Tools and Techniques for Internal Auditors to More Effectively Look at Fraud

Monday, June 18, 2012
10:20 a.m.–11:40 a.m.

23rd Annual ACFE Fraud Conference–Orlando, Florida
Program Agenda

10:20–10:25  Greetings and Introductions
10:25–10:45  Hot Topics
10:45–11:00  Improving Interviewing Skills
11:00–11:15  Fraud Risk Assessments
11:15–11:35  Data Analytic Ideas
11:35–11:40  Q&A
Greeting and Introductions
Hot Topics for Auditor Consideration
How does your company define fraud? Defining fraud helps to detect and find it

**Black’s Law Dictionary**

All means by which one individual can 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.

**Institute of Internal Auditors**

Any illegal acts characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the application of threat of violence or of physical force. Frauds are perpetrated by parties and organizations to obtain money, property or services; to avoid payment or loss of services; or to secure personal or business advantage.

**Statement on Auditing Standards No. 99 (SAS 99)**

An intentional act that results in a material misstatement in financial statements that are the subject of an audit. Two types of misstatements are relevant to the auditor’s consideration of fraud: (1) fraudulent financial reporting and (2) misappropriation of assets.
Current Environment
Understanding current environment helps to better understand risk of fraud

- **Internal Controls**
- **Pressure**
- **Rationalization**
- **Opportunity**
- **Opportunity to Commit Fraud**
- **Internal and External Pressure**
- **Internal Controls**

**Having decentralized operations can have an immediate impact on internal controls.**

- Layoffs, unemployment, and unease continue in United States.
- Personal retirement plans and market levels are increasing but remain low.
- Stressed and disaffected employees may have greater ability to rationalize improper actions.
- Regulatory focus continues to increase overall, especially in highly regulated industries.
- Budgets are decreasing. Companies and organizations are doing more with less.
- Acquisitions will increase risks.
The Fraud Tree
Where do you focus your time and resources?

Compliance
- General Counsel
- Corporate Security

Internal Auditors
- External Auditors
- Corporate Security

Fraud Tree

Corruption
- Conflicts of interest
- Bribery and corruption/FCPA
- Illegal gratuities
- Bid-rigging/procurement

Fraudulent Statements
- Revenue recognition
- GAAP
- Reserves
- Non-financial

Asset Misappropriation
- Cash larceny
- Theft of other assets–inventory/AR/ fixed assets
- Fake vendor
- Payroll fraud
- T&E fraud
- Theft of data

Internal Auditors
- Human Resources
- Corporate Security
Impact to Auditors—Does this change your perspective of where to audit?

CORRUPTION PERCEPTIONS INDEX 2010 RESULTS

Headquarters in United States
Improving Interview Techniques
Why is interviewing important?
Basic Interview Skills

• Be prepared.
• Set aside ample time.
• Establish clear understanding of each participant’s role during the interview.
• Don’t overwhelm the interviewee with people—two is best.
  – Lead interviewer
    • Focus on listening to answers.
  – Second interviewer
    • Focus on taking notes, helping with documents, observing the demeanor of individual, following up on missed questions and incomplete answers.
  – Use caution in allowing others to sit in on the interview.
Basic Interview Skills

• Establish a conversational tone.
• Ask open-ended questions (e.g., who, what, when, where, why, how, explain, walk me through, etc.).
  – Consider going through a situation several times with different focus.
    • Focusing on process, sequence, documents, people
• Do not interrupt the witness—let the witness talk (80/20 rule).
• Listen carefully to the answers; follow up on the answers rather than only following your outline.
• Leave open the possibility to contact with clarification or follow-up questions.
• Do not misrepresent yourself or facts in an interview.
• Do not prevent an interviewee from leaving an interview.
• Do not threaten an interviewee to gain cooperation (e.g., threat of termination of employment).
• Do not promise total confidentiality.
• Ensure that all necessary agenda items are addressed.
Do you know what to look for?
Indicators of truthfulness

<table>
<thead>
<tr>
<th>Nonverbal</th>
<th>Verbal</th>
</tr>
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<tbody>
<tr>
<td>Direct eye contact</td>
<td>Quick, spontaneous answers</td>
</tr>
<tr>
<td>Consistency of non-verbal movements with threatening and non-threatening questions</td>
<td>Consistent strong denial</td>
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<tr>
<td>Frontal alignment</td>
<td>Direct, brief answers</td>
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<tr>
<td>Relaxed, natural hand movement</td>
<td>Answers the question asked</td>
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<tr>
<td>Verbal and non-verbal is consistent</td>
<td>Denies in general</td>
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<tr>
<td></td>
<td>If falsely accused, responds with anger and irritation</td>
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<tr>
<td></td>
<td>Fewer excuses or rationalization</td>
</tr>
<tr>
<td>Nonverbal</td>
<td>Verbal</td>
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<td>------------------------------------------------------------------------</td>
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<tr>
<td>Changes from the norm: eyes, movement or non-movement, voice, posture</td>
<td>Hesitant</td>
</tr>
<tr>
<td>Physiological responses to stress: perspiration, flushing, saliva decreases</td>
<td>Denies in specifics; overly specific in these answers (answers too narrowly or too detailed)</td>
</tr>
<tr>
<td>Inconsistency between nonverbal and verbal</td>
<td>Weak denials, failure to deny (“I’m innocent.” “How could I?”)</td>
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<td></td>
<td>Verbal attacks directed at the interviewer</td>
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<td></td>
<td>Stalling tactics: answers a different question, answers with a question, asks for clarification, restates the question as part of the answer, requests break, repeats the question</td>
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**Do you know what you are looking for?**
**Indicators of non-truthfulness**

<table>
<thead>
<tr>
<th>Nonverbal</th>
<th>Verbal</th>
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</thead>
<tbody>
<tr>
<td>Continually adjusting clothes, hair, jewelry, inspecting hands in great detail, lint picking, scratching</td>
<td>Limiting qualifiers—basically, sort of, fundamentally, not really, possibly, perhaps, etc.</td>
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<tr>
<td>Repeated unusual activity—hands over the face, covering the mouth, swallowing, coughing</td>
<td>Invokes religion—“I swear to god.” “As god is my witness…”</td>
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<tr>
<td>Closed posture, blushing, facial tics, blinking</td>
<td>Selective memory—not that I can remember; to the best of my knowledge</td>
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<td></td>
<td>Inappropriate or out-of-ordinary questions for the interview</td>
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<td></td>
<td>Protesting statements—“I wouldn’t do that I am the…” “If I did that, the auditors would discover that immediately.” “Everyone knows I wouldn’t do that.”</td>
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How to Structure Questions

• Direct questions involve the use of who, what, when, where, why, and how.

• Leading questions begin with phrases such as “Isn’t it true?”

• Most interviews will involve a combination of direct and leading questions.

• Open-ended questions may be appropriate where the interviewee is cooperative or talkative. Pursue responses with follow-up questions, which may be direct or leading in nature.

• Tone and content of the questions are more important than the form.

  Isn’t it true...

  Is it fair to say...

  How did you...

  What were you...
Conclusion

- Prepare for each and every interview the same way—thoroughness is the standard.

- Attempt to know your subject matter as well as the individual with whom you are speaking. Your knowledge will be updated from interview to interview, therefore update your outlines, approach, etc.

- Listen carefully to the responses your questions elicit and be patient in pursuing each line of questioning.

- Do not hesitate to tell the witness that you do not understand his response or the substance of the response, and seek clarification.

- Be flexible in your approach to the interview—just because your outline is written one way does not mean it is the only way to conduct the interview.

- Be prepared to cede the questioning to your colleagues in areas that are beyond your expertise.
Fraud Risk Assessments
The Elements of an Anti-Fraud Program
Who does what with respect to proactive and reactive approaches to fraud?

Assess
Setting the proper tone
- Code of Ethics
- Fraud Prevention Policies
- Communication and Training
- Fraud Risk Assessment
- Controls Monitoring

Proactive

Reactive
- Fraud Response Plan

Moderate

Communicate

Who Owns Fraud?

Who should have a seat at the table in your organization?

Board
Audit Committee
Executive Mgmt.
Controllers Group
Internal Audit
IT
General Counsel
OIG
HR
Can you identify red flags on your audits? In your organization?

**Overall**

- The majority of fraud cases are committed by lower-level employees, but the highest losses are by upper-level management.
- Over 60 percent of fraud is committed by men.
- Most fraudsters have never been charged or convicted of a crime.
- Nearly 40 percent of fraud is committed by two or more individuals.

**Employee Red Flags**

- Lifestyle changes or behavioral changes
- Significant personal debt and credit problems
- Refusal to take vacation
- Lack of segregation of duties in vulnerable areas
- Incentive program that incentivize bad behavior or program is not clearly understood
- Abnormal reimbursement request(s)
Can you identify red flags on your audits? In your organization?

**Audit Red Flags**
- Excessive number of year-end adjustments or adjustments with little to no supporting documentation
- Unreasonable answers to variance analysis or other questions asked during the course of the audit

**Line of Business Red Flags**
- Reluctance to provide information to auditor!!
- Internal control weaknesses noted in previous audits have not been corrected
- High employee turnover in a particular line of business
- Sudden activity in dormant bank accounts
- Un-reconciled differences in account reconciliations or other reconciliations
- Large number of write-offs that cannot be easily explained
- Payments to vendors that are not on approved vendor list
How to Conduct a Risk Assessment
Fraud overall, FCPA, Bribery and Corruption (for example)

Survey(s)
- Create and deliver customized surveys to different levels of management and employees throughout the organization.
- Allows for a mechanism to capture employees perception of fraud risks and overall tone and culture within an organization.
- Employee responses are anonymous, and this typically allows for more candid response.
- Graphical analysis and sharing of results with management provide insight into unforeseen risks, potential fraud, or other concerns.

Interview(s)
- One-on-one interviews allow participants the opportunity to have focused discussions, share opinions, review facts, and generate consensus on key business risk in the organization.
- Sometimes participants feel more comfortable in a small setting to share potential fraud risks.

Facilitated Session(s)
- Effective facilitated workshop sessions allow participants the opportunity to have focused discussions, share opinions, review facts, and generate consensus on key business risk in the organization identified in the survey, interviews, or during these sessions.
- Prioritize risks inside the organization into Heat Maps.
- Determine next steps such as data analytics and review of controls.
End Result: Where are your risks? Next steps?

- Fraudulent Statement Schemes
- Corruption Schemes
- Misappropriation of Asset Schemes
Using Data Analytics More Effectively
The Value Proposition

"IT IS BETTER TO DRAIN THE SWAMPS THAN TO FIGHT THE ALLIGATORS"

Prof Irvin Waller, Director General, International Centre for the Prevention of Crime - 8 March 1996
Data Sources in Today’s Organization

Source: Gartner Research

Unstructured Data

Structured Data

Focus of most audits

OPPORTUNITY for audit

Text

Graphics

Email

Presentations & Spreadsheets

CRM

Databases

Accounting Systems

20%

80%

Source: Gartner Research
Forensic Analytics Maturity Model
Become more proactive in detecting fraud…

Detection Rate

Low     | High
---|---

False Positive Rate

Low     | High
---|---

Structured Data

Traditional Rules-Based Queries & Analytics

Model-Based Analysis

Visual Analytics

Unstructured Data

Traditional Keyword Searching

Proactively Searching for Text
List supporting information for each scheme, classified into the above areas of the Company. (definition, examples, red flags, potential audit procedures to detect proactively, did the scheme occur before, etc.)
Conclusion—Questions
Thank You!

Mike Sherrod, CFE, CPA