FRAUD RISK ASSESSMENT
Building a Fraud Audit Program

Leonard W. Vona

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Preface

People commit fraud. Therefore, corporations, not-for-profit organizations, business systems, personal computers, and cell phones do not. This distinction is simple, but an important one to note. Fraud investigation from the accounting perspective naturally arose from the investigative tenets of auditing. Unfortunately, auditing standards, although requesting that auditors look for fraud, do not provide a way to adapt the existing audit tools to detect fraud. After spending more than thirty years performing diversified auditing and forensic accounting, I have developed a fraud audit theory, the principles of which will assist auditors in what traditionally has been one of their most nebulous responsibilities.

My theory includes the steps of a proactive approach in responding to fraud risk. Using a framework familiar to all auditors, the theory recognizes and categorizes the multitude of fraud schemes. The application of my fraud theory provides the necessary steps needed to, not only detect fraud specific to a situation, but that are indicative of the preventive actions to be taken.

The theory addresses the perpetrator's role in committing the fraudulent act. The auditor is not required to think like a perpetrator of fraud, a useless act, but to be as creative and intuitive in their response to fraud, as the perpetrator is in their pursuit of carrying out a fraudulent act. The difference between right and wrong is simple; however, people complicate the difference, by what they choose to desire. Hopefully, this book will help the profession understand the important consequences of wrongdoing with regards to fraud, thereby, making the auditor better equipped to detect fraud, and, lastly, to confer an understanding of the detrimental consequences of fraud, not only to the individual making the choice to commit fraud, but to society as a whole.

About the Author

Leonard W. Vona is a financial investigator with more than thirty years of diversified auditing and forensic accounting experience, including a distinguished eighteen-year career in private industry. His firm advises clients in the areas of fraud litigation support, financial investigations, and fraud prevention. He has successfully conducted more than one hundred financial investigations. With his extensive trial experience, he is a qualified expert witness and has been cited in West Law for the successful use of circumstantial evidence.

Mr. Vona lectures on fraud topics both nationally and internationally. He regularly speaks at audit conferences, and he has developed the fraud training curriculum for the MIS Training Institute, an internationally recognized audit training organization. Having provided more than one thousand days of fraud training to organizations around the world, he has been a member of the faculties of the National Association of Fraud Examiners and at Rensselaer Polytechnic Institute's Lally School of Management. In addition, Mr. Vona has written the training course on Auditor's Responsibility for Detecting Fraud, SAS No. 99, used by CPA Societies across the nation.

A graduate of Siena College in Loudonville, New York, having received a Bachelor's degree in accounting with honors, Mr. Vona is a Certified Public Accountant and a Certified Fraud Examiner. He was recognized by Arthur Anderson as one of the top 25 Audit Directors in North America. He is a member of the American Institute of Certified Public Accountants, the Association of Certified Fraud Examiners, and the Institute of Internal Auditors. He is a former President of the New York Capital Chapter of the Association of Government Accountants and the founding President of the Albany Chapter of Certified Fraud Examiners.

Acknowledgments

It is interesting to reflect on one's career, and wonder how I could go from Rensselaer Boys Club to writing a book on a subject that has been a part of my life for over thirty years. Undoubtedly, a countless number of professionals have helped me in reaching this point in my career. However, most of the credit goes to the women in my life, who have helped establish the values that have guided me. My perseverance and work ethic, I learned from the example set by my mom, known as Peachy. Compassion, I learned from my grandmother Edith. My choices of right over wrong, I owe to my great-grandmother, Ethel. The shaping of the person I am today is the result of the seemingly endless patience and encouragement given to me by my wife, Pat.

A special thank you needs to be made to Joel Kramer, who provided me with the opportunity to speak about fraud. In addition, I want to thank the MIS Training Institute for providing me with a platform to present my ideas about fraud. I also thank my numerous students over the years, whose questions have helped me improve the articulation of my fraud theory. Lastly, I wish to express my appreciation to my administrative assistant, Melissa Daley, who always kept me organized throughout the writing of this book.

Also, I would like to thank my editor, Shek Cho, for encouraging me to write this book.

Leonard W. Vona

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Fraud Theory

Auditors today are at a crossroads regarding how to incorporate fraud detection into their audit plans. Sarbanes-Oxley, Public Company Accounting Oversight Board (PCAOB) regulators, and the professional standards of auditing are requiring auditors to give greater consideration to incorporating fraud detection into their audit plan. Companies' boards of directors, management, and the public are asking why is fraud occurring and going undetected in our business systems. Auditors are asking themselves whether fraud can be detected when there is no predication or allegation of a specific fraud.

Traditionally, the auditing profession had two fundamental ways to deal with the fraud question:

1. Search for fraud using a passive approach of testing internal controls. The approach relies on auditors seeing the red flags of fraud. Although few audit programs incorporate specific red flags for audit observation, the assumption is that professional experience will provide auditors with the skills to observe the red flags.
2. React to fraud allegations received through a tip or some other audit source. Since studies continue to indicate that most frauds are detected through tips, we need to ask ourselves how effective past audit approaches have been.

Historically, the profession relied on evaluating the adequacy and effectiveness of internal controls to detect and deter fraud. Auditors would first document the system of internal controls. If internal controls were deemed adequate, the auditors would then test those controls to ensure they were operating as intended by management. The test of internal controls was based on testing a random, unbiased sample of transactions in the business system. Conventionally, audit standards stated that auditors should be alert to the red flags of fraud in the conduct of an audit. Study after study indicates that the lack of professional skepticism is a leading cause for audit failure in detecting fraud.

In one sense, the search for fraud seems like a daunting responsibility. However, fraud in its simplest form should be easy to find. After all, the key to finding fraud is looking where fraud is and has been. This book focuses on the use of fraud auditing to detect fraud in core business systems. Fraud auditing is a proactive audit approach designed to respond to the risk of fraud. Essentially, the fraud audit approach requires auditors to answer these questions:

- Who commits fraud, and how?
- What type of fraud are we looking for?
- Should fraud be viewed as an inherent risk?
- What is the relationship between internal controls and fraud opportunity?
- How is fraud concealed?
- How can we incorporate the fraud theory into our audit approach?
- What are the ways fraud auditing can be used to detect fraud?

BUILDING FRAUD THEORY INTO THE AUDIT PROCESS

Fraud auditing is similar to, but different from traditional auditing in several ways. Typically, an audit starts with an audit plan, whereby, risks are identified through a risk assessment, controls are linked to the risks, sampling plans and audit procedures are developed to address the risk(s) identified. The audit steps are the same regardless of the system(s) being targeted. Throughout the process, the auditor must have an understanding of the system(s) being audited. For example, to audit financial statements, auditors must understand generally accepted accounting principles (GAAP). In the same way, to audit a computer system, auditors must understand information technology (IT) concepts.

Using the Fraud Risk Assessment

If the steps are the same, then what feature makes fraud auditing different from traditional auditing? Simply, the body of knowledge associated with fraud. The fraud theory must be built into the audit process. Specifically, during the audit planning stage, auditors must determine the type and the size of the fraud risk. By performing a fraud risk assessment, the identified fraud risk is associated with the core business systems. As in the traditional audit, controls are linked to the risk, but in this circumstance it is the fraud risk that is targeted. By incorporating the fraud theory in the fraud risk assessment, the concealment strategies employed by the perpetrator(s) are also considered. Auditors rely on the red flags of fraud to prompt awareness of a possible fraudulent event, known as the specific fraud scheme. The sampling plan is used to search for the transaction indicative of the specific fraud scheme. Then, the audit procedure is designed to reveal the true nature of the transaction.

The Principles of Fraud Theory

Although the fraud risk assessment is a practical tool, there are principles upon which fraud auditing is based that auditors should know before initiating a fraud audit plan. These principles are as follows:

- Fraud theory is a body of knowledge.
- Fraud is predictable to the extent of how it will occur in a specific situation, not necessarily in the actual occurrence.
- The key to locating fraud is to look where fraud occurs.
- If you want to recognize fraud, you need to know what fraud looks like.
- People commit fraud, not internal controls.
- Fraud risk and control risk have similarities. However, fraud risk differs from control risk by containing the elements of intent and concealment.
- Fraud audit procedures must be designed to pierce the concealment strategies associated with the fraud scheme.
- Fraud audit procedures must validate the true economic substance of the transaction.
- Fraud audit comments differ from the traditional management letter or internal audit report.

ATM: AWARENESS, THEORY, METHODOLOGY

Fraud is like an ATM machine at a bank. Both are designed to withdraw money. ATM machines enable users to withdraw money from banks. Fraud is the withdrawal of funds from an organization. The funds may be embezzled directly, siphoned off through kickback schemes, or be the result of inflated costs due to bribery and conflict of interests. The fraud audit approach requires awareness, theory, and methodology (ATM) to detect fraud. Successful auditors need:

Awareness of the red flags of fraud:

- Fraud concealment strategies
- Sophistication of the concealment strategy
- Indicators of fraudulent transactions

Theory provides an understanding how fraud occurs in a business environment:

- Fraud definitions
- The fraud triangle

Methodology designed to locate and reveal fraudulent transactions. The methodology employed in designing a fraud audit program consists of the following stages:

- Define the scope of fraud to be included and excluded from the audit program.
- Verify compliance with the applicable professional standards.
- Develop the fraud risk assessment including:
  - Identify the type of fraud risk.
  - Identify business processes or accounts at risk.
  - Internal controls are linked to the fraud risk.
  - Concealment strategies revealed using the red flags of fraud.
  - Develop a sampling plan to search for the specific fraud scheme.
  - Develop the appropriate fraud audit procedures.
- Write the fraud audit report.
- Understand the fraud conversion cycle.
- Perform the fraud investigation.

The search for fraud is built on both awareness and methodology; however, both items are predicated on auditors having a sufficient knowledge of the science of fraud, hence the fraud theory. Auditors are not born understanding fraud. The awareness needs to be incorporated into the audit plan through audit team discussions during the planning stages. Audit programs must incorporate a methodology that responds to the identified fraud risks existing in core business systems.

Theory

The "T" in ATM stands for theory, specifically, fraud theory. Given that the knowledge of fraud theory is needed by auditors in order for "awareness" to be incorporated into the audit plan and for a "methodology" to be established, the specific elements of fraud theory need to be discussed as a first step.

Definitions Inherent to the process of searching for fraud is having a clear definition of fraud to be incorporated into the fraud risk assessment. Throughout the process, a thorough understanding of the fraud theory is critical to an auditor's success in preventing, detecting, deterring, and prosecuting fraud.

Auditors need to understand that fraud is an intentional and deliberate effort by the perpetrator to conceal the true nature of the business transaction. Fraud perpetrators have varying levels of sophistication, opportunity, motives, and skills to commit fraud.

The fraud risk assessment starts with a definition of fraud and the type of fraud facing organizations. The assessment can be based on a legal definition, an accounting definition, or the author's definition specifically designed for fraud risk assessments.

The Legal Definition

- A known misrepresentation of the truth or the concealment of a material fact to induce another to act to their detriment.
- A misrepresentation made recklessly without the belief in its truth to induce another person to act.
- A tort arising from a knowing misrepresentation, concealment of material fact, or reckless misrepresentation made to induce another to act to their detriment.
- Unconscionable dealing especially in contract law. The unfair use of power arising out of the parties' relative positions and resulting in an unconscionable bargain.

The legal definition requires auditors to understand the legal implications of the terms in the definition. The term "misrepresentation" includes concealment, nondisclosure, or false representation. The misrepresentation must relate to a material fact rather than a simple opinion. However, opinions made by an individual purportedly with superior knowledge could become a misrepresentation. Concealment, referred to as suppression of facts, is also a critical aspect of the misrepresentation. The courts have accepted these theories of concealment:

- Intentional concealment of known defects.
- Active prevention of the discovery of the defects.

- Uttering lies, with the intent to deceive.
- Nondisclosure typically does not rise to the level of fraud, unless a fiduciary relationship exists.

In reality, the use of the legal definition of fraud is impractical for most audit organizations simply because the definition is written for civil and criminal prosecutions.

The Accounting Definition Given the specific usage of the legal definition, auditors typically look to the applicable professional standards followed by the audit organization. The American Institute of Certified Public Accountants (AICPA) offers guidance in its Statement of Auditing Standards (SAS No. 99) as to the auditor's responsibilities to detect fraud that would have a material impact on the financial statements. The standards focus on financial statement and asset misappropriation schemes. Interestingly, the standard does not provide a definition of fraud. Rather auditors are guided by the standard definitions of errors in financial statements. An example of a professional standard applicable to fraud is the Institute of Internal Auditors Standard 1210.A2.

The Institute provides guidance on *Auditor's Responsibilities Relating to Fraud Risk Assessment, Prevention, and Detection*. The standard states that internal auditors should have sufficient knowledge to identify the indicators of fraud, but they are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud. The standard contains a section called "What is Fraud." This section states:

Fraud encompasses a range of irregularities and illegal acts characterized by intentional deception or misrepresentation, which an individual knows to be false or does not believe to be true. Throughout this practice advisory, and in PA1210.A.2-2, the guidance may refer to certain actions as "fraud," which may also be legally defined and/or commonly known as corruption. Fraud is perpetrated by a person knowing that it could result in some unauthorized benefit to him or her, to the organization, or to another person, and can be perpetrated by persons outside and inside the organization.

The institute provides guidance on auditor's Practice Advisory 1210. A2-2: *Auditor's Responsibilities Relating to Fraud Investigation, Reporting, Resolution and Communication.*

The Author's Definition of Fraud Acts committed on the organization or by the organization or for the organization. The acts are committed by an internal or external source and are intentional and concealed. The acts are typically illegal or denote wrongdoing, such as in the cases of: financial misstatement, policy violation, ethical lapse, or a perception issue. The acts cause a loss of company funds, company value, or company reputation, or any unauthorized benefit whether received personally or by others.

The Fraud Triangle Once a fraud definition has been adopted, the fraud triangle must be incorporated into the fraud audit plan. Therefore, fraud theory includes an understanding the fraud triangle.

The fraud triangle is generally accepted as part of the process of identifying and assessing fraud risk. The concepts are inherently simple. The fraud theory states that for fraud to occur there needs to be rationalization, pressure, and opportunity. The AICPA has referred to these three elements as the fraud risk factors or conditions of fraud.

Rationalization People rationalize. The reasons vary, but the justification always exists. Fundamentally, rationalization is a conscious decision by the perpetrator to place their needs above the needs of others. The ethical decision process varies by individual, culture, and experience. The ability to identify and rank rationalization is difficult on a person-by-person basis within the audit process, because of the fact that organizations are comprised of a number of individuals. Therefore, at an organizational or departmental level, the issues influencing individuals are easier to determine.

Pressures The pressures are the events occurring within the organization or in the individual's life. The pressures vary by the global risk factor. With the

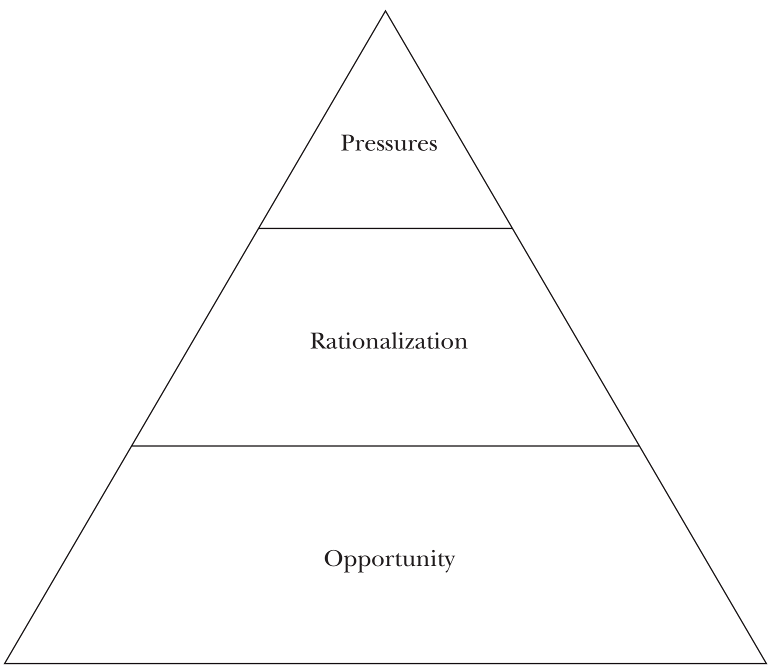

Exhibit 1.1 The Fraud Triangle

pressures of fraud, the individual's personal needs become more important than personal ethics or the organization's needs and goals.

The motive to commit the fraud is often associated with personal pressures and/or corporate pressures on the individual. However, the motive is actually the willful desire to commit the fraudulent act. The motive to commit fraud may be driven by the pressures influencing the individual, by rationalization, or by sheer opportunity.

Opportunity To commit a fraud, an individual must have access to the asset or manage a control procedure that allows the commission of the fraud scheme. A person's position, as well as, their responsibilities and authorization, also contribute to the opportunity to commit fraud. There is a direct correlation between opportunity to commit fraud and the ability to conceal the fraud. In assessing the fraud risk factor, auditors need to consider both opportunity and the ability to conceal in the design of an audit plan.

Premises Six premises must be understood in applying the fraud triangle concepts:

1. The three elements of fraud—rationalization, pressure, and opportunity—coexist at different levels per individual.
2. The elements of fraud will vary based on personal circumstances.
3. The strength of one element may cause an individual to commit a fraudulent act.
4. The strength of one element may eliminate the worry of detection.
5. Identifying the three elements is easier than measuring the three elements.
6. The fraud risk factors may originate from internal sources or external sources.

The three elements of fraud coexist at different levels within the organization and influence each individual differently. The strength of one element may cause fraud to occur or some combination of the elements. Perhaps the strength of an element may eliminate the perpetrator's fear of detection. Therefore, the fraud assessment process must consider the fraud conditions.

Measuring the three elements of the fraud triangle is not as simple as taking someone's temperature. The audit process should identify and understand how the fraud conditions lead to the likelihood of fraud. In reality, identifying the fraud condition is easier than measuring the elements. The audit process should be aware of the fraud condition, but ranking the three factors is highly subjective.