Fraud Concepts and Techniques

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Fraud Definition

- "..all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get an advantage over another by false suggestions or suppression of the truth. It includes all surprise, trick, cunning or dissembling, and any unfair way by which another is cheated."

Fraud Impact to business

- Organisations loose over $ 660 billion dollars every year to fraud.

- Losses due to fraud are added to the cost of doing business.

- If a company nets 20% profit in sales of a product, they must sell five times at the regular prices to recover losses from fraudulent transaction worth that one product.

Fraud Impact to business

- Research has it that companies / organisations loses more than 9 % a day per employee to fraud and abuse.

- The average company loses about 6 % of its total annual revenue to fraud committed by its own employees.

- In addition to the direct economic losses, there are indirect costs to be considered – loss of productivity, legal action, increased unemployment, government intervention and other hidden costs.

Fraud Governance

- Reactions to recent corporate scandals have led the public and stakeholders to expect organizations to take **a "no fraud tolerance" attitude**.

- Good governance principles demand that an organisation's board of directors, or equivalent oversight body, ensure overall high ethical behaviour in the organization, regardless of its status as public, private, government, or not-for-profit; its relative size; or its industry.

Fraud Governance

- In addition to the board, personnel at all levels of the organization — including every level of management, staff and internal auditors as well as the organization's external auditors have responsibility for dealing with fraud risk.

Fraud Governance

- Particularly they are expected to explain:

- What form of fraud risk management program the organization has in place;

- How it identifies fraud risks;

- What it is doing to better prevent fraud or at least detect it sooner and

- What process is in place to investigate fraud and take corrective action.

Civil Vs Criminal Fraud

- In criminal cases, the burden of proof standard is "beyond reasonable doubt".

- In civil litigation, the standard of proof is much lower and may be decided merely by a "preponderance of evidence". **Example of civil fraud - consumers who have been defrauded by a manufacturer's written warranty on a consumer good**.

- Normally in either criminal or civil cases, an intent to defraud or wrongful intent or guilty knowledge must be proved.

- Both criminal and civil cases require "wrongful intent" to be proved. However, in criminal it must be proven that the defendant acted with 'intent to defraud', while in civil cases it generally need only be shown that the defendant acted either "with knowledge or reckless disregard for the truth".

- The criminal standard for acting "willfully" is usually set forth in the statute under which the defendant is charged.

Fraud Red flags and their purpose

- Fraud detection consists of identifying indicators otherwise known as red flags of fraud sufficient to warrant an investigation.

- The Auditor ought to have sufficient knowledge of fraud to be able to identify indicators that fraud might have been committed.

- There are numerous methods for detecting fraud in organizations.

- Once fraud is suspected, it should be documented and investigated.

- These investigations include interviews, surveillance, audits, record searches, etc.

Fraud Red Flags

Some fraud indicators are as listed below:

- Rapid turnover of employees-quitting or being fired.

- Company failing to periodically rotate or transfer key personnel.

- Failing to take annual leave

- Inadequate personnel screening policies when hiring new employees to fill positions of trust.

Fraud Red Flags

- Company lacking a good system of internal security

- Inadequate internal control system or failing to enforce the existing controls.

- Employee appearing to be a 'wheeler dealer' who enjoy feelings of power, influence, social status and excitements associated with financial transactions involving large sums of money.

Fraud Red Flags

- Key employees appearing to exhibit extreme greed or an overwhelming desire to self enrichment or personal gain.

- Excessive gambling

- High expenses due to personal involvement with other people by maintenance of separate apartments.

Fraud Red Flags

- **Undue family, community and social expectations or pressures.**

- **Excessive use of alcohol or drugs regularly.**

- **Beliefs of unfair treatment eg underpaid, poor job assignments.**

- **Appearing to resent their superiors.**

Fraud red flags

- Employees having unusually high personal debts or financial losses unable to meet with their own level of income / salary

- Employees appearing to be living beyond their means.

- Employees involved in extensive
  investment that would cause them financial difficult

Fraud red flags

- Organization where management do not inform employees rules of personal conduct and do not discipline fraud perpetrators?

- Employees having criminal or questionable backgrounds.

- Employees having a poor past work records or references.

How do frauds come to view in organisations?

- Tips ------------------40.2 %
- Management Review -------------15.4 %
- Internal Audit -------------- 13.9 %
- By Accident --------------8.3%
- Acct Reconciliation --------6.1%
- Document Examination------5.2%
- External Audit ------4.6%
- Surveillance/Monitoring----2.6%
- Notified by police ---1.8%
- Confession --1.0%
- IT Controls - 0.8%

What motivates people to commit Fraud

- Although the incidence of fraud cannot be completely eliminated, auditors, managers and staff must have an understanding of the proven techniques to minimise the elements which give rise to fraud occurrence.

- There are three characteristics attributed to fraudsters as to why they commit fraud, thus
  - ➢ Motive
  - ➢ Opportunity
  - ➢ Rationalisation

Cause- Motive /Pressure

- This is the unshakable financial need.

- Employers cannot eliminate the employee's need for additional money.

- Examples of such financial pressures are

- ❖ Excessive spending to keep up appearances of wealth.
- ❖ Outside personal business strains
- ❖ An illicit romantic relationship
- ❖ Alcohol, drug and gambling problems.

Cause-Opportunity

- This is controllable and it refers to the internal control system of a company which is within the scope of the management.

- The employee often think he/she can 'borrow' from the company and thus take advantage of a trusting relationship.

- The fraudster thinks also that the 'borrowing' can be concealed.

- The perception of detection is a proactive preventive measure.

- If internal control measures are strong as not to conceal the theft, then the employee will be less likely to commit fraud.

Cause- Rationalisation

- An employee's rationalisation is his/her belief that a crime has not been committed

- Typical rationalisations include:
- ➢ "Borrowing" money temporarily.
- ➢ Being underpaid
- ➢ Depersonalising the victim of the theft – ' I wasn't stealing from my boss; I was stealing from the company'.

Prevention –The Triangle

- The key element to fraud prevention is the interruption of one of the three elements of the fraud triangle.

- Just as fire cannot exist without heat fuel and oxygen, fraud dies not normally occur without the three elements.

- It may be difficult to eliminate the elements of fraud, but if they are minimised, then the likelihood that fraud will occur will also be minimised.

Reduce Motives/Pressures

- Have an open door policy – Employees can talk freely, managers will understand pressures and possibly eliminate them.

- Management attitudes – Management is conducted by objective rather than subjective measures. In this employees will not manufacture or imagine performance criteria. (Eg in mortgage loans, consider not only volume measured in shs/$ but also quality to avoid default).

- Employee support programs – Financial, Alcohol, marital problems counselling.

Reducing Perceived Opportunities

- Management oversight - It is common for employees who defraud to use the proceeds for lifestyle improvement such as:

- More expensive cars, extravagant vacations, expensive clothing, new or remodelled homes, expensive recreational property and personal investments.

- Managers should be educated to be observant for these signs/red flags.

- Example - Discovery of a Kshs 80,000,000 fraud over a three year period resulted when an observant manager asked an internal auditor to examine the responsibilities of a 7 – year veteran of the company. The manager noticed that this employee had began wearing designer clothes and was driving a new Prado. The manager was also aware that the employee had no outside income which might explain the upgrade in lifestyle.

Reducing Perceived Opportunities

- Job Rotation

- Some frauds are detected during sickness or unexplained absences of the perpetrator, because they require continuous, manual intervention.

- Job rotation may be an excellent preventative measurea company can employ in an effort to deter fraud.

Fraud Risk Management

- To help ensure an organization's fraud risk management program is effective, it is important to understand the roles and responsibilities that personnel at all levels of the organization have with respect to fraud risk management

- Policies, job descriptions, charters, and/or delegations of authority should define roles and responsibilities related to fraud risk management.

- In particular, the documentation should articulate who is responsible for the governance oversight of fraud control (i.e., the role and responsibility of the board of directors and/or designated committee of the board).

Fraud Risk Management - Strategy Documentation

- Documentation should also reflect management's responsibility for the design and implementation of the fraud risk strategy, and how different segments of the organization support fraud risk management.

- Fraud risk management will often be supported by risk management, compliance, Legal counsel, the ethics office, security, information technology (IT), and internal auditing, or their equivalents.

Fraud risk management- Responsibilities

- The board of directors, audit committee, management, staff, and internal auditing all have key roles in an organization's fraud risk management .

- To help ensure an organization's fraud risk management program effective, it is important to understand the roles and responsibilities that personnel at all levels of the organization have with respect to fraud risk management.

Fraud Risk Management - Board of Directors.

- To set the appropriate tone at the top, the board of directors first should ensure that the board itself is governed properly.

- This encompasses all aspects of board governance, including independent-minded board members who exercise control over board information, agenda, and access to management and

- Outside advisers who independently carry out the responsibilities of the nominating/governance, compensation, audit, and other committees

Board

- The board also has the responsibility to ensure that management designs effective fraud risk management documentation to encourage ethical behaviour and

- To empower employees, customers and vendors to insist those standards are met every day.

Fraud Risk Management – Board Responsibilities

- The board should:

- Understand fraud risks.

- Maintain oversight of the fraud risk assessment by ensuring that fraud risk has been considered as part of the organization's risk assessment and strategic plans.

- This responsibility should be addressed under a periodic agenda item at board meetings when general risks to the organization are considered

Fraud Risk Management - Board responsibilities

- Monitor management's reports on fraud risks, policies, and control activities, which include obtaining assurance that the controls are effective.

- The board also should establish mechanisms to ensure it is receiving accurate and timely information from management, employees, internal and external auditors, and other stakeholders regarding potential fraud occurrences.

- Oversee the internal controls established by management.

- Set the appropriate tone at the top through the CEO, job description, hiring, evaluation, and succession-planning processes.

- Have the ability to retain and pay outside experts where needed.

- Provide external auditors with evidence regarding the board's active involvement and concern about fraud risk management.

Fraud Risk Management: Management Responsibilities

- Management has overall responsibility for the design and implementation of a fraud risk management program, including:

- Setting the tone at the top for the rest of the organization. As mentioned, an organization's culture plays an important role in preventing, detecting, and deterring fraud.

- Management needs to create a culture through words and actions where it is clear that fraud is not tolerated, that any such behaviour is dealt with swiftly and decisively and that whistle-blowers will not suffer retribution.

Fraud Risk Management: Management Responsibilities

- Reporting to the board on *what actions have been taken to manage fraud risks* and regularly reporting on the effectiveness of the fraud risk management program.

- This includes reporting any *remedial steps that are needed*, as well as reporting *actual frauds.*

Fraud risk management - External Auditor liaison with management

- Whenever the external auditor has determined that there is evidence that fraud may exist, the external auditor's professional standards require that the *matter should be brought to the attention of an appropriate level of management in a timely manner.*

- If the external auditor suspects fraud involving management, the *external auditor must report these suspicions to those charged with governance (e.g., the audit committee).*

- In many organizations, one executive-level member of management is appointed to be responsible for fraud risk management and to report to the board periodically.

- This executive, a chief ethics officer or manager internal audit for instance, is responsible for entity-level controls that establish the tone at the top and corporate culture.

Fraud Risk Management: Staff

- Strong controls against fraud are the *responsibility of everyone in the organization.*

- It is necessary to note the importance of internal control in fraud risk management.

- Internal control components consist of - control environment, risk assessment, control activities, information and communication and monitoring — that may serve as the premise for the design of controls.

- The elements are deeply intertwined and overlapping in their nature, providing a natural interactive process to promote the type of environment in which fraud simply will not be tolerated at any level.

Fraud Risk Management: Staff

- All levels of staff, including management, should:

- Have a basic *understanding of fraud and be aware of the red flags.*

- Understand their roles within the internal control framework.

- Staff members should understand how their job procedures are designed to manage fraud risks and

- When non-compliance may create an opportunity for fraud to occur or go undetected.

Fraud risk Management - Staff

- Read and understand policies and procedures (e.g. the corporate fraud policy, code of conduct, and whistle-blower policy), as well as other operational policies and procedures, such as procurement manuals.

- As required, participate in the process of creating a strong control environment and designing and implementing fraud control activities, as well as participate in monitoring activities.

- Report suspicions or incidences of fraud.

- Cooperate in investigations

Internal audit responsibilities

- The IIA's Definition of Internal Auditing states, "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations.

- It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes."

- In relation to fraud, this means that internal auditing provides assurance to the board and to management that the controls they have in place are appropriate given the organization's risk appetite.

Internal audit

- Internal auditing should provide objective assurance to the board and management that fraud controls are sufficient for identified fraud risks and ensure that the controls are functioning effectively.

- Internal auditors may review the comprehensiveness and adequacy of the risks identified by management — especially with regard to management override risks

Internal Audit

- Internal auditors should consider the organization's assessment of fraud risk when developing their annual audit plan and *review management's fraud risk management capabilities* periodically.

- They should interview and communicate regularly with those conducting the organization's risk assessments, as well as others in key positions throughout the organization, to help them ensure that all fraud risks have been considered appropriately.

Internal Audit – During engagements

- When performing engagements, internal auditors should spend adequate time and attention to *evaluating the design and operation of internal controls related to fraud risk management*.

- *They should exercise professional scepticism* when reviewing activities and be on guard for the signs of fraud.

- Potential frauds uncovered during an engagement should be treated in accordance with a well-defined response plan consistent with professional and legal standards. Internal auditing should also *take an active role in support of the organization's ethical culture.*

Internal Audit Charter

- The internal audit charter, which is approved by the board or designated committee, should include internal auditing roles and responsibilities related to fraud.

- Specific internal audit roles in relation to fraud risk management could include initial or full investigation of suspected fraud, root cause analysis and control improvement recommendations, monitoring of a reporting/whistle-blower hotline and providing ethics training sessions

Internal Audit skills in managing fraud risk

- If assigned such duties, internal audit has a responsibility to obtain sufficient skills and competencies, such as knowledge of fraud schemes, investigation techniques and laws.

- Effective internal audit functions are adequately funded, staffed and trained with appropriate specialized skills given the nature, size, and complexity of the organization and its operating environment.

- Internal audit should be independent (have independent authority and reporting relationships), have adequate access to the audit committee and adhere to professional standards.

Effective Anti-Fraud Approach requires that an organisation have:

- **A Code of Ethics** – Promoting honest and ethical conduct, compliance with applicable laws and regulations and prompt reporting of violations of the code.

- **Fraud Prevention Policies** - Provide channels for employees and third parties to report fraud. Provide support and protection for whistle blowers.

- **Communication and Training**
  - Educate employees regarding code of ethics.
  - Communicate the disciplinary procedures that will be taken in the event of fraud.
  - Raise awareness of fraud schemes specific to the company.

Effective Anti-Fraud Approach

- **Fraud Risk Assessment** - Identify common fraud schemes that could happen to any organisation.

- *Specify fraud schemes that are industry and sector specific* as well as geographic.

- Create a road map for future areas to analyse with analytics and determine if controls exist to mitigate .

- Provide annual and real time updates to fraud risk assessment work plan to address change in business environment, acquisitions, current issues, etc.

Effective Anti-Fraud Approach

- **Controls Monitoring**
  - Rank fraud schemes identified within the risk assessment .   -
  - Develop action plan to assess, improve and monitor the controls associated with the identified risks.
  - Report the results of the action plans to executive management/audit committee.

- **Fraud Response Plan**:
  - Establish investigation protocols.
  - Coordinate remedial action plans across business units.
  - Maintain constant disciplinary procedures.
  - Develop investigation protocols for internal and external resources.