

# Internal Audit's Role in Fraud Prevention and Detection

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# Agenda

**Era of Fraud Scandals**

**The Fraud Triangle**

**The Responsibility for Fraud**

**The COSO Fraud Control Model**

**Case Studies**

**Q&A**

# The Era of Fraud Scandals

- At the beginning of the 21<sup>st</sup> century fraud scandals dominated the news headlines.
- Enron shareholders lost \$11 billion to debt concealment and early revenue recognition schemes.
- WorldCom had a \$3.8 billion fraud of capitalizing expenses and recording false revenue.
- Tyco executives were convicted of stealing \$150 million living lavish lifestyles at company expense.

# Regulatory Response to Fraud Scandals

- ❑ SAS 99
- ❑ Sarbanes-Oxley Act of 2002
- ❑ COSO Fraud Control Model

# The Fraud Triangle

## ❑ Motives

- Non-sharable
- Many sources of pressure

## ❑ Opportunities

- Controls are weak
- Detection is unlikely

## ❑ Rationalizations

- End justifies the means
- I deserve it!

# Breaking the Triangle

- Best way is through opportunities.
  
- Set up good control framework:
  - Segregation of duties.
  - Transactions are monitored.
  - Employee awareness of potential fraud.
  - Employee commitment to preventing fraud.

# So Whose Job Is It Anyway?

- Historically management believed that external auditors would uncover fraud.
- SAS 99 is limited.
- Sarbanes-Oxley specifically holds management responsible.
- Internal Audit is an extension of management.

# The COSO Fraud Control Model

- ❑ Developed in response to the era of fraud scandals.
- ❑ Committee Of Sponsoring Organizations.
- ❑ Widely accepted as the theoretical guideline.

# Five Considerations in the COSO Model

- 1) The Control Environment
- 2) Control Activities
- 3) Risk Assessment
- 4) Information and Communication Systems
- 5) Monitoring the System

# The Control Environment

- ❑ Management Style
- ❑ Audit Functions
- ❑ Employee Policies

# Control Activities

- Authorization processes
- Segregation of duties
- Adequate documentation of transactions
- Physical control over assets and records
- Independent checks
- Do accounting rules or preferences drive the payment method instead of growth or risk considerations?

# Risk Assessment

- Not an exact science
- All of management should be involved, not just financial
- Steps to risk assessment
  - Identify potential risk
  - Assign a dollar value loss
  - Assign a probability of occurrence
  - Perform cost-benefit analysis on risk mitigation

# Information and Communication Systems

- Information should show that transaction is accurate.
- Information should be retrievable in a usable format.
- Information should be communicated to the appropriate people.

# Monitoring the System

- Must be monitored to be effective
- Monitors should have proper training
- Variance reporting
- Continuous monitoring techniques
- Does this make sense?

# Internal Auditor's Role

- The boring, repetitive work is what yields fraud findings.
- Willingness to question the process.
- Understanding of the Fraud Triangle and how it specifically impacts the organization.
- Understanding the COSO Fraud Control Model.
- Understanding management's fraud controls in policies and procedures.

# Fraud Risk and Internal Audit

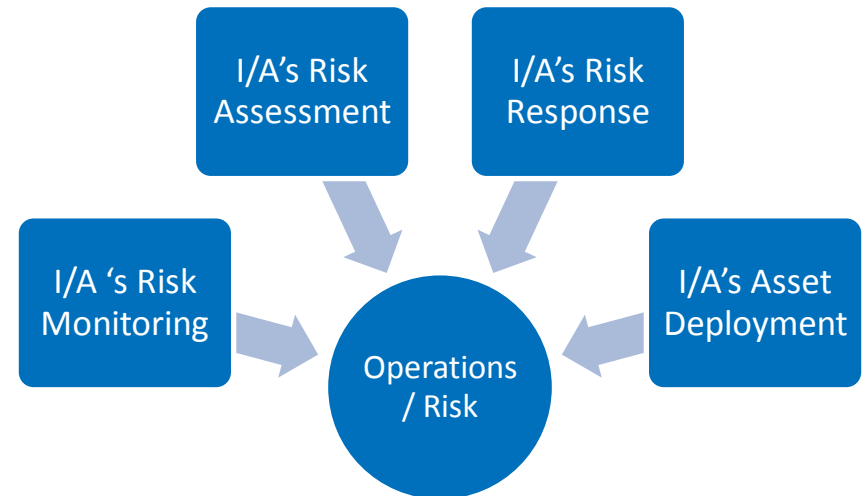
- ❑ Fraud by nature encompasses intentional misconduct that is designed to circumvent detection.
- ❑ Consider how the Fraud Triangle may apply to specific circumstances at your organization, especially where resources (people and money) are stretched thin and companies look to continue cutting costs in a down economy.
- ❑ The fraud risk assessment should consider identified issues from prior audits and also potential behaviors that could result in fraudulent activity.

# Fraud Risk and Internal Audit

- The fraud risk assessment should also include the perspectives of line management, as they are the closest to daily business operations.
  
- Fraud detection procedures requires a skeptical mindset.
  
- Consider the following questions:
  - How might a fraud perpetrator exploit weaknesses in the system of controls?
  - How could a perpetrator override or circumvent controls?
  - What could a perpetrator do to conceal the fraud?

# Fraud Risk and Internal Audit

- Internal Audit's Role
  - Risk Response
  - **Driving Returns...**
- Risk Readiness is the RESPONSE to identified Fraud Risk



# Internal Audit and Data Analytics

- Data analytics can be used to drive the risk assessment.
- Embed data analytics in your internal audit program.
- Ensure timely identification of issues.
- Data analytics adds value to other audit elements.
- Use data analytics to drive development of audit plan.
- Create your own metrics, using basic commands to identify patterns and concentrations within data.
- Use results in risk assessment process and audit planning to focus the audit scope.

# Case of the Daisy DOC – Background

This story happened long, long ago, in the olden days, before there was EDI and transactions still happened on paper. The Daisy Company is a distributor of inexpensive china. They sell to stores like Target and JC Penney and their cheap china is very popular. Orders come in all month long. The Controller of Daisy Company does an annual budget, including a sales forecast by pattern of china. Daisy Company has traditionally made a modest profit with slow and steady growth. They consistently made their monthly sales targets and operated under a well-managed expense and cost base.

The Accounting Manager produced a daily report that she distributed to all key management personnel. The report was called the Daily Operating Control (DOC). The DOC showed the daily and current month cumulative orders received, orders shipped and orders on backorder. The orders shipped were compared to prior year actual for the same day and month and the report also showed the monthly sales target.

Daisy had one internal auditor who was stretched pretty thin. One day the internal auditor was reviewing a whole year's worth of DOCs. She noticed something unusual. Even though orders came in evenly during the course of the month as stores replenished their stock, there was consistently little shipping done the first week of every month.

# Case of the Daisy DOC – Questions

- How would you begin to investigate this?
  
- What was going on here?
  
- What part of the COSO Fraud Model gave rise to the internal auditor's detection of the problem?

# Case of the Carson Cars & Cash Back –

## Background

There was a car dealer that sold Chevrolets in Carson City. The car dealership was owned by a very good salesperson named Carl Carson who sold many cars. Carl's dad started the business and Carl was a great salesperson since birth, but he did not understand financial information at all. Therefore, he hired a General Manager who took care of all that stuff.

During that time, General Motors (who built Chevys) was offering "cash back" deals on most of their vehicles as part of a huge promotion. When the salesperson sold a car with cash back, he noted the incentive on the deal invoice and the following entry was posted: Dr. Factory Receivables, Cr. COS. The salesperson's commission was based on two components of the car deal, the margin and the selling price. If the dealership met the monthly margin and profit targets, the General Manager also got a bonus.

The dealership was profitable and usually met its margin targets. Expenses were under control and consistent with prior years; they had been in business for nearly 50 years so nothing could surprise him. That is why Carl thought it was strange when he started to fall short on cash. His balance sheet was healthy except there seemed to be a sustained high balance in factory receivables.

# Case of the Carson Cars and Cash Back – Questions

- How would you begin to investigate this?
  
- What was going on here?
  
- What part of the COSO Fraud Model, if implemented, could have led to an earlier detection of the problem?

# Case of the Imported Tablecloths – Background

There was an importer named Ivan who sold tablecloths and the importer got such a good deal on his imported tablecloths that he was able to compete, both in quality and price with all the other domestically made products sold by his competitors. One of his more popular tablecloths was imported from Belgium. When the supplier billed Ivan for the tablecloths, he billed him in Euros and Ivan kept a balance of Euros in a special bank account just to pay the supplier.

Ivan's operation was not big enough to support his own internal audit staff; however, it was big enough to warrant some internal audit review. Ivan hired an outside consultant to do this internal audit work. One day the internal auditor was doing some routine and very boring checking of supplier invoices to supporting documentation. He came across the payment of the Belgian supplier and could not figure out how the amount was converted to dollars when it was posted to the GL.

Therefore, the Internal Audit Consultant went to ask the Accounts Payable Clerk who processed the invoice. "Oh, that's easy!" she said. "You just take the commercial invoice, which is in dollars, that comes with the package and double that amount and that agrees with the purchase order and the amount you post in dollars. Then when you apply that amount to the invoice conversion rate, that's what I pay in Euro and it matches what's on the Euro invoice!" "Joe the Purchasing Manager showed me how to check it, isn't he helpful?"

# Case of the Imported Tablecloths – Questions

- Do you think the AP Clerk understood the logic behind what she was checking?
  
- What was going on here?
  
- What part of the COSO Fraud Model led to the detection of this fraud?

## In Summary

- ❑ Internal Audit, on behalf of the Board of Directors and Management, is directly responsible for the performance of job functions, which result in the prevention and detection of fraud.
- ❑ As part of their job function, Internal Audit employs the COSO Fraud Control Model and other tools to ensure that Management's policies and procedures are functioning as designed within a solid fraud control framework.

Questions?

# Want More Information?

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