Fraud Risk Management for Internal Auditors

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CONTEX

Opportunity Knocks
In many organizations, the Internal Audit Team knows more about Fraud Risk Management than anyone else.

How can I use this? HCIUT? TRY B4 TOSS

CRITICAL FIRST STEP (most organizations ignore)
Correct Flawed Beliefs
• Beliefs lead to Actions
• Flawed Beliefs lead to Flawed Actions

Five Flawed Beliefs
1. We don't have much fraud
2. Our controls will prevent it
3. Managers and employees review reports
4. Our people know what their fraud responsibilities are
5. Most people would never commit wrongdoing or fraud

3 Campaign Levels
1. Deterrence and Prevention
2. Early Detection
3. Effective Handling

ORGANIZATIONS MUST BE PREPARED AT ALL THREE LEVELS
How Much Fraud Do You Have?
$________

Your fraud losses are 1% of revenue.
Here’s how to cut it in half in 18 months.
THE FRAUD PIE

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Honesty Scale

The Fraud Triangle
People (and Organizations) Change Over Time

Completely Dishonest — Completely Honest

Action 1
Recruit the CEO and Their Direct Reports

Recruit the CEO
Nothing Meaningful Happens Without Visible, Vocal CEO Involvement

Here’s Why

Visible and Vocal Leadership
1. The Chief Executive must lead the charge
2. Talk about it – explicitly
3. Invest in being actively involved in employee awareness and training
4. Make people feel safe to report suspicions
5. Appoint a trusted leader for the anti-fraud campaign and insist on results
Policy on Fraud Responsibilities
★★★★

1. Positive message
2. Manager and staff responsibilities
3. Exposure awareness
4. Procedures & behaviors to prevent
5. Procedures & behaviors to detect
6. What to do / what not to do
7. Emphasis on SUSPECTED acts
8. Annual certification -- ???

Make it Easy to Report

1. Make it as positive as possible
2. Fraud ‘Hotline’ in place, understood and trusted
3. Consider retaining a third-party service to administer your hotline
4. Tell everyone exactly how the hotline works

Nothing important happens unless all supervisors are committed to fighting fraud

Sample Policy on Fraud Responsibilities
TEXT audit to 720-613-2620

Introduction
Like all organizations, ours is faced with risks from wrongdoing, misconduct, dishonesty and fraud. As with all business exposures, we must be prepared to manage these risks and their potential impact in a professional manner. The impact of misconduct and dishonesty may include:

- the actual financial loss incurred
- damage to the reputation of our organization and our employees
- negative publicity
- the cost of investigation
- loss of employees
- loss of customers
- damaged relationships with our contractors and suppliers
- litigation
- damaged employee morale

Our goal is to establish and maintain a business environment of fairness, ethics and honesty for our employees, our customers, our suppliers and anyone with whom we have a relationship. To maintain such an environment requires the active assistance of every employee and manager every day.

Our organization is committed to the deterrence, detection and correction of misconduct and dishonesty. The discovery, reporting and documentation of such acts provides a sound foundation for the protection of innocent parties, the taking of disciplinary action against offenders up to and including dismissal where appropriate, the referral to law enforcement agencies when warranted by the facts, and the recovery of assets.

Purpose
The purpose of this document is to communicate company policy regarding the deterrence and investigation of suspected misconduct and dishonesty by employees and others, and to provide specific instructions regarding appropriate action in case of suspected violations.
How Fraud is Detected
1. Managers and staff
2. Internal auditors
3. External auditors
4. Third parties
5. The fraudster
6. Luck or accident

Every employee must be recruited into anti-fraud efforts

Clarify Fraud Expectations
1. Never assume that others know what you expect
2. Put it on the agenda at a staff meeting
3. Say, “We’ve never talked about fraud prevention and detection before – Here’s what I expect of you”
4. Include your thoughts on risks, awareness, prevention, early detection and proper response

Example Expectations Script
TEXT audit to 720-613-2620

Action 2
Active Fraud Risk Brainstorming

THE CHALLENGE
Fraud Risk Brainstorming: Think Like A Thief (when you don’t know how)
“Be aware of fraud risks” is imprecise and leads to confusion and uncertainty.

The Destination Must Be Clear

Some is not a number; soon is not a time.

“If you confuse me, you lose me.”
– Rachel Hanfling

Commonly Accepted Abbreviation for ‘Brain Storming’
B.S.

The Simple Beauty of “Hey Boss!” Questions
Fraud Risk Brainstorming: 3 Key Questions

1. How could someone exploit weaknesses in our controls?
2. How could someone override or circumvent our controls?
3. What could someone do in our organization to conceal their wrongful actions?

The Secret Sauce
...begin (plan) with the PRESUMPTION that a fraud incident has already occurred

Planning Target

Work Target

SAS 99
Required audit project team brainstorming session

- Chief Auditor present and active
- Homework is assigned in advance
- Many "Hey Boss..." questions
### Fraud Loss Scorecard

|   | Disbursements |   | Inventory |   | Construction/Facilities |   | Health Care Costs |   | Payroll |   | T&M contracts |   | T&E reimbursement |   | Other – Unique to You |   | TOTAL   |   |
|---|---------------|---|-----------|---|--------------------------|---|----------------------|---|---------|---|-------------|---|------------------|---|-------------------|---|---------|
| 1 |               | $ XXX |           |   |                          |   |                      |   |         |   |             |   |                  |   | $ XXX |   |
| 2 |               | $ XXX |           |   |                          |   |                      |   |         |   |             |   |                  |   | $ XXX |   |
| 3 |               |       |           |   |                          |   |                      |   |         |   |             |   |                  |   |       |   |
| 4 |               |       |           |   |                          |   |                      |   |         |   |             |   |                  |   |       |   |
| 5 |               |       |           |   |                          |   |                      |   |         |   |             |   |                  |   |       |   |
| 6 |               |       |           |   |                          |   |                      |   |         |   |             |   |                  |   |       |   |
| 7 |               |       |           |   |                          |   |                      |   |         |   |             |   |                  |   |       |   |
| 8 |               |       |           |   |                          |   |                      |   |         |   |             |   |                  |   |       |   |
|   |               | $ XXX |           |   |                          |   |                      |   | $ XXX |   |

### Managing the Business Risk of Fraud: A Practical Guide

**Action 3**

**Anti-Fraud ‘How-To’ Skills Training**

★★★★

### Effective Internal Controls

**Procedures**

**Behaviors**

### Anti-Fraud Controls

1. Fraud exposures are identified.
2. Specific control procedures and behaviors are developed, implemented and maintained to both prevent these events from happening and to detect them should they occur.
3. Controls include emphasis on both hard control procedures and soft control behaviors.

### Control Procedures

1. Leadership words and deeds
2. Culture of quality
3. Finance and accounting knowledge
4. Exposure assessment
5. Limited access
6. Policies, procedures and systems
7. Transaction initiation, review and approval
8. Effective screening (and re-screening)
Control Procedures Alone Do Not Prevent Fraud

The Limits of Controls
1. Control design, implementation and maintenance
2. No control is perfect
3. It’s a cat and mouse endeavor
4. Effective controls make a fraudster change their method
5. The cumulative nature of controls
6. What about small organizations?
7. Controls tend to break down over time

Effective Daily Human Execution Of Controls Prevents Fraud

MACRO Context

Which of the four options below would make the most significant impact on helping your organization be more effective in fighting fraud, misconduct, and wrongdoing?

- Implementing a Fraud Policy 14%
- Conducting an organization-wide Comprehensive Fraud Exposure Analysis, including the creation of a Fraud Risk Inventory 14%
- Providing awareness, prevention and early Detection Skills Training for managers and staff 62%
- Catching and Prosecuting Wrongdoers 10%
Who Do We Train?
1. All new hires
2. All new supervisors
3. Board members
4. Relevant third parties
5. Periodic reminders for everyone

Include real cases and documents
Find a way to say what happened

What Skills Are Needed
- General knowledge of fraud risks
- What can happen in their areas
- Suggestions on prevention
- Suggestions on prompt detection when prevention fails
- What it looks like in documents, reports and behaviors they see

How Do We Deliver Training?
1. Group live
2. Technology-based
   - Teleseminars
   - Webinars
   - Video
3. 1 on 1 coaching by supervisors
4. 1 on 1 by auditors
5. Written

Newsletters Article Ideas
Good Questions Before Approving:
1. Invoices from suppliers
2. Out of pocket cost reimbursement
3. Purchasing card transactions
4. Time sheets
5. Invoices from contractors
6. One-time wire transfers
7. Journal entries
Action 4
Look
Ask
Doubt
RESOLVE

Three-Step Fraud Detection
1. Think like a thief
   a) Individual and group brainstorming
2. Use discovery techniques aggressively
   a) Discovery-based tests
   b) Targeted interviews
   c) Continuous monitoring
3. Determine the cause of all fraud indicators surfaced
   a) Root Cause Analysis

100% testing produces reliable results

1. Look for fraud indicators
2. Use “How do I know?”
3. When in doubt, doubt
4. Resolve or refer suspicions

Probability of 1 in Sample, if population = 100,000

<table>
<thead>
<tr>
<th>Sample Size</th>
<th>Number of Problem Transactions</th>
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<tbody>
<tr>
<td>10</td>
<td>0.002 0.004 0.006 0.012 0.025</td>
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<tr>
<td>25</td>
<td>0.005 0.007 0.012 0.025 0.049</td>
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<td>0.010 0.015 0.025 0.049 0.095</td>
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<td>100</td>
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<td>250</td>
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<tr>
<td>500</td>
<td>0.098 0.140 0.232 0.385 0.634</td>
</tr>
</tbody>
</table>
Valid business license and TIN
Sent one low value item
UPS receipt – False security

Root Cause Analysis

If a condition exists is interesting
Why it exists is important

Root Cause Analysis

1. What happened?
2. What were the root causes of the problem?
3. What options are available that will deal with the problem?
4. What is the cost of acting upon each of the available options?
5. Which decision options will provide the most cost-effective solution?

Action 5

LEAD

“The Power of Presence”
Kristi Hedges

“The Power of Presence”
Kristi Hedges

“Every day is a bombardment of opportunities to persuade, influence, motivate, attract or inspire others”
Purpose = WHY?

Common Sense Must Become Common Practice

Move the Needle in 2017

It’s your time.

Questions, Comments, Feedback

Let me know how I can help!

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