

What Does Fraud Look Like

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Who Steals?

Basically Honest People
We're the ones internal
controls are for

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Why Auditors Fail To Detect Fraud

Question

**Have you ever thought
about stealing?**

Would you steal?

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What Does Fraud Look Like

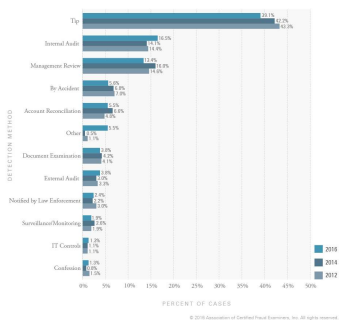
Per SAS No. 122, AU 240, *Consideration of Fraud in a Financial Statement Audit*, CPAs fail to detect fraud for two primary reasons:

1. They don't know what fraud looks like and,
2. They haven't been trained to look for it

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Initial Detection of Occupational Frauds

Figure 21: Initial Detection of Occupational Frauds



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What Does Fraud Look Like

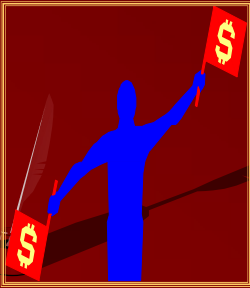
Often, fraud is right in front of you IF you know what to look for.....

.....and look for it!



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RED FLAG



➤ A set of circumstances that are unusual in nature or vary from the “normal activity”

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CAUTION

- ❖ Do not ignore a red flag
 - Conduct inquiry to determine reason for abnormal circumstances
- ❖ Sometimes an error is just an error
 - Is there *intent*?



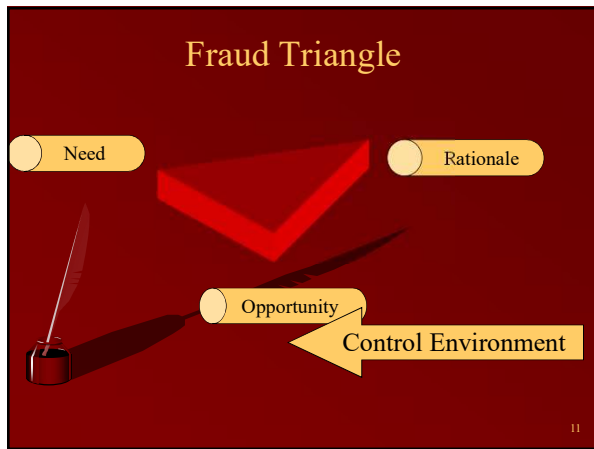
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Quote of the Day

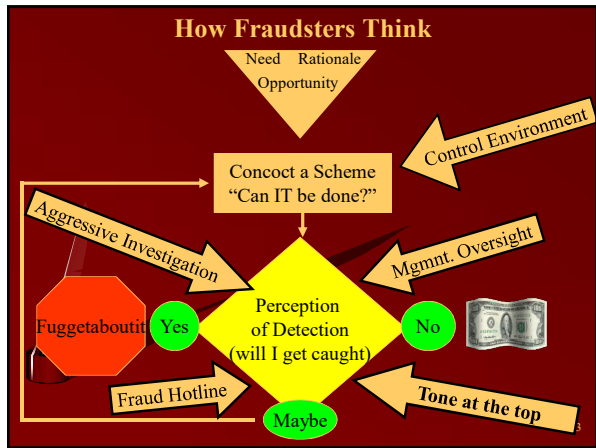
Fraud and Stupid
Often Look
Exactly the Same

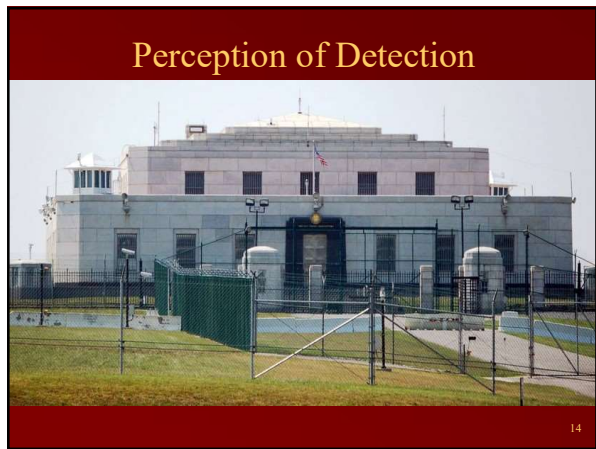
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Now Why Do You Think No One
Has Ever Try To Rob Fort Knox

The
Perception
Of Detection



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Corruption Schemes and Fraud in
Compliance Programs

1 Reason Fraud
Occurs

Blind Trust



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What Does Fraud Look Like

Remember This:

Trust Is Not An Internal Control



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EMPLOYEE RED FLAGS

- ❖ Living beyond their means (45.8%)
- ❖ Significant personal debt and credit problems (30%)
- ❖ Behavioral changes
 - Drug or alcohol related
 - Gambling
 - Fear of losing job
- ❖ Stress has many repercussions



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EMPLOYEE RED FLAGS

- ❖ Living beyond their means (45.8%)
- ❖ Significant personal debt and credit problems (30%)
- ❖ Behavioral changes
 - Drug or alcohol related
 - Gambling
 - Fear of losing job
- ❖ Stress has many repercussions
- ❖ High employee turnover
- ❖ Refusal to take vacation or sick leave
- ❖ Lack of segregation of duties (36%)



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EMPLOYEE RED FLAGS



- ❖ Low or inadequate salary
- ❖ Difficulty in obtaining audit evidence
- ❖ Severe disciplinary actions
- ❖ Lack of respect or appreciation by superiors
- ❖ Open-ended contracts
- ❖ Resentment for not being treated fairly

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What Does Fraud Look Like

- ❖ Remember that employees will circumvent internal controls not for the purpose of committing fraud, but because
- ❖ It makes their job easier
- ❖ But by doing so, an *opportunity* is provided

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What Does Fraud Look Like

- ❖ Sooner or latter, an employee will have a need
- ❖ They only need to be able to rationalize in order to take advantage of the *opportunity*



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DANGER!

BEWARE OF BLACK HOLES AHEAD



MANAGEMENT RED FLAGS


1. Reluctance to provide information to auditors
2. Excessive number of checking accounts
3. Frequent changes in banking accounts
4. Frequent changes in external auditors
5. Company assets sold under market value



MANAGEMENT RED FLAGS




6. Significant downsizing in a healthy market
7. Continuous rollover of loans
8. Excessive number of year-end transactions
9. High employee turnover rate
10. Unexpected overdrafts or declines in cash balance




MANAGEMENT RED FLAGS

11. Refusal by company or division to use serial numbered documents
12. Compensation program out of proportion with its profits
13. Any transaction that does not make sense




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MANAGEMENT RED FLAGS

14. Refusal by company or division to use serial numbered documents
15. Compensation program out of proportion with its profits
16. Any transaction that does not make sense
17. Photocopied or missing documents



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RED FLAGS IN CASH/ ACCOUNTS RECEIVABLES



- ❖ Excessive number of voids, discounts and returns
- ❖ Unauthorized bank accounts in company name
- ❖ Sudden activity in dormant banking accounts
- ❖ Customers receiving late notices on accounts where payments have been made

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RED FLAGS IN CASH/ ACCOUNTS RECEIVABLE

- ❖ Discrepancies between bank deposits and posting to the account
- ❖ Abnormal number of expense items or supplies reimbursement by employees
- ❖ Presence of employee checks in petty cash for the employee who is responsible for petty cash
- ❖ Unjustified cash transactions
- ❖ Large number of written-off accounts
- ❖ Bank accounts that are not reconciled on a timely basis

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RED FLAGS IN CASH R/D ACCOUNTS RECEIVABLE

- ❖ Unusual checks/invoices



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RED FLAGS IN CASH R/D ACCOUNTS RECEIVABLE

- ❖ Unusual checks
- ❖ Any check for an even amount in excess of \$50
- ❖ Any deposit of currency in a large amount
- ❖ Any non-payroll or expense reimbursement check made payable to an employee
- ❖ Large and frequent change orders
- ❖ High level approval of a low level transaction
- ❖ Odd purchases

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RED FLAGS IN CASH R/D ACCOUNTS RECEIVABLE

- ❖ Copies of invoices rather than originals

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- ❖ Excessive use of clearing accounts

- ❖ Excessive purchases of small tools

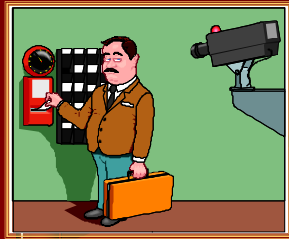
- ❖ Bids/High-Low/Same Ones/Splitting

Look for things that should be there but aren't

Look for things that are there but shouldn't be

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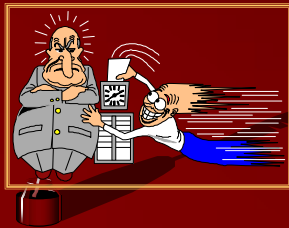
RED FLAGS IN PAYROLL



- ❖ Inconsistent overtime hours for a cost center
- ❖ Overtime charged during a slack period
- ❖ Overtime charged for employees who normally would not have overtime pay
- ❖ Budget variations for payroll by cost center

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RED FLAGS IN PAYROLL



- ❖ Employees with:
 - Duplicate Social Security numbers
 - Same names
 - Same addresses
- ❖ Employees with few or no payroll deductions

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RED FLAGS IN PURCHASING/INVENTORY



- ❖ Increasing number of complaints about products or service
- ❖ Increase in purchasing inventory but no increase in sales
- ❖ Abnormal inventory *shrinkage*


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Red Flags in Purchasing/ Inventory

- ❖ Increase in scrap materials and then reorders for the same items
- ❖ Lack of physical security over assets/inventory
- ❖ Sales without shipping documents
- ❖ Payments to vendors who aren't on an approved list
- ❖ High volume of purchases from new vendors

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Red Flags in Purchasing/ Inventory

- ❖ Purchases that bypass the normal procedures
- ❖ Vendors without physical addresses
- ❖ Vendor addresses that match employee addresses
- ❖ Excessive inventory and inventory slow to turnover
- ❖ Purchasing agents that pick up vendor payments

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Reasons Auditors Fail To Detect Fraud

- ❖ We mechanically “tick and turn,” and we are darn good at it!
- ❖ We don’t perform the basic, traditional audit tests and procedures
- ❖ Lack of substantive testing
- ❖ We avoid those “high risk” areas, especially if immaterial in amount
- ❖ Inadequate time budgets

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Reasons Auditors Fail To Detect Fraud

- ❖ Lack of training to recognize fraud indicators (But we sure can follow that audit program!)
- ❖ We don’t have adequate training in order to recognize basic internal control weaknesses and what can happen as a result of such
- ❖ We just don’t want to find fraud

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Reasons Auditors Fail To Detect Fraud

- ❖ We tend to accept any “Reasonable” auditee explanation for an audit exception. (Sounds good to me!)
- ❖ We ASSUME!

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ANALYZING RED FLAGS

- ❖ Recognizing the red flag is not sufficient
 - Action must be taken to determine the cause and possible effect
- ❖ Evaluate by
 - Financial analysis
 - Observation
 - Techniques which will mitigate the apparent weakness



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ANALYZING RED FLAGS

- ❖ Determine the effect on the business
 - Red flags are most likely a warning that something is wrong
 - If can not be explained, the next step is to conduct an examination
- ❖ Financial analysis is conducted to establish workable leads



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ANALYZING RED FLAGS

- Computer Analysis
- ❖ Listing of discounts, voids and refunds by employee
 - ❖ Actual vs budgeted reimbursements by employee
 - ❖ Unusual payment by vendor
 - ❖ Duplicate or fake SS No. by employee/vendor



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ANALYZING RED FLAGS

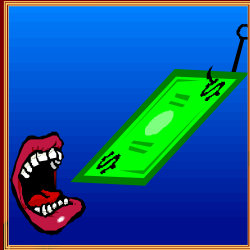
Computer Analysis

- ❖ Customer complaints
- ❖ Unusual patterns in overtime payments



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ANALYZING RED FLAGS



- ❖ Observation
- ❖ Correct the situation
- ❖ Educate the responsible area

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ANALYZING RED FLAGS CONCLUSION

- ❖ Red Flags are “Warnings”
- ❖ Do not ignore (They will be waiting for you!)
- ❖ There are no “Little Frauds”

They’re just little ones waiting to grow

And they grow real **FAST**

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That little *immaterial* fraud
that you passed on this year

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Will be the 800 pound gorilla in the
room when you come back next year ⁵⁶

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Closing comment from a CPA who attending my
Auditing For Fraud class in which I discussed
indicators of possible fraud.

Auditor: I want you to know that you caused me
not sleep a wink last night.

Me: Why?

Auditor: I laid there thinking about all of those
indicators of fraud you talked about and I've seen
them all but didn't recognize them for what they
were; and I keep thinking to myself:

My God What Have I Missed!

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