

**INTERGOVERNMENTAL
AUDIT FORUMS**

COLLABORATION
PROFESSIONALISM
INTEGRITY

Auditor Responsibilities for Detecting Fraud



by
Richard Woodford, JD/CFE

Objectives

- *Learn* terms & procedures to detect fraud, “irregularities,” errors, abuse, & illegal acts.
- *Identify* different attributes of fraud and fraud indicators (**RED FLAGS**).
- *Review* communications techniques to assist auditors in the detection of fraud.

Pearls Before Swine | *Stephan Pastis*

What is the common denominator?

Enron
WorldCom
Madoff Securities...



ALL THREE HAD CLEAN AUDIT OPINIONS!

*Timing Is Everything**




What is Fraud?

Fraud is
Hidden...

Lying

Cheating

Stealing



A Weekend at Bernie Madoff's?



Maddox	Madoff
1989	2008
Insurance Fraud	Investment Fraud
Life of the Party	Likewise
Dead	150 years in prison (age 71)

White Collar Crimes are...

Illegal Acts Using Deceit and Concealment

- Not by force or threats of force
- to get money, property, a business or professional advantage

White collar criminals **occupy positions of responsibility and trust:**

- in government, at all levels
- in every profession
- and in civic and social organizations

THE INSPECTORS GENERAL



Trust but Verify...

Deterring & Detecting **FRAUD** with

PROFESSIONAL SKEPTICISM



&

COMMUNICATION

Professional Skepticism

Maintaining an Open-Minded Attitude that

presumes Management and other Parties

are neither Totally Honest

nor Totally Dishonest.



Elements of Fraud

To prove fraud beyond a reasonable doubt, there must be:

- A *Material* false statement
 - made with *Knowledge*
 - *Reliance* by the victim
 - that causes *Damages*
- Federal False Claims Act – *the attempt to cause loss is sufficient, no actual damages are required.*

“Fraud” from GAO

Fraud is a type of *Illegal Act* involving the Obtaining of *Something of Value* through *Willful Misrepresentation*.

“Fraud” - According to the Institute of Internal Auditors

Fraud encompasses an array of

Irregularities and Illegal Acts

characterized by *Deception*.

“Fraud” from Webster

- **Deceit**, a deliberate deception...to secure unfair or unlawful gain;
- **Trickery**;
- One who defrauds: **CHEAT**
- One who pretends to be what he is not: **IMPOSTOR**.

Many Names, Same Game

- Deceivers, Magicians, Tricksters (Tricky Dick), Grifters...
- Cheats, card sharps, con men, scammers, swindlers, flim-flam, bunko artists...
- Posers, usurpers, impostors, fakes, charlatans, phonies, ...FRAUDS

“Fraud” from legal dictionary

- A *Willful Misrepresentation*
 - Of a *Material Fact*
 - that Deceives Another
 - and Causes Economic Detriment

As distinguished from *negligence*, fraud is always positive, intentional. It can include anything calculated to deceive: speech, silence, a look, gesture, omission, even the truth!

Statement of Auditing Standards

SAS #1: Auditor Responsibility

Responsibility to **Plan and Perform** the audit to obtain **Reasonable Assurance** about whether the Financial Statements are Free from **Material Misstatement**.

SAS #54

- Illegal Acts by Clients
- Distinguishes between Illegal Acts having a Direct and Material Effect on Financial Statement Amounts and Other Illegal Acts.

SAS #54

- If you become aware of a possible Illegal Act, apply procedures to obtain an understanding of the circumstances.
- Make inquiries of Management, at a Level above those involved, if possible.
- Very Difficult Situation:
 - When *Management IS Involved*.

SAS #54

- Adequately inform the Audit Committee, or Equivalent Authority, with respect to Illegal Acts.
- Ensure Material Illegal Acts are disclosed in any Audit Opinion.

SAS #99

Consideration of Fraud
in a
Financial Statement Audit



SAS #99

- **Description and characteristics**
- **Professional skepticism**
- **Risks of material misstatements**

SAS #99

- **Obtaining information to identify risks and identifying risks**
- **Assessing identified risks**
- **Evaluating evidence**
- **Communicating and documenting**

Fraud Detection Standards GAO Yellow Book

- Financial Audits (§4.10 & 4.27)
 - Design the audit to provide Reasonable Assurance of Detecting Material Misstatements due to violations of Contract provisions or Grant agreements
 - Be Alert to Situations or Transactions that could be Indicative of Abuse
 - Exercise Professional Judgment in pursuing indications of Fraud, Illegal Acts, Violations, or Abuse

Fraud Detection Standards GAO Yellow Book

Performance Audits: Planning §§7.06 - 7.27

- Design audit to provide Reasonable Assurance of Detecting Non-compliance that could significantly effect Audit Results, when Laws, Regulations, Contracts or Grant Agreements are Significant to Audit Objectives

Fraud & Abuse are covered in §§7.30 – 7.33

Fraud Detection Standards

- Could possible fraud significantly affect audit results?
- If so, extend the audit steps:
 1. Determine if fraud has likely occurred
 2. Determine the effects on audit results

Fraud Detection Definitions

- **Anomaly:**
 - An outcome that is other than the norm or what was expected.
 - An Anomaly can be an Indicator of an
 - Error,
 - Illegal Act, or
 - **Fraud.**

Fraud Detection Definitions

- **Errors:**
 - Unintentional Misstatements or Omissions in an Assertion.
- **Abuse:**
 - Conduct of program or entity falls far short of behavior that is expected to be reasonable & necessary business practices by a prudent person.

Fraud Detection Definitions

- **Illegal Acts:**
 - Violations of Laws or Governmental Regulations.
- **Concealment:**
 - Any attempt by a Perpetrator to reduce the likelihood of detection.

Fraud Detection Definitions

- **Employee Fraud:**
 - Committed by an Employee in which the Employer is the Victim.
- **Management Fraud:**
 - Committed by an Individual Serving in a Managerial Capacity.

Fraud Assumptions

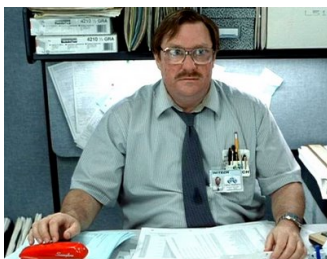
**Fr@ud
can
happen
to
you**



Little things, over time, add up...



I believe you have my stapler...



Lin Yutang

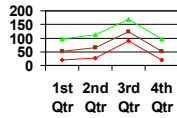
10 Oct 1895- 26 Mar 1976



“When a man is past forty and does
not become a crook, he is either
feebleminded or a genius.”

Fraud's Consequences

Loss of
Reputation,
Trust and
Confidence



Further costs of Fraud



- Administrative
- Civil Actions
- Criminal Enforcement
- Societal
- Psychological
- Personal

Audit vs. Fraud Examination

- | | |
|---|-------------------------------------|
| • Recurring | • Non-recurring |
| • General Scope | • Specific Focus |
| • Express an opinion
– non-adversarial | • Assess and affix
– adversarial |

Audit vs. Fraud Examination

- | | |
|---|--|
| • Data review
– analysis
– testing | • Document review
– Public records
– Interviews |
| • Professional Skepticism | • Sufficient Proof to sustain or refute allegations |
| • Predictable costs
– based on past work | • Costs will vary by task
– travel / testing / fees |

Audit vs. Fraud Examination

- | | |
|--|---|
| • Reasonable Assurance | • Evidentiary standard
-Never Absolute! |
| • Sampling | • Admissible proof and evidence to sustain or refute allegations |
| • Management's word is taken at face value | • No one is above suspicion
– Trust but verify
– Word taken under oath |

The Harsh Reality

Your Risk Management program
is only as effective
as the *Least trained employee*



The 5 Attributes of Fraud

- Victim
- Perpetrator
- Motive
- Oppportunity
- Scenario

Victim

The Entity, Person, or Persons

Harmed by

the Error, Illegal Act(s), Abuse or Fraud.

**A Company, Employees, the Government
or Taxpayers.**

Perpetrator

The Person or Persons Directly or

Indirectly Responsible for

an Error, Illegal Act(s),

Abuse or Fraud.

Motive

The Underlying Reason(s) that the

Perpetrator Decided or Might have

Decided to Initiate the Illegal Acts or

Fraud.

Opportunity

The Physical and Time Relationships that

Allowed the Perpetrator to Commit the

Error or to Initiate and Undertake the

Illegal Act(s), or Fraudulent Activity.

Scenario

**The Method of Operation
(*modus operandi*) -the Act or**

Series of Acts through which the

Perpetrator Carries out the Error,

Illegal Act(s), or Fraud.

“V-P MOS”

- Victim --- Perpetrator(s)
 - Motive
 - Opportunity
 - Scenario



Organizational Weaknesses Are Fraud Opportunities

- Inadequate Separation of Asset Custody from Asset Accounting.
- Inadequate Separation of Accounting Duties.
- Lack of Attention to Detail.
- Indefinite or vague Lines of Authority.

Dis-Organization fosters Fraud

- Infrequent Audits, Inspections, or Reviews.
- No Financial Disclosures.
- Inadequate or Missing Records.
- No Separation of Transaction Authority from Custody of Assets.

Fraud Tree

In the early 1990s, an ACFE research project classified 2,608 cases of occupational fraud. The researchers divided these offenses into three main categories, with 11 individual sub-classifications, that collectively form what has become known as the “fraud tree.”



© 2006 by Joseph T. Wells

COMMON CONTRACT FRAUD SCHEMES

- ★ CORRUPTION
- ★ CONFLICTS OF INTEREST
- ★ ANTI-TRUST VIOLATIONS
- ★ COST MISCHARGING
- ★ PRODUCT SUBSTITUTION
- ★ EMBEZZLEMENT
- ★ OTHER MISCONDUCT (Improper Information Sharing, etc...)

Common Grant Fraud Schemes

- ❖ Conflicts of Interest
- ❖ False Statements
- ❖ Lying About the Use of Funds
- ❖ Theft / Embezzlement

Conflicts of Interest

- ✓ **Typical Issues:**
 - ✓ Related Party Transactions (rental agreements...)
 - ✓ Grant / Sub Grant Award Decisions
 - ✓ Consultants: why, who, what, how, how much?
 - ✓ Grant Writer Fees / Contingent Fees
- ✓ Grants to For-Profit Entities = Potential Special Problems
- ✓ Internal or External Conflicts of Interest?
- ✓ Know your Grantee's Conflicts of Interest Statement/Policy

False Statements

- **Typical Issues:**
 - Labor Hours / Wages
 - Types of Equipment / Supplies / Events; Indirect Cost Rates; “Level of Effort”
 - Program Income / Matching Funds promised
 - Other Federal Grants Also Funding the Same Program or Project (undisclosed funding).

False statements, continued

- ➔ Statement Must be Material (“Victim” makes this determination, that’s U.S.)
- ➔ Financial Certifications must be supported with evidence
- ➔ There should be only one explanation for a cost or the accounting method used
- ➔ If a grant-funded activity did not produce the intended results then someone may have misrepresented about how the funds were used.

Embezzlement

- ✓ Invoices, price quotes, disbursement request forms, billing statements, etc are NOT proofs of payment.
- ✓ You must review bank records / cancelled checks to determine where the funds went – grantee books and records are often unreliable or unavailable.

Embezzlement cont’d

- ✓ Poor or no internal controls inevitably leads to theft because the opportunity is irresistible for many.
- ✓ Checks routinely written to employees as “reimbursement” for expenses should be carefully analyzed for patterns and expenditures.
- ✓ ATM / Debit / Purchase Cards are easy to abuse but they leave great records of purchases and withdrawals.

Embezzlement Scheme Considerations

- ★ Smart, Sophisticated Subjects (... Lin Yutang)
- ★ Most Believe They Will Remain Undetected
- ★ They are Often Years Ahead of “U.S.”
- ★ They are Usually Trusted & “Above Suspicion”
- ★ Anomalies Can Often Be Explained away as a “One-Time Honest Mistake” (reasonable doubt)
- ★ Most Embezzlers are Discovered by Accident / Tip

Every Auditor Must...



**Be Familiar with and Recognize
the Most Common Fraud Indicators.**

How to recognize a grant scam...

- **THE U.S. GOVERNMENT DOES NOT CALL TO "OFFER" YOU A GRANT.**
- **THERE ARE NO APPLICATION FEES FOR ANY U.S. GOVERNMENT GRANT.**
- **ALL U.S. GOVERNMENT GRANTS INVOLVE AN APPLICATION PROCESS**
 - NEVER TAKEN OVER THE PHONE
 - AND GRANT INFORMATION IS FREE.

Grant Fraud **Red Flags**...

- New or unknown to the government?
- Lacking strong internal controls and/or any separation of duties?
- Does the grant involve a complex or difficult to measure purpose (i.e. research or social programs)?

More grant fraud **Red Flags**

- Has the project timeline been compressed by the government or the grantee?
- Are the grantee's books and records disorganized, missing, or nonexistent?
- Is the grantee or an employee of the grantee under known financial strain?

Grant Fraud **Red Flags**...

- Is oversight / monitoring / fact-checking insufficient or absent?
- Is the grantee evasive, inconsistent or unresponsive when asked to explain how and where they used grant funds?
- Grantees have a duty to fully explain their spending when asked & to maintain records.

Contract Fraud Risk Factors to Consider

- Unknown / new contractor
- Circumvention of the procurement process
- Complex / technical product or service
- Compressed timeline for delivery
- Financial pressures (vendor or employee)
- Insufficient or absence of QA oversight
- Under-qualified vendors
 - Lack of capacity / knowledge / qualifications

Red Flags start here



Red Flags for “Pressure”

- Unfavorable economic conditions
- Heavy investment losses
- Dependence on one or two customers or products
- Excess productive capacity
- High debt loads
- Extremely rapid expansion
- Reduced ability to borrow
- Difficulty in collecting receivables
- Unusually high competition
- Urgent need for favorable earnings
- Significant litigation
- Costs rising faster than sales

Red Flags for “Pressure”

- High personal debts
- Living beyond means
- Extensive stock market speculation
- Gambling (addiction or high losses)
- “Extra-curricular” relationship(s)
- Unusual family expectations
- Excessive use of alcohol / drugs
- Frustration with job situation
- Perceived problems with organization
- Peer group pressures
- **Greed** or desire for personal gain
 - Resentment of superiors

Red Flags for “Opportunities”

- Very familiar with operations
- In position of trust, “above suspicion...”
- Close association with cohorts (suppliers)
- No communication about rules, and little discipline or oversight
- Rapid, high turnover of staff
- No annual vacations (Always there...)
- No rotation or transfers (Been here forever...)
- Inadequate personnel screening

Red Flags for “Opportunities”

- Absence of personnel policies
- No executive disclosures
- Weak or absentee leadership
- Dominant top management
- Always operates at crises levels
- Inadequate training program/process
- Little trust in key employees
- Poor attention to detail
- Poor or unrealistic performance measures

Red Flags for “Opportunities”

- Has related party transactions
- Complex business structure
- No or ineffective audit function
- Inexperienced people in key positions
- Extremely large decentralized organization
- Reluctance to provide auditors with information, or at the last minute
- Has different kinds of contracts with different agencies

Red Flags for “Opportunities”

- Poor internal controls, or no internal control review system
- Liberal accounting practices, or poor records
- Inadequate staffing in the accounting department
- Has poor time-keeping records OR
- Does not have originals signed by employees
- Time cards with multiple shifts between contracts

Red Flags “Opportunities & Indicators”

Accounting System

- Many contentious accounting issues
- Difficult to audit transactions
- Inadequate or missing documentation
- Unusual unexplained entries or changes
- Payments for cash
- Inordinately large transactions
- Photo copies instead of originals
- Large error rates
- Mix of government contracts (types)
- Losses on commercial contracts
- Low number of bidders

Control Procedures

- **Altered/suspect records**
- **Unauthorized transactions**
- **Nonserial numbered transactions**
- **Lack of operating procedures**
- **Assets not secured**
- **Poor time keeping system**
- **Uncorrected problems reported in prior audit**
- **No independent checks/reviews**

Red Flags “Opportunities & Indicators”

Control Environment

- One person in control
- No separation of duties
- Person living beyond means
- No prior audits
- Decentralized management without monitoring
- Evasive responses to audit inquiries
- Excessive attempts to delay audit
- Limitations on scope of audit
- Recent money problems
- Management admits to mismanagement in serious matters
- High turnover in senior staff
- Recent changes in working procedures
- Attempts to terminate audit
- Unusual concern with audit documentation
- Management too cooperative
- Conspicuous charity
- Unusual behavior

Red Flags “Rationalizations”

- Fraudsters often think of themselves as honest and law-abiding “victims.”
- “It was only borrowing...”
- “I didn’t take anything that wasn’t mine...”
- “Everyone does it...”
- “The company owes me this...”
- “It’s for a good purpose...”
- “It was only the one time...”

Red Flags “Rationalizations”

- “The ends justifies the means...”
- “I’ll pay it back...” or “I meant to...”
- “Around here, no one really cares...”
- “What I took is nothing compared to...”
- “It’s not like I broke any laws...”
- “It never was a problem before the audit...”

Fraud Prevention & Deterrence

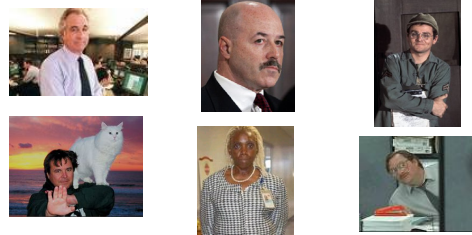
- “All Hands” employee education & awareness
- Proactive fraud policies & Communication
- High standards set by management, auditors, and investigators
- Increased use of analytical review & data analysis
- Ambitious fraud identification steps in audit programs
- An active reporting process by managers
- Anonymous, accessible hotlines.

Key Point for Deterrence

Employees and contractors who perceive that they will be caught engaging in fraud and abuse are less likely to commit it.

Ten Commandments for Fraud Detection

- Remember: **Anyone** can Commit Fraud.



Improved Fraud Detection



- Remember: **No Internal Control is perfect.**

Improved Fraud Detection



- Honor your Yellow Book and keep your continuing professional knowledge (CPE) current.

Improved Fraud Detection



- Always remember that documents can bear false witness just as easily as the people who present them to you.

Improved Fraud Detection

- Follow up on ALL tips, hunches, hints or rumors to verify whether they contain relevant, factual information.*

Experience builds confidence: have faith in yourself, your auditing skills, and your abilities to discern fact from opinion or fiction.

Improved Fraud Detection

- Use statistical sampling and data analysis tools to look for patterns and make note of all anomalies. A slight “irregularity” or “aberration” may be due to fraud.
- The *complete absence of errors* in any human undertaking is itself an anomaly to examine.

Improved Fraud Detection

- Do not covet “*different*” facts, documents, or data – work with all the information that you find and faithfully report all of your work.

HOPE is not an audit plan!

Improved Fraud Detection

- Develop a theory of fraud and proceed to test the theory and report the results of your audit testing.
- Rendering an verdict (opinion) of “guilt” or “innocence” is the role for a court of law.
- Reasonable assurance is not absolute!

Improved Fraud Detection

- Put **all** explanations to the test and persevere until your understanding of the answer(s) is complete.

Improved Fraud Detection

- Show respect to all you encounter and all shall recognize you as a professional by your manner and integrity.

Three Steps to Evaluate Internal Controls

1. Consider the types of Errors and Frauds that could possibly occur.
2. Determine the Control Procedures that would Prevent or Detect such Errors and Frauds.
3. Determine Whether those Controls are in Place and are being followed satisfactorily.

Integrating Fraud Detection and the Review of Internal Controls

- Understand and Document:
 - the Control Environment
 - the Accounting System
 - Existing Control Procedures
- Summarize all Strengths and Weaknesses

Questions to ask:

- What Opportunities for Fraud does this Weakness Provide?
- What are the Possible Motives of the Individuals Involved?
- Design Appropriate Tests and Evaluate Results.

Remember: No perfect controls!

Is there is a difference between the formal control System and the Informal Control System?

If yes, **why?**

What can happen “*informally?*”

Process of Elimination

- Error? One time or systemic?
- Illegal Act/Fraud? One time or systemic?
- Possible Fraud Attributes? **Red Flags?**

Errors

- Mistakes in Accounting Data
- Incorrect Accounting Estimates
- Misapplication of Accounting Principles

Illegal Acts / Fraud

- Fraudulent Financial Reporting
- Misappropriation of Assets
- Manipulation / Falsification / Alteration of Accounting Records

Errors, Illegal Acts & Fraud

1. Identify the underlying causes.
2. Attempt to Identify:
 - Potential Victim(s).
 - Possible Perpetrators.
 - Likely Motives.
 - Available Opportunities.
 - Probable Scenarios

Telling Errors from Illegal Acts/Fraud

3. If One or More Attributes are Clearly Missing, the Anomaly is Probably an Error.
4. If All Five Attributes (VP-MOS) are present, Fraud is Possible.
Formulate other Possible Scenarios.
5. Test Fraud Theory / Hypotheses through focused testing and questions.

Errors from Illegal Acts/Fraud

- Be aware that every anomaly is a potential Indicator of Fraud.
- Not all Red Flags are Frauds, but all Frauds have **Red Flags!**
- The more Fraud Indicators present, the higher the probability that Fraud is present.

Interviewing Skills

- **Communications** & Active Listening
- Keep Asking questions
 - Open-ended
 - Direct
 - Don't avoid asking at the top level
 - Keep asking until you understand
 - Do **NOT** assume terminology

Know more and more...

- **About**

• Less

and

less.



Ask These Questions...

As you know, part of my job is to help detect and deter fraud.

Do you have any reason to believe that this organization has any problem in that regard?

After the “Icebreaker” ask:

Has anyone in the organization
asked you to do
something that you thought
was illegal or
unethical?

Test the culture and reporting

- Icebreaker
- Specific request for information
- What would you do if someone asked you to do something that you thought was wrong?

The Moment of Truth

I am required to ask you one final question:

*Have you committed fraud
against this agency
(program, contract, grant, etc.)?*

Other possible questions

- If I wanted to commit fraud against this department, what would be the easiest way to do it?
- What frauds have occurred in the past?
- What do you perceive as the greatest risk to your department (grant, program)?
- If you become aware of illegal activity, may I ask you to contact me?

Review



Another Bite of Reality

Your **AUDIT PROGRAM**
is only as effective
as the *Least Trained Auditor*



Deterring & Detecting **FRAUD** with **PROFESSIONAL SKEPTICISM**



&
COMMUNICATION



The 5 Attributes of Fraud

Victim
Perpetrator
Motive
Opportunity
Scenario

What Do You Really Need to Know?

- The private sector has different ethics rules.
- Some contractors are strongly motivated by personal financial interests.
- We are all responsible to not use our positions for personal gain – or the appearance of gain.
- The FAR, internal controls, ethics laws and the procurement process all exist for a reason – any shortcuts should be causes for concern.
- Fraud/unethical conduct hurts everyone, including fraudsters.

Fraud Detection Resources

Your peers and other auditors/OIG's
• Share Information, when appropriate.

Professional associations

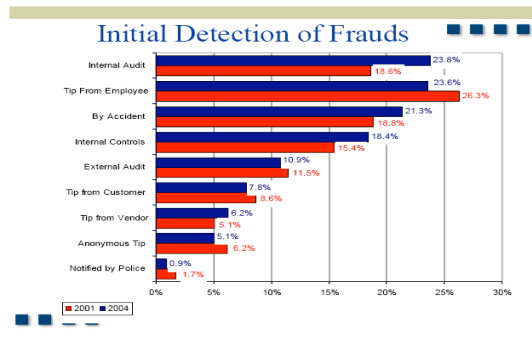
- ACFE www.acfe.com
- AICPA www.aicpa.org

Office of Government Ethics www.usoge.gov
Gov't Accountability Office www.gao.gov

*Appearance is everything



Auditor's Responsibility for Detecting *Fraud*



If you must **cheat**...choose carefully



Remember these points:

- The Ten Commandments for Fraud Detection
- Not all **Red Flags** are frauds
– But all Frauds have **Red Flags**
- When in doubt, Ask – *That is your job.*
- What you learned today should be put to practical use as soon as possible.

Acknowledgements

- MAMIAF & GAO for the invitation
- DOL OIG colleagues
- Joe Wells, CPA, CFE
- Michael Binder, EPA OIG
- Ken Dieffenbach, DOJ OIG
- YOU! *Be a Student, not an Expert.*

Questions? Comments?

Richard Woodford
U.S. Department of Labor
Office of Inspector General
(202) 693-7002
Woodford.Richard@OIG.DOL.GOV



**INTERGOVERNMENTAL
AUDIT FORUMS**

COLLABORATION
PROFESSIONALISM
INTEGRITY

- Keep up the good fight!