

# Consider Fraud: What Does This Mean?

NYSICA

# Speaker



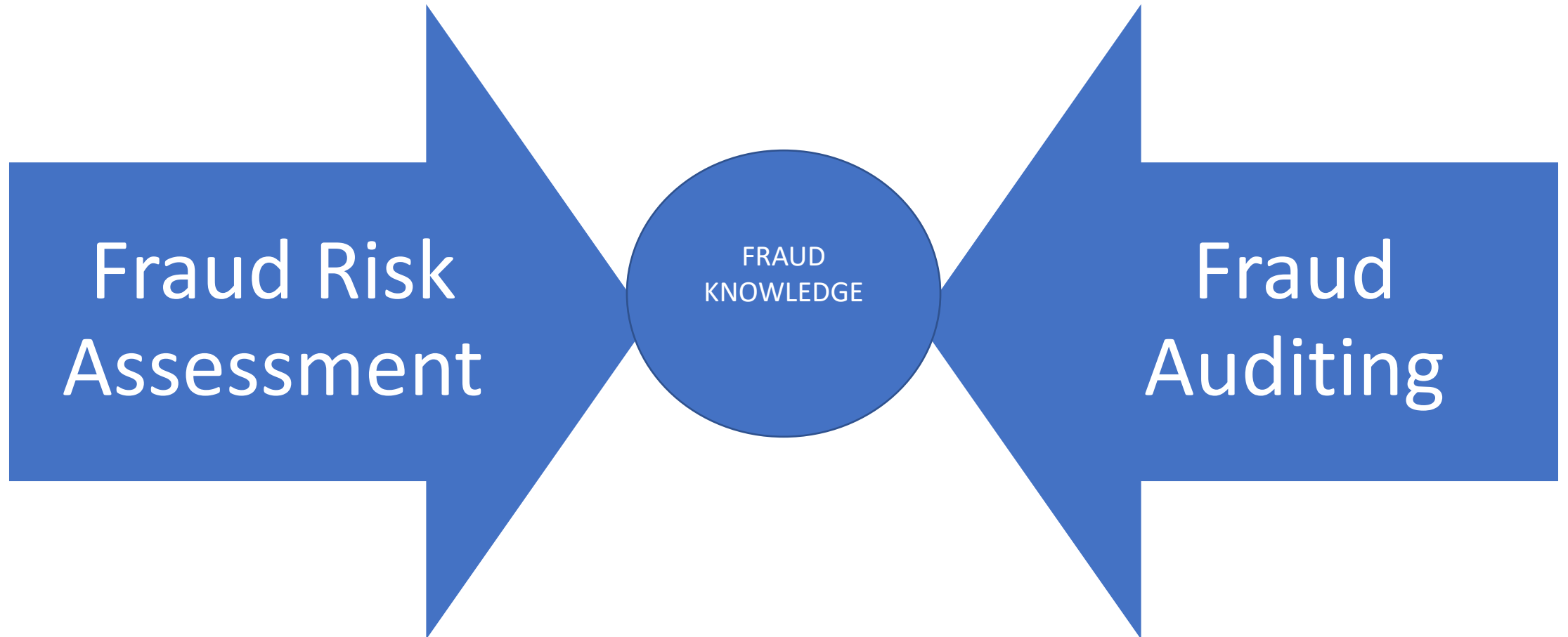
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CEO Fraud Auditing, Inc.

Mr. Vona is the author of three books published by Wiley, *Fraud Risk Assessment: Building a Fraud Audit Program* and *The Fraud Audit: Responding to the Risk of Fraud in Core Business Systems*, *Fraud Data Analytics Methodology: The Fraud Scenario Approach to Uncovering Fraud*.

Wiley has referred to Mr. Vona as a worldwide renowned authority on internal fraud risk.

Mr. Vona's trial experience is extensive, including appearances in federal and state courts. He is qualified as an expert witness, as a CPA and a CFE, and is cited in West Law for the successful use of circumstantial evidence.

# What this Session is About



# Challenge your Thought Process About Fraud Risk

- There is no authoritative standards on how to describe a “statement of fraud risk”
- You can compute the number of “statements of fraud risk” in a core business system with mathematic precision (Finite )
- You can not compute the number of “fraud scenarios” in a core business system (Infinite)
- Anti fraud controls calibrated to the sophistication of the perpetrator committing the fraud scenario?
- Your dilemma: at what level should you describe fraud risk?

# IIA Standards

- The interpretation of Standard 2230 clarifies that appropriate refers to the **mix of knowledge, skills, and other competencies** needed to perform the engagement, and sufficient refers to the amount of resources needed to accomplish the engagement with due professional care.
- 2210. A2 - Internal auditors must **consider the probability** of significant errors, fraud, noncompliance, and other exposures when developing the engagement objectives.
- 2210. A3 - Adequate criteria are needed to evaluate governance, risk management, and controls.

# IIA Knowledge / Competency Framework

- General Awareness: Recognize types of fraud, fraud risk and red flags of fraud
- Applied Knowledge: Evaluate the potential for fraud and how the organization detects and manages fraud risk; recommend controls to prevent and detect fraud and educate to improve the organizations awareness
- Expert: Apply forensic auditing techniques in fraud prevention, deterrence and investigation

# Elements of Professional Skepticism

- A component of the auditor's **general duty of care** that applies throughout the audit.
- An attitude that includes a questioning mind and a critical assessment of the appropriateness and sufficiency of audit evidence.
- Comprises three elements—auditor attributes, mindset, and actions.

# *Cooley on Torts*, a legal treatise, describes the obligation for due care as follows:

“Every man who offers his services to another and is employed assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all these employments where **peculiar skill** is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill **commonly possessed** by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession.



## *Cooley on Torts*, continued:

“But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon pure errors of judgment.” —D. Haggard, *Cooley on Torts*, 472 (4th ed., 1932)

# Expression: Professional Skepticism

- The Key: Educated Skepticism
- Knowledge through study; what I call the science of fraud risk and fraud auditing
- Knowledge through experience; what I call the art of fraud risk and fraud auditing

# Building Your Road Map to Become a Master of Fraud Risk

- Science of Fraud Risk and Fraud Auditing:
  - Understanding the fraud universe
  - Knowledge of fraud audit theory
  - Knowledge of sufficiency of audit evidence
  - Understanding sophistication of concealment theory
- Art of Fraud Risk and Fraud Auditing:
  - How to create a fraud audit program
  - Calibrate your audit program for sophistication of concealment
  - Sufficiency of audit evidence
  - Degree of certainty to arrive at a conclusion

# Fraud Trivia-1

Why is *Upjohn v. United States*, 449 U.S. 383 (1981) important to fraud auditors?

- a) It is not.
- b) Legal issues are beyond audit responsibility.
- c) The principal case defining privilege in the context of corporate investigations.

# Leonard's Axioms after 40 years of Searching for Fraud

- Your ability to consider fraud risk is limited your knowledge of fraud risk.
- We can compute the number of fraud risk statements confronting a business system, but we can not compute the number of fraud scenarios.
- The world's best audit program and the world's best auditor cannot detect fraud unless their sample includes a fraudulent transaction.
- Fraud risk statements can occur and comply with your internal controls. Therefore, probability of occurrence can not be judge by internal controls alone.
- Your start with the science of fraud risk and followed by the art of fraud risk. This is how you can detect fraud in core business systems.

# Considering Fraud as Part of Every Audit

Has our company identified all fraud risks impacting organizational goals?

- Historical: Known fraud risk statements or fraud scenarios
- Future: Anticipate new fraud scenarios

Have we identified all fraud risks in our audit scope?

Have we identified the right controls to manage fraud risk?

**Let me introduce: The Fraud Risk Universe**

# What is the Fraud Risk Universe?



Historical Fraud Risks

Future Fraud Risks

Key: Identification of Fraud Risks

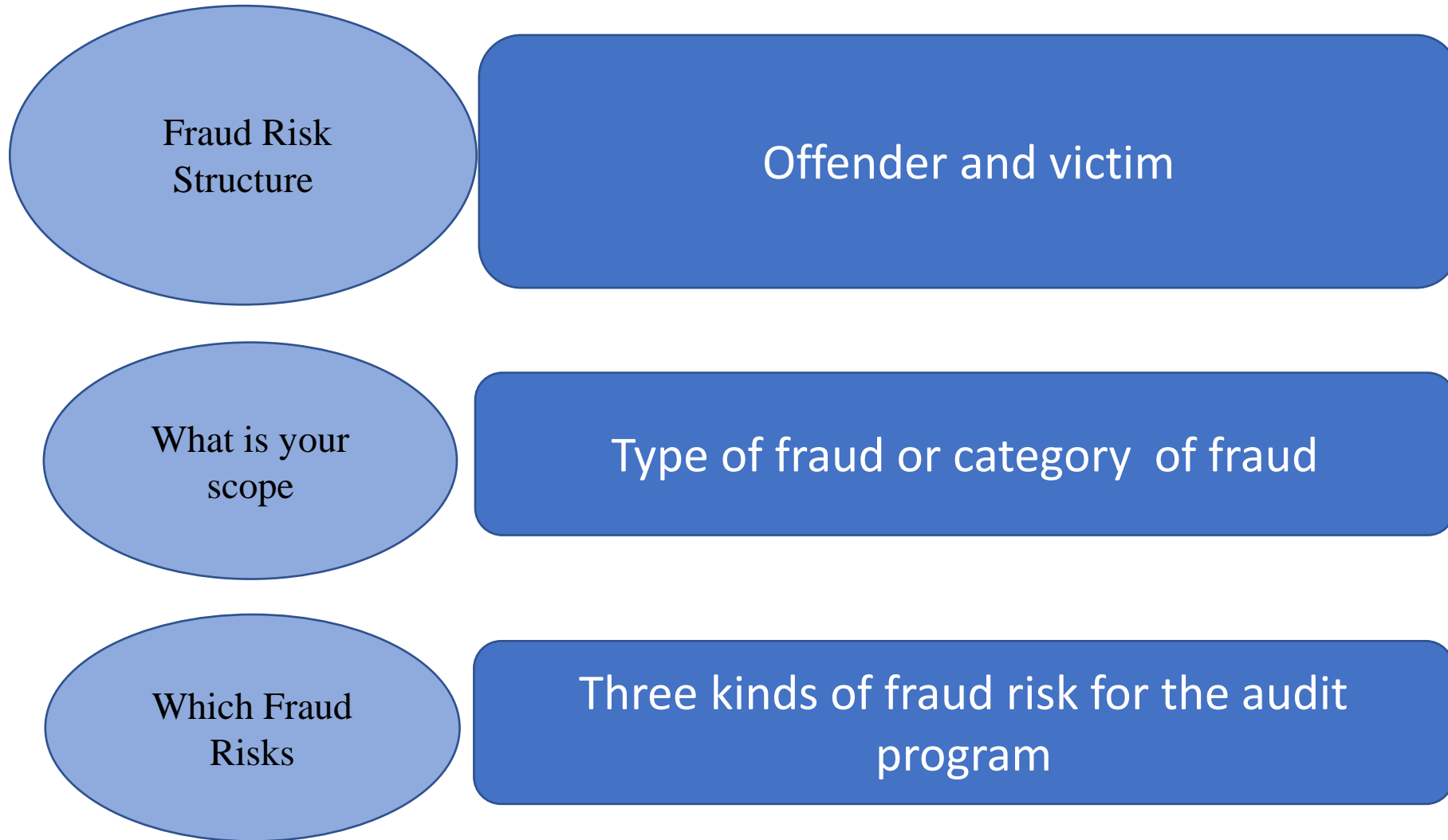
Anticipate and Manage

# My Definition of Fraud Risk

- **Fraud Risk:** An intentional and concealed threat designed to cause harm to the organization by exploiting the natural vulnerabilities that exist within our overall internal control structure.
  - **Vulnerabilities:** Points in the internal control structure that can be exploited
  - **Threats:** Possible danger that someone might exploit a vulnerability in our internal control structure, thereby causing monetary or non-monetary harm
  - **Risk:** Threat, probability, and business impact



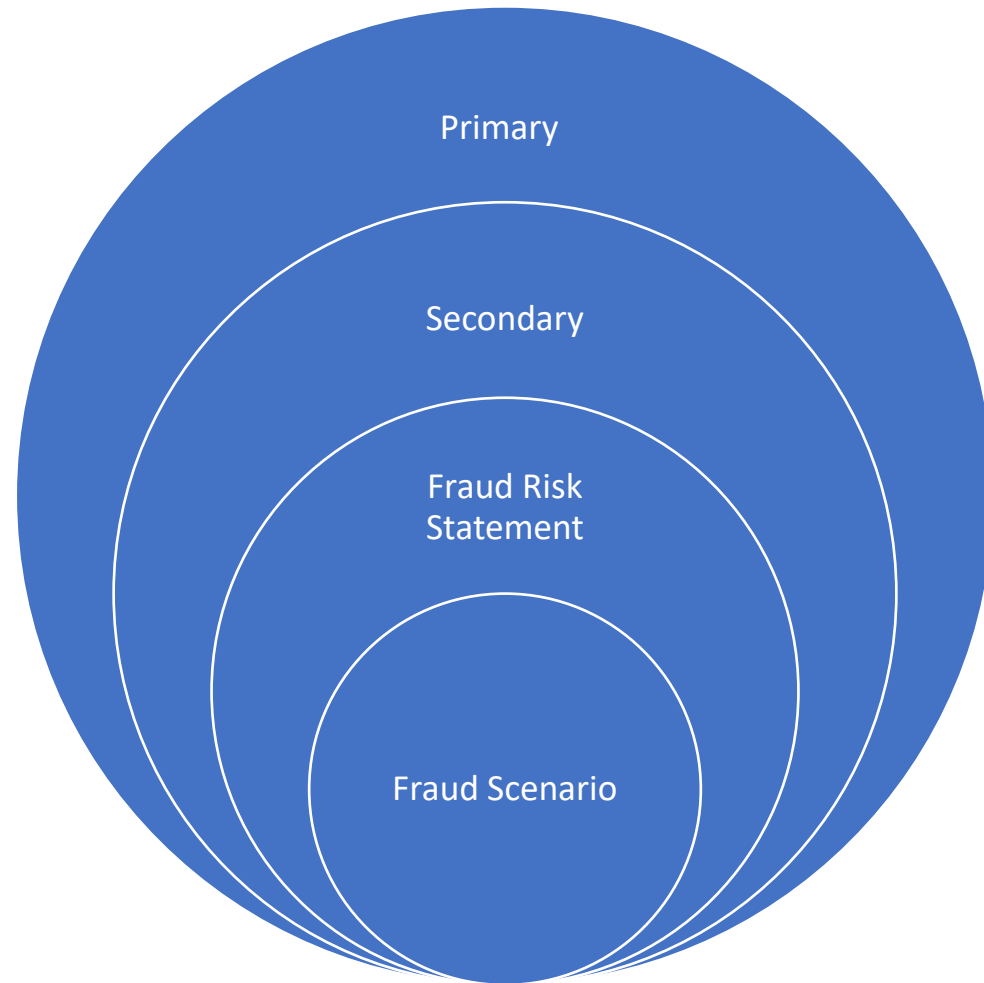
# Fraud Risk Universe



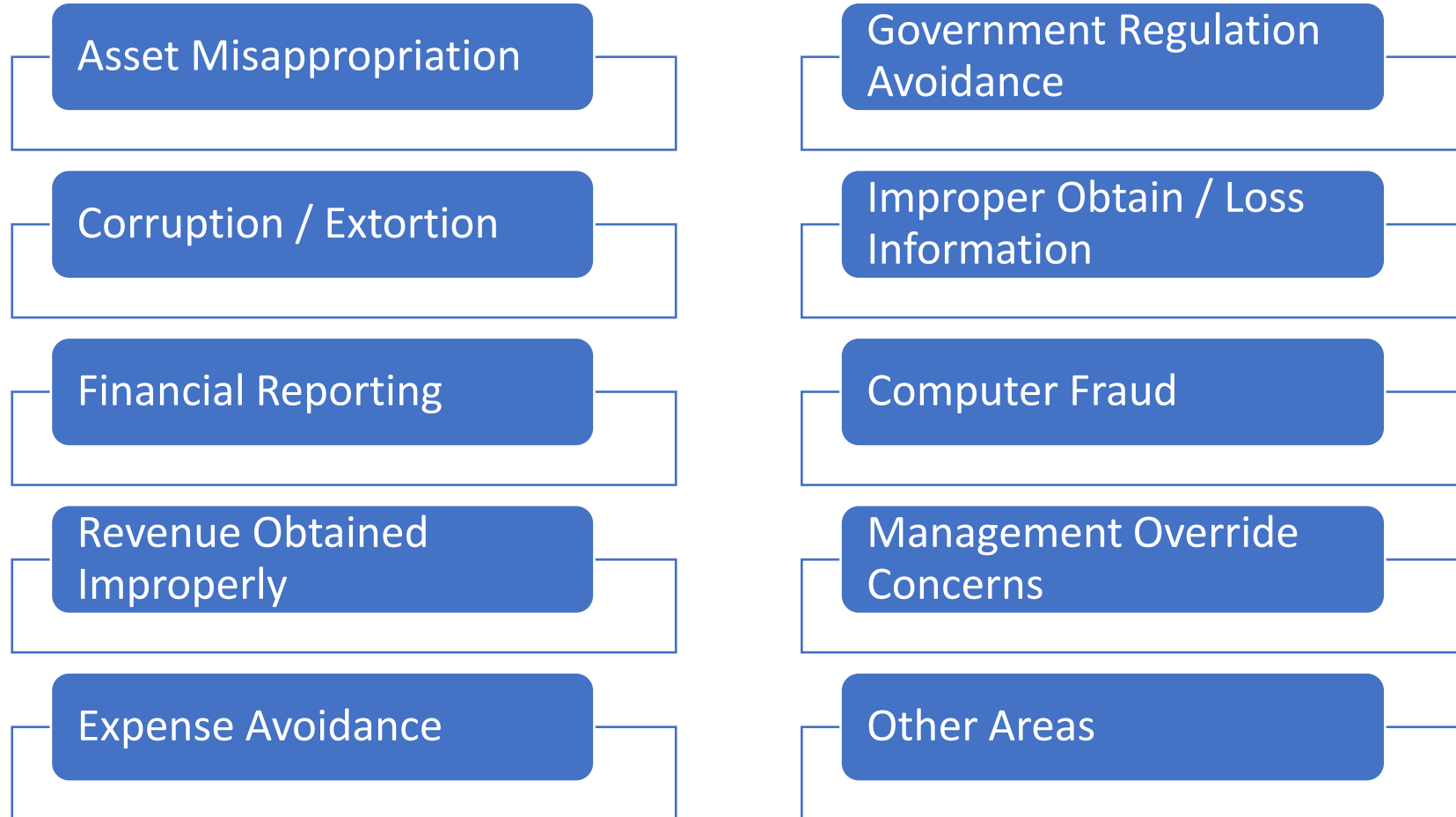
# Offender and Victim Analysis

- There are two parties to every fraud transaction
  - Victim
  - Perpetrator
- The first question you must ask: Who are these parties
- Now that we have identified the actors, are we considering fraud committed by an internal person & external person or are we considering: collusion; management override or opportunity created by an internal control weakness?
- What are your considerations?

# My View of the Fraud Risk Universe



# Primary Fraud Risk Categories



# Secondary Fraud Risk Categories



## Asset Misappropriation

- Theft of monetary funds
- Theft of tangible asset
- Misuse of assets
- Lack of business purpose
- Related party/conflict of interest
- Dispose of asset below FMV
- Acquire of asset above FMV

# Secondary Fraud Risk Categories



## Corruption

- **Start with person committing**
- Internal collusion
- External collusion
- Internal and external collusion
- **Next the business system**
- Identify the decisions
- Link person to decisions

# Definitions of Major Categories

- **Asset misappropriation:** application of another's property or money dishonestly to one's own use (source Blacks Law Dictionary)
- **Corruption:** is the use of entrusted power for personal gain (source Transparency international) Conceptually, corruption is a form of behaviour which departs from ethics, morality, tradition, law and civic virtue.
- **Financial reporting:** Financial statement fraud is the process of intentionally misleading the reader of the financial statements. It is the deliberate misrepresentation, misstatement, or omission of financial data to provide the impression that the organization is financially sound.

# Fraud Risk for Auditors

## Inherent Fraud Risk

- Generic or high level
- Entity / action
- Easy to understand

## Fraud Risk Statement

- Description of a threat facing the organization that has an element of deceit or concealment
- Five components
- Drives the audit program

## Fraud Scenario

- How someone would perpetrate a fraud risk statement against your organization
- Five components
- Internal control vulnerability



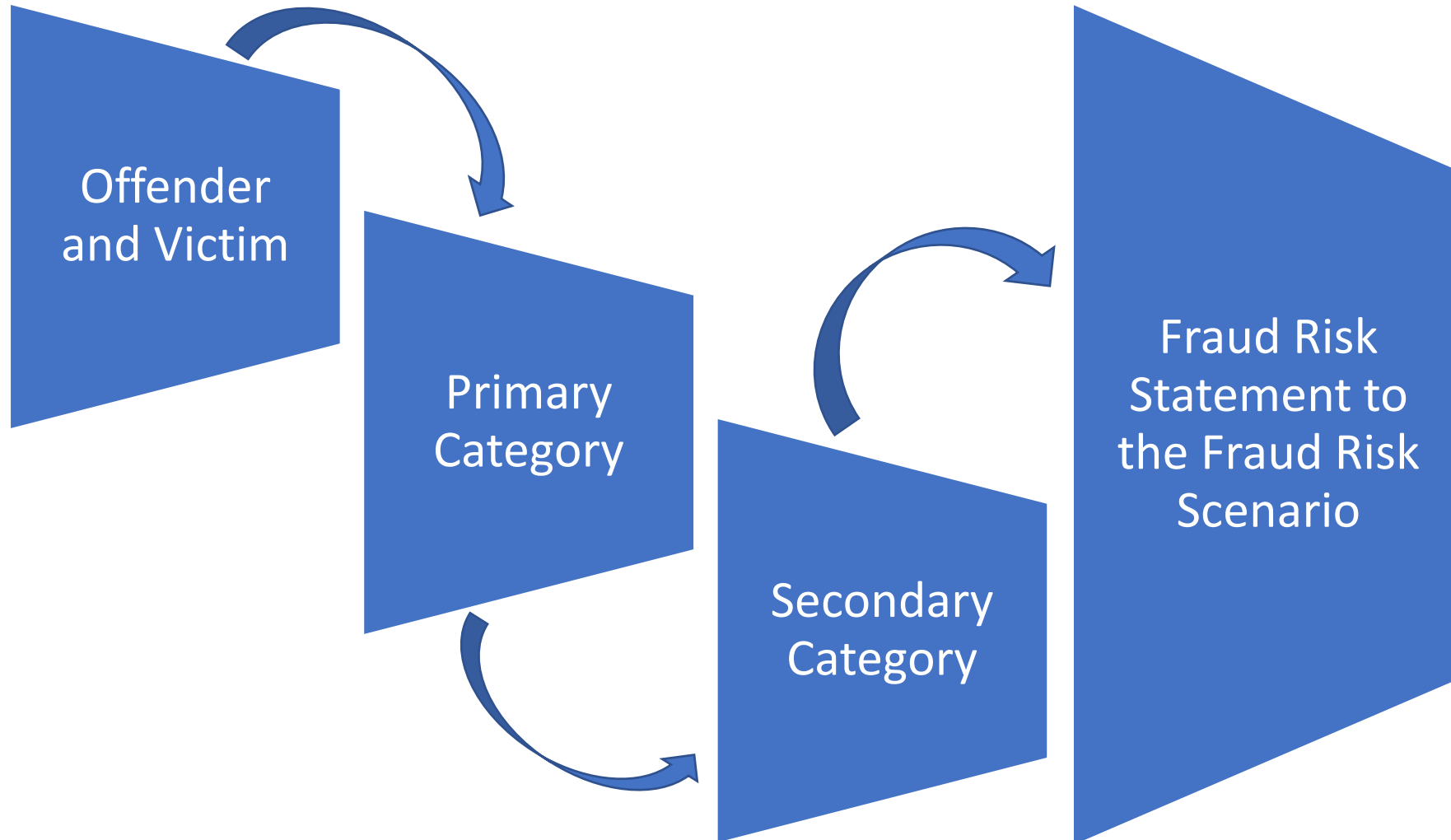
# Inherent Fraud Scheme Example: Disbursement

- False entity: vendor
  - False billing: receive no goods or services
  - Pass through billing: receive goods or services
  - Conflict of Interest
- Real entity: vendor
  - Over billing: overpay on some aspect or some way
  - Disguised expenditure: personal or theft conversion
  - Conflict of Interest
- **THE PREDICTABLE PHASE**

# Elements of a Fraud Risk Statement

- What are the combinations? What is the primary element?
- Permutation analysis
  - **Opportunity:** person committing or job title or department
  - **Entity:** Vendor, employee, customer or intangible
    - False: Created or assumed
    - Real: Complicit or not complicit
  - **Fraud action statement:** the fraud threat or fraud risk statement
  - **Impact statement:** Monetary or non-monetary
  - **Fraud conversion statement:** How person committing financial benefits from the fraud action statement

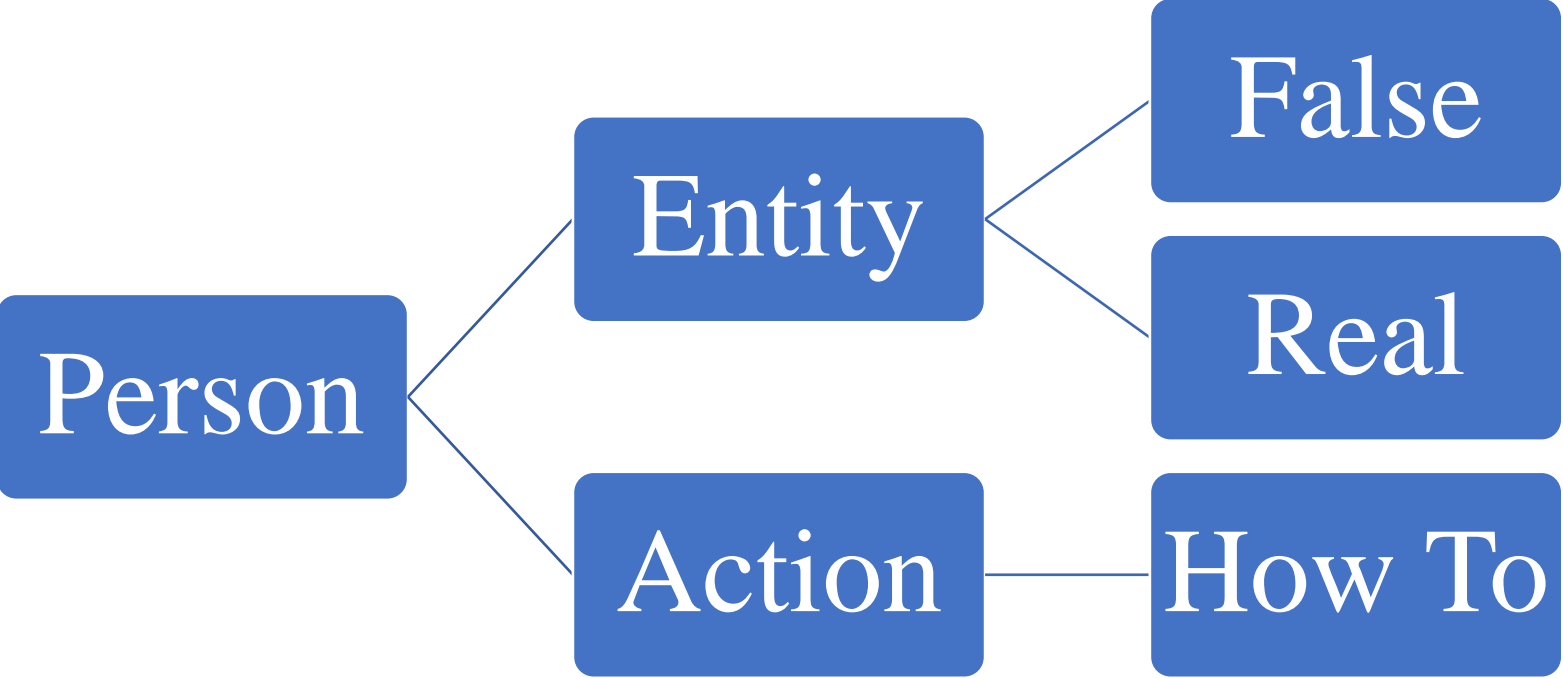
# Fraud Risk Structure



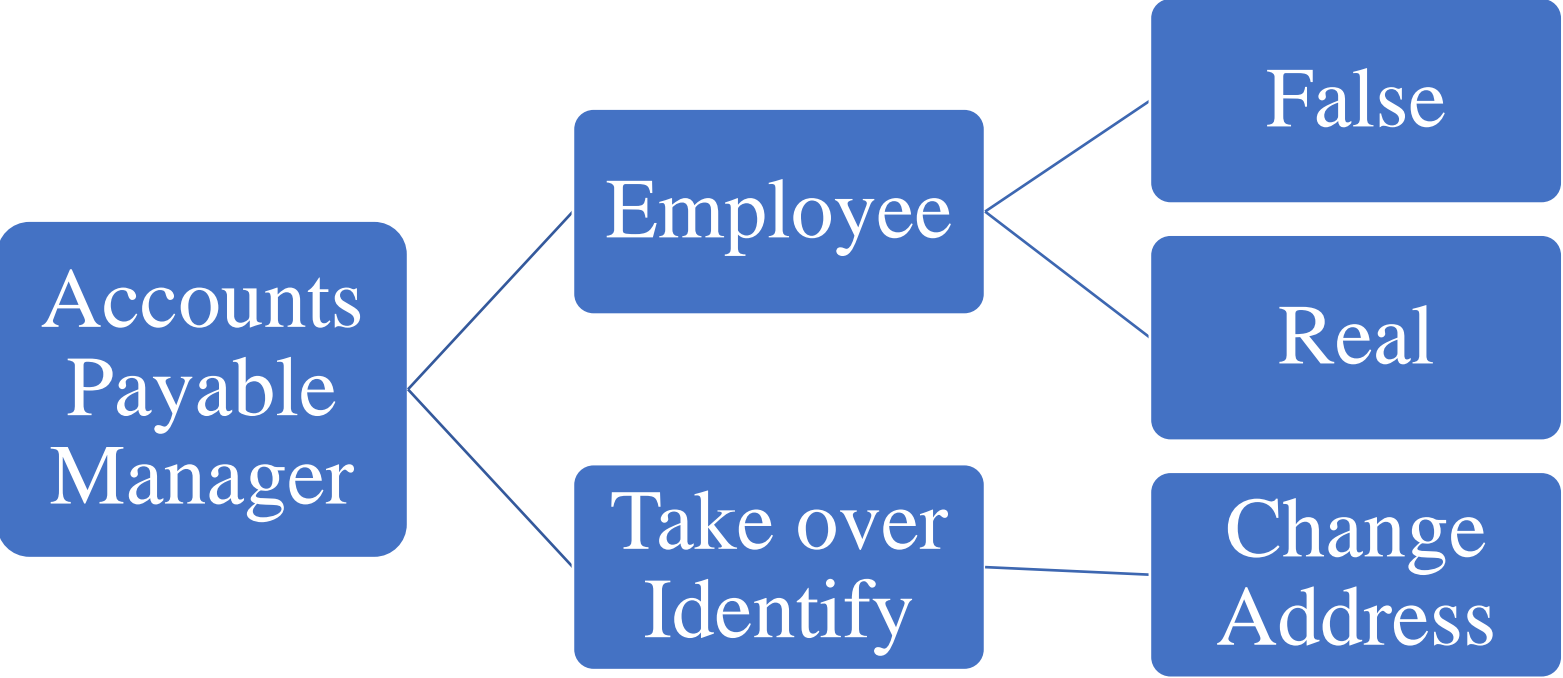
# Illustration of Fraud Risk for Auditors

- Inherent fraud scheme
  - Fraud risk statement
  - Fraud scenario
- False Entity / Paid for services not performed
  - Budget owner or payroll function causes a fictitious person to be set up on the employee master file, the budget owner or payroll submits time and attendance records for the fictitious person causing the diversion of funds.
  - Manager at a fast-food restaurant submits an employee action form to payroll department listing a fictitious employee/ The manager prepares, approves and submits a time-card for the fictitious employee causing payroll to calculate a pay-check and direct deposit the money.

# Just a Different Look at Fraud Risk



# Just a Different Look at Fraud Risk



# Types of Fraud Risk Statements

- Common to all business systems
- Company specific
- Industry specific
- Unauthorized access
- Internal control inhibitor

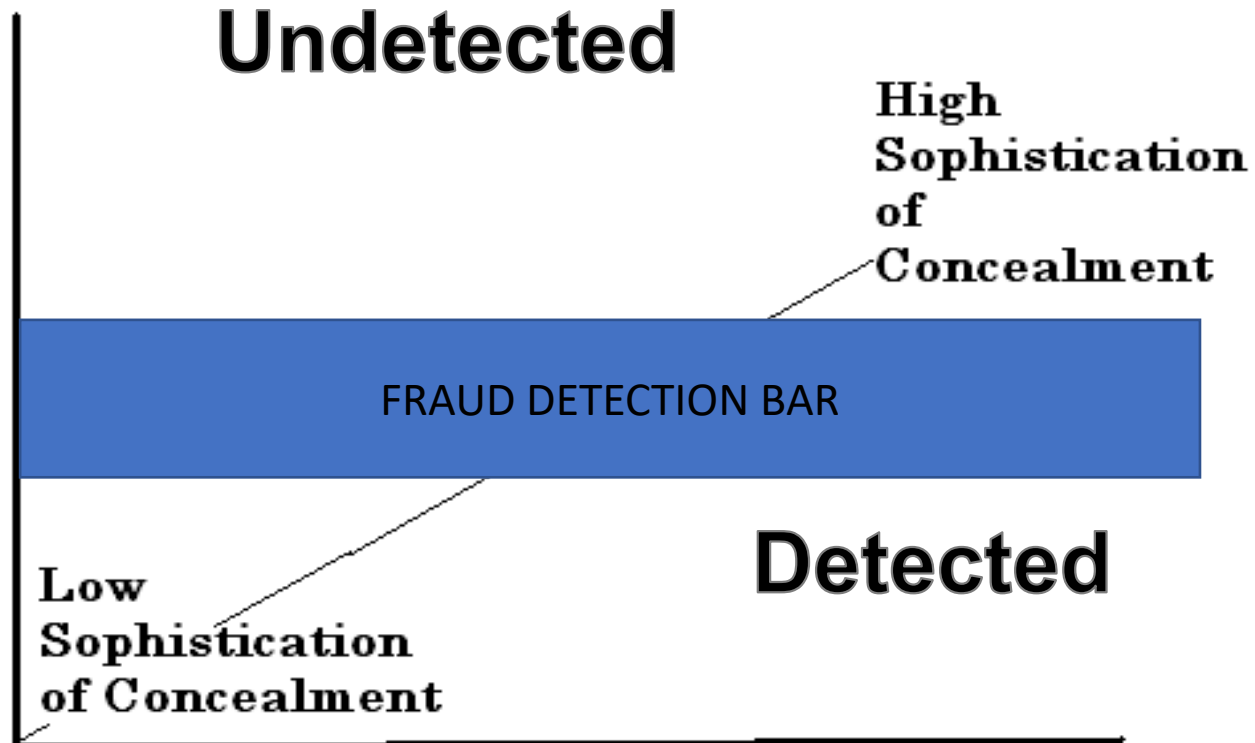
# Nuances by Type of Fraud Scheme

- Asset misappropriation ( Theft of asset)
  - Primary element varies by scheme
  - Conversion cycle varies by scheme
- Corruption (decision / bribe)
  - Opportunity is always collusion
  - Entity is almost always one element of opportunity
- Financial Reporting (misstatement)
  - Direction of misstatement
  - GAAP Implication

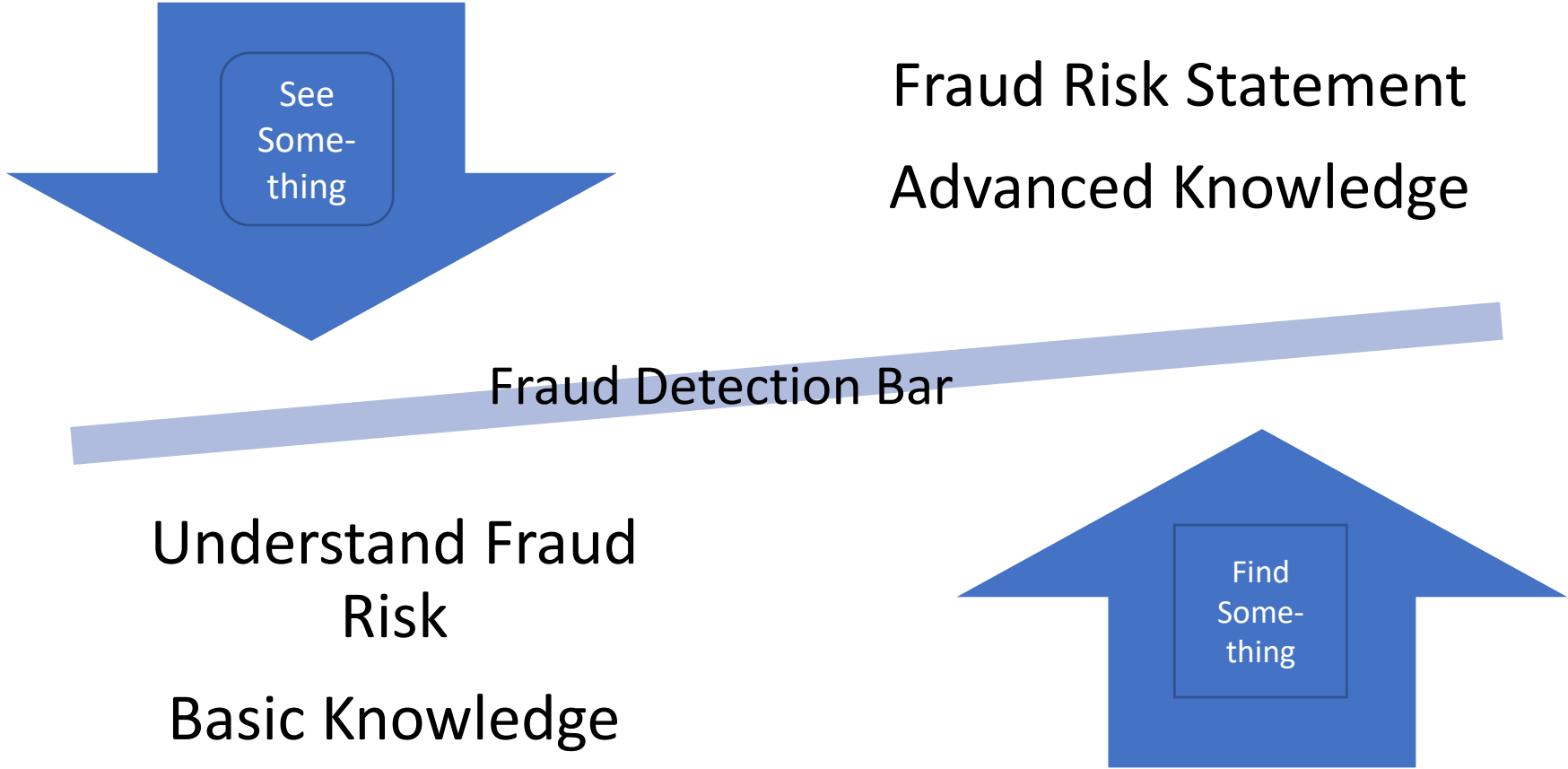


# Fraud Sophistication Chart

## Detection Of Fraud

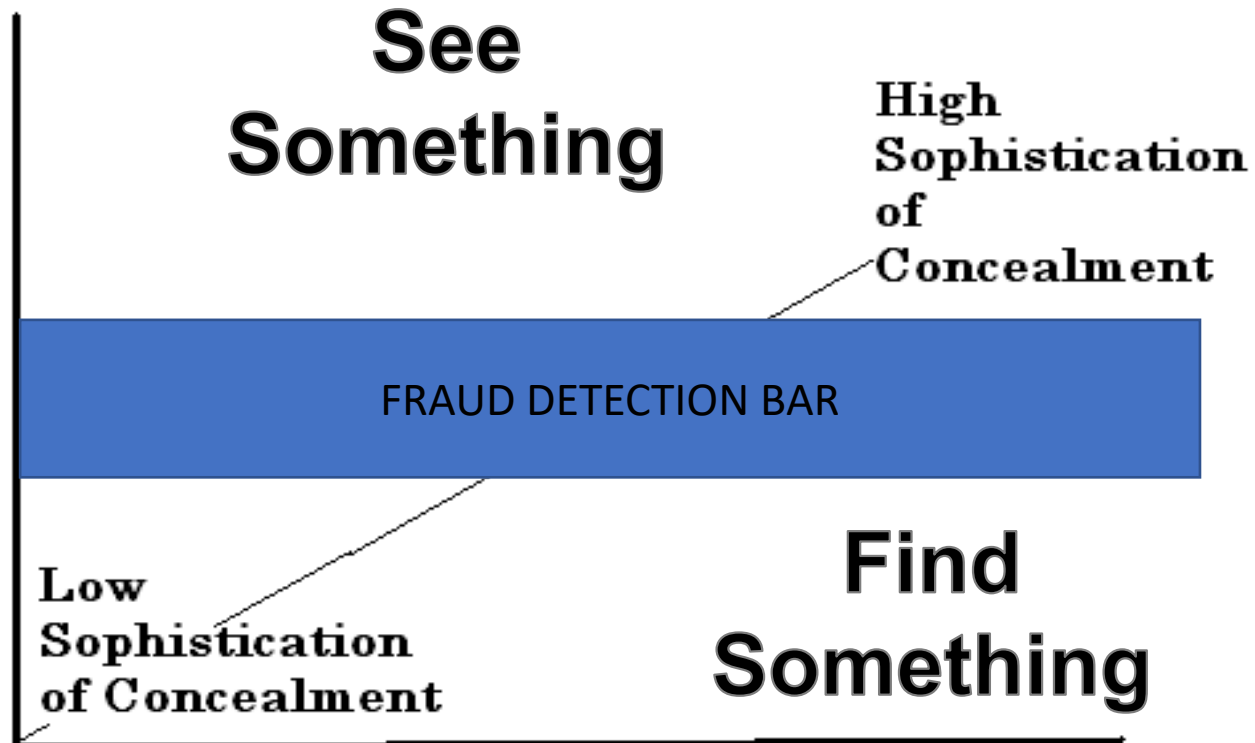


# Fraud Detection Dilemma



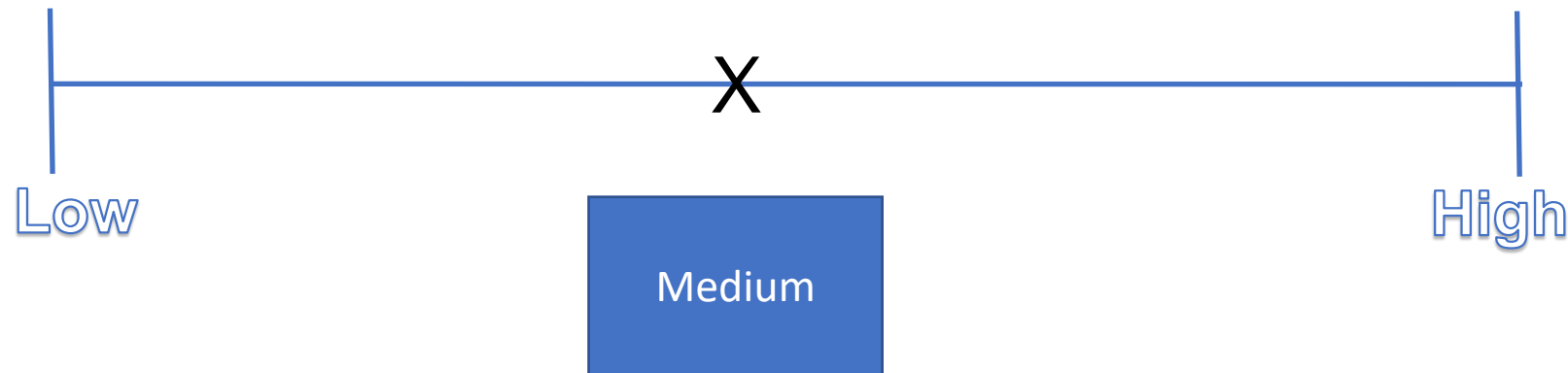
# Fraud Sophistication Chart

## Detection Of Fraud



# Sophistication Of Concealment

- Level of sophistication of concealment will vary based on perpetrators' knowledge and/or pressures
- Range of sophistication to conceal



# Fraud Concealment Linkage Master File Data

## High Concealment

- A/P PO BOX 697 VALATIE, NY 12184
- HR 934 BROADWAY RENSSELAER, NY 12144

## Medium Concealment

- A/P PO BOX 101 RENSSELAER, NY 12144
- HR 934 BROADWAY RENSSELAER, NY 12144

## Low Concealment

- A/P 934 BROADWAY RENSSELAER, NY 12144
- HR 934 BROADWAY RENSSELAER, NY 12144

# Fraud Concealment Transactional File Data

## High Concealment

- Inv # 10258, 10314, 10559, 11244,12213 etc.
- Now what?

## Medium Concealment

- Inv. # 195,210,211,259,275,etc
- Limited linkage pattern

## Low Concealment

- Invoice # 100,101,102,103,104,etc
- Sequential pattern

# Fraud Trivia-2

After a four-month trial and a week of deliberations by a jury, the auditors went to jail for which corporate fraud case?

- a) Enron
- b) Barings Bank
- c) Equity Funding
- d) ZZZ Best

# Quandary: Risk Statement or Fraud Scenario

- Unlike the fraud risk statement, the number of fraud scenarios should be viewed as infinite. While I do not believe the number is infinite, I am sure that we can not count or identify all the fraud scenarios. This is why at that phase; I classify fraud scenarios into three categories:
- Historical methods that should be anticipated
- Unknown methods that could be anticipated
- Unknown / unknown methods that would not be anticipated but could occur
- The goal of this phase is to understand how the perpetrator would commit the fraud risk statement, pierce your internal controls, and create the illusion that the transaction is proper.

Thank you Donald Rumsfeld



# How to Create a Comprehensive List of Fraud Risk Statements

- Start with the scope of your audit program
- Believe it or not: How detailed do you want your fraud risk statement?
- Should I be using fraud risk statements or fraud scenarios
- How will the fraud risk statements be used
  - Fraud risk management
  - Audit program development
  - Experience of the team

# How Detailed do you Want Your Fraud Risk Statement?

- First: (generic) level: Vendor overbills the company
- Second level: Vendor commits a product substitution scheme: Product substitution refers to the knowing and willful substitution, without the purchaser's knowledge or consent
- Third Level, Perpetrated by Supplier:
- I.e., of a fraud risk statement: Supplier alone (or in collusion with an internal person) commits a product substitution scheme (or provided expired goods) resulting in warranty issues (or internal person receives a bribe for accepting expired goods).
  - Fitness issue
  - Knock off scheme
  - Obsolete or expired scheme
  - Used, surplus, or outdated materials or components
  - Materials that do not conform to contract requirements

# How Detailed do you Want Your Fraud Risk Statement?

- Third Level, Perpetrated by Manufacturer:
  - I.e., Manufacturer alone intentionally misstates the chemical composition of their goods resulting in potential legal liabilities costs.
    - Chemical composition
    - Country of origin
    - False testing statements
    - False specification
- Third Level, Perpetrated by a Counterfeiter
  - I.e., Counterfeiter sells to your company refurbished components resulting in a damages to company reputation.
    - Parts which do not contain the proper internal construction (die, manufacturer, wire bonding, etc.) consistent with the ordered part
    - Parts which have been used, refurbished, or reclaimed, but represented as a new product.
    - Parts which have a different package style or surface plating/finish than the ordered parts. Parts sold with modified labeling or markings intended to misrepresent the part's form, fit, function, or grade.

# How Detailed do you Want Your Fraud Risk Statement?

- **Fourth Level, Expenditure specific**
  - Supplier operating alone mislabels seafood as wild catch versus raised in a farm resulting in potential reputation risk.
  - Fisherman (Manufacturer) mislabels sea bass or snapper when the actual fish is a less desirable fish resulting in an intentional product substitution scheme.
  - Restaurant or grocery store intentionally mislabels a less desirable fish as sea bass or snapper resulting in mischarging of consumers.

# What a Fraud Risk Statement Looks Like: Simple

- Real supplier acting **alone** overbills the company by increasing the prices or cost of the invoice and the company employee approving the increase based on a false pretense causing the diversion of company funds.
- Real supplier acting **in collusion** with company employee overbills the company by increasing the prices or cost of the invoice and the company employee intentionally approving the increase (management override) based on a false pretense causing the diversion of company funds.

# What a Fraud Risk Statement Looks Like: Complex

- A budget owner or a senior member of management provides a real complicit supplier / with advance information on future changes to the purchase requirements listed on the bid documents providing the real complicit supplier an unfair competitive advantage in the bidding process. After the purchase order is issued to the complicit vendor, the budget owner or senior member of management / allow or cause changes to the original purchase commitment which may or may not cause a change to the purchase order total amount. / The changes allow the real complicit supplier to invoice for items with higher margins than originally stated in the bid response by the budget owner and:  
**CONTINUED**

# What a fraud risk statement looks like: Complex

- Change line-item quantities with no change to the original purchase order amount.
- Change the items purchased allowing the supplier to provide inflated prices on the changed item (product mix) within the original purchase order amount.
- Change line-item quantities and increase the purchase order amount.
- Change product mix and increase the purchase order amount.
- The complicit vendor provides a kickback to the budget owner in consideration of the advance communication of information which results in a corruption scheme and an overbilling fraud scheme.

# Fun Fraud Trivia-3

What is the full name of the person who first perpetrated the Ponzi scheme?

- a) Charles Ponzi
- b) George Parker
- c) Sarah Howe

A common theme among Ponzi schemes is “irrational exuberance”, which flower was the first to be involved in a Ponzi scheme?

- a) Tulip
- b) Orchard
- c) Rose



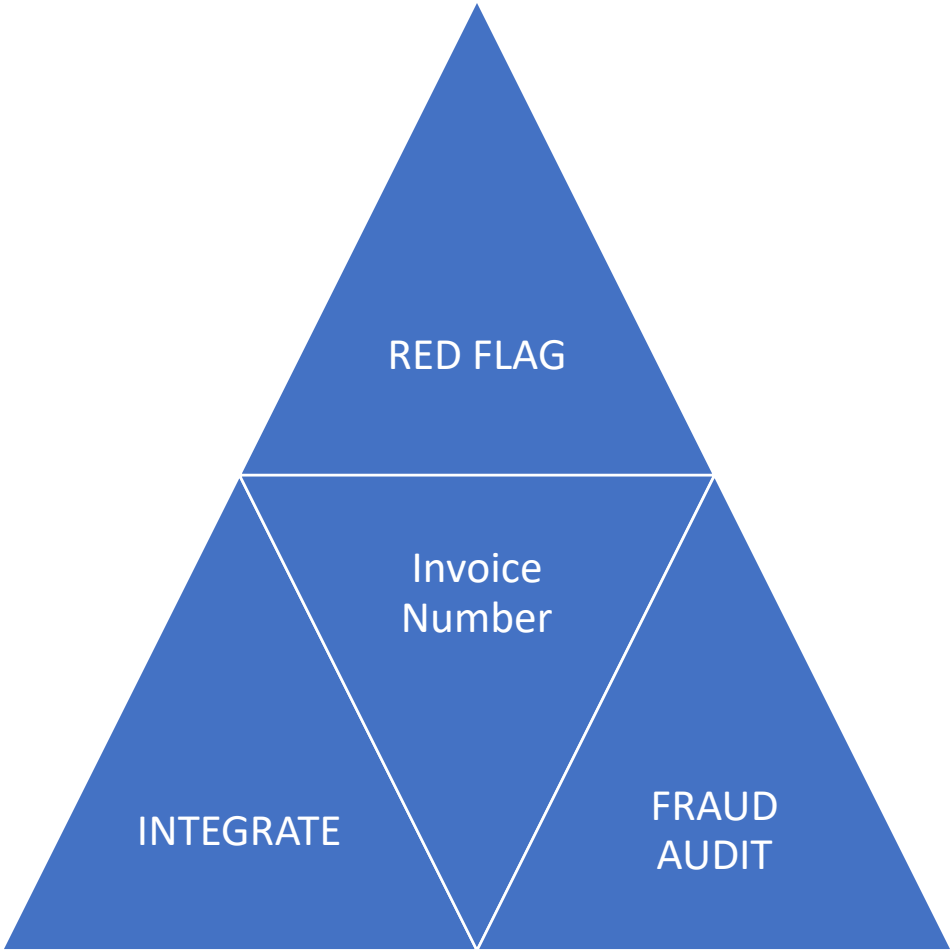
# How to Define the Audit Scope for Fraud Risk

- Start with the actors
- Identify the primary and secondary type of fraud risk
- Identify entity structures: false or real
- Identify the permutations of your entity structure
- Identify the fraud action statements
- Identify the permutations of your fraud action statements
- Create the fraud risk statements
- Purpose of your audit program

# What is your Strategy

1. Perform a **fraud risk assessment** with the fraud scenario approach. There is no change to the field work stage. The focus is on the adequacy of the design of internal controls to mitigate a fraud scenario. The fieldwork methodology follows the traditional internal control approach.
2. Use the **red flag approach** combined with a fraud scenario or a fraud risk statement approach. The sampling phase is random, but the audit program includes document red flags or control red flags associated with the fraud risk statement.
3. **Integrate fraud test procedure** combined with the fraud risk statement within the internal control approach. The sampling is random, but a fraud test procedure is added to the test of internal controls.
4. Use the **fraud audit approach** driven by the fraud risk statement. The sampling is based on fraud data analytics, and the test procedure uses a fraud audit test procedure. There is no testing of internal controls.

# Illustration Of Fraud Testing: Vendor Invoice



# Practical Example: Payroll Fraud

- Operating management remote location to corporate payroll
- Asset misappropriation / theft of monetary assets
- False entity (known as a ghost employee)
  - Fictitious / Real but not complicit / Real but complicit
  - Permanent or Temporary
- Paid for services not performed
- Theft for profit / Pay a bribe
- Use the **fraud audit approach** driven by the fraud risk statement. The sampling is based on fraud data analytics, and the test procedure uses a fraud audit test procedure. There is no testing of internal controls.

# Fraud Trivia-4

In which country is the first known fraud?

- a) China
- b) France
- c) Greece

As a follow up, do you know the year?

# Now You Have Consider Fraud

To quote a famous individual:

- “That’s all, folks.”
- Questions now: I am here till tomorrow
- Questions later: [lvona@leonardvona.com](mailto:lvona@leonardvona.com)
- Please visit my website, [Leonardvona.com](http://Leonardvona.com)
- Sign up for my monthly fraud blog
- I promise it’s not a marketing ploy