentence convicted offenders.

Corrections: Correction officers supervise convicted offenders when they are in jail, in prison, or in the community on probation.

How the Criminal Justice Process Works

Report: Law enforcement officers receive the crime report from victims, witnesses, or other parties (or witness the crime themselves and make a report).

Investigation: Law enforcement investigates the crime. Officers try to identify a suspect and find enough evidence to arrest the suspect they think may be responsible.

Arrest or summon: If they find a suspect and enough evidence, officers may arrest the suspect or issue a summon for the suspect to appear in court at a specific time. This decision depends on the nature of the crime and other factors. If officers do not find a suspect and enough evidence, the case remains open.

Prosecution and Pretrial

Charges: The prosecutor considers the evidence assembled by the police and decides whether to file written charges (or a complaint) or release the accused without prosecution.

Court Appearance: If the prosecutor decides to file formal charges, the accused will appear in court to be informed of the charges and of his or her rights. The judge decides whether there is enough evidence to hold the accused or release him or her.

Bail or Bond: At the first court appearance (or at any other point in the process-depending on the jurisdiction) the judge may decide to hold the accused in jail or release him or her on bail, bond,

Post investigation – Internally

These actions could include:

- changes to compliance policies and procedures,
- improvements to internal controls,
- Staff dismissals

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Open Discussion

QUESTIONS

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Services Offered

- Unclaimed financial assets compliance services
- Fraud Risk Assessment
- Forensic Investigations
- Fraud Training & Awareness Programs
- Anti-money Laundering
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- Loss Prevention Consulting
- Dispute Advisory
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- Background Screenings

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“ Your unclaimed assets solutions and compliance provider”

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