Fraud Insight and Auditors' Responsibilities

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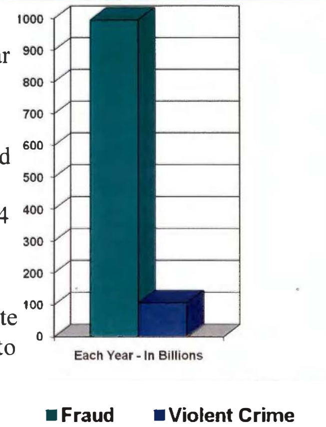
Fraud: A Growing Problem

- The economic losses to fraudulent activity each year are staggering.
- The Association of Certified Fraud Examiners estimates that fraud costs the US $994 billion dollars a year.
- That compares to its estimate of $105 billion dollars lost to violent crime each year.



Estimates of Fraud in the US

- **Health Agencies** – Cost of $68 billion per year.
- **Income tax payments** – Cost exceeds $200 billion per year. (Difference between what is due and what is paid).

  Credit Card Sales – Mastercard alone reports fraud costs at $48 million per year. (This is an estimate of 7% of all credit card sales.
- **Telephone Fraud** – Costs exceed $40 billion per year.
- An estimated **60% of Americans have shoplifted**. Cost to businesses exceed $12 billion per year.

Corporate Fraud Investigations

- Historically investigated tax evasion and related financial crimes in the business communities:

	FY 2009	FY 2008	FY2007
Investigations Initiated	123	117	124
Prosecution Recommendations	86	60	77
Indictments	90	80	53
Sentenced	72	57	51
Incarceration Rate	77.8%	78.9%	68.6%
Average Months to Serve	43	49	20

The Pervasiveness of Dishonesty

Not only are losses to fraud very high, but the prevalence of individuals who would act dishonestly are very high.

Here are some Unnerving Estimates!

- **A director of fraud and security for a large consulting company stated that out of every 10 workers, 3 look for a way to steal, 3 would steal if given an opportunity, and 4 would usually be honest.**
- **2 out of every 3 college students admit to cheating on exams.**
- **An Institute of Management study found that 87% of managers were willing to commit fraud if it would make their organizations look better.**
- **A study of 400 people found that 47% of top executives, 41% of controllers, and 76% of graduate level business students were willing to commit fraud by understating write-offs that cut into their company's profits.**

Who Commits Fraud – and Why?

Usually the perpetrator is a well-respected employee who seemingly has everything to lose and nothing to gain by committing the fraud.

3 Main Categories of Fraud

1. Asset misappropriation
2. Fraudulent statements
3. Bribery and corruption

**The education industry experiences the lowest median losses.

Shocking Facts about Fraud Perpetrators (1 of 7)

Many auditors describe the defrauders as having to be some of the best employees in order to perpetrate and cover up the fraud while performing at least satisfactory work.

- **38%** of perpetrators were described as being among the company's **best employees** prior to the detection of the fraud.
- **59%** were described as being **average employees.**
- **3%** were described as being **below average employees.**
- The most costly abuses occur in organizations with less than 100 employees.

Facts about Fraud Perpetrators
(2 of 7)

Most of the perpetrators were between the ages of 26 and 45.

- ✓ **14%** of perpetrators were younger than age 26.
- ✓ **38%** were between the ages of 26 and 35.
- ✓ **35%** were between the ages of 36 and 45.
- ✓ **13%** were older than 45.

Facts about Fraud Perpetrators
(3 of 7)

Most of the perpetrators were not able to operate their fraud for very long before they were caught.

- ✓ **51%** of the frauds were committed for less than a year.
- ✓ **22%** were committed from 1 or 2 years.
- ✓ **13%** were committed from 2 or 3 years.
- ✓ **14%** were committed for more than 3 years.

Facts about Fraud Perpetrators
(4 of 7)

The less time they were employed, the more likely they were to COMMIT A FRAUD.

- ✓ **26%** were employed less than 3 years.
- ✓ **15%** were employed between 3 and 5 years.
- ✓ **31%** were were employed between 5 and 10 years.
- ✓ **21%** were employed between 10 and 20 years.
- ✓ **7%** were employed more than 20 years.

Facts about Fraud Perpetrators
(5 of 7)

The older the perpetrator

The greater amount of the fraud.

Facts about Fraud Perpetrators
(6 of 7)

Most perpetrators were NOT college graduates

- ✓ **52%** had some high school education or had graduated from high school.
- ✓ **16%** had some college education.
- ✓ **26%** were college graduates.
- ✓ **6%** had some graduate school education.

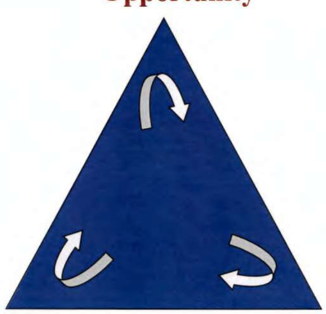
Facts about Fraud Perpetrators
(7 of 7)

More Interesting Facts

- ✓ **53%** of the perpetrators were men.
- ✓ Median losses caused by males are **3 times** those caused by women.
- ✓ **71%** of the frauds were perpetuated by a single individual; **29%** involved collusion.
- ✓ **Few frauds (18%)** were uncovered by auditors.
- ✓ **49%** of the frauds were uncovered by accident, and **33%** were uncovered by anonymous tips.

The Fraud Triangle

Opportunity



Pressure Rationalization

SAS 56, SAS 99, and SAS 110

Fraud Risk Assessment and New Guidance for Auditors

SAS 56 and SAS 110 Detection of Fraud

- **SAS 56, Analytical Procedures**, require that analytical procedures be performed in planning the audit with an objective of **identifying the existence of unusual transactions or events.**

- **SAS 110 gives direction as to obtaining sufficient audit evidence to provide a reasonable basis to form an opinion**
  - ***"The assessment of the risks of material misstatement at the financial statement level is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control."***

SAS 99

SAS 99 does REQUIRE additional procedures and provides additional guidance to make auditors more effective in identifying risky situations and then following through ***with a heightened level of professional skepticism.***

- *"The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud."*

Two Basic Types of Fraud

Two types of fraud are identified in our standards.

1) **Misstatements arising from fraudulent financial statements.**

2) **Misstatements arising from misappropriation of assets (sometimes referred to as theft or a defalcation).**

Responsibility of NPO

- The primary responsibility for the prevention and detection of fraud and error rests with both:
  - Those Charged with Governance
    - Oversight
  - Management
    - Tone at the Top

What is Tone at the Top?

- The ETHICAL ATMOSPHERE that is created in the workplace by the organization's leadership
  - Tone at the top will trickle down to employees
- Over 100 public company CEOs have been sued over the last 5 years for committing white collar crimes.
  - What message were these CEOs sending to their employees?
    - *Committing fraud is acceptable as long as it makes the company seem profitable*

SAS 99 Adopted An 8 Stage Approach As Follows:

Team Discussion of Fraud Risks	**Gather Information** of Fraud Risks	**Identify** Fraud Risks
Assess Fraud Risks	**Respond** to Fraud Risks	**Evaluate** audit test results.
Communicate about Fraud.	**Document** Fraud Considerations	

Fraudulent Financial Reporting (Detailed on Next 3 Slides)

Opportunities

Incentives/ Pressure

Attitude/ Rationalization

Fraudulent Financial Reporting * Opportunities *

1) Nature of Operations;
2) Ineffective Monitoring of Management;
3) Complex / Unstable Organizations; and
4) Weak Internal Control.

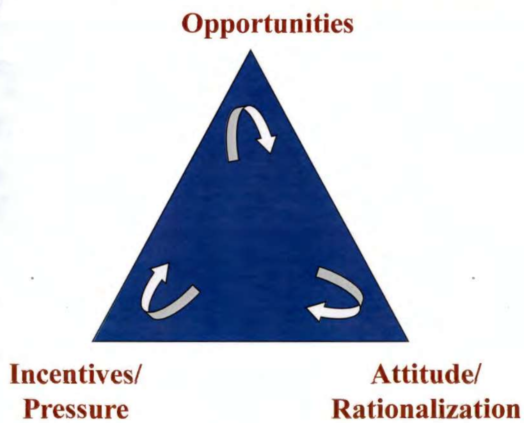
Fraudulent Financial Reporting
* Incentives/Pressure *

1) Economic, Industry & Operating Conditions;
2) Third Party Inspection;
3) Personal Financial State in Company; and
4) Rigid Financial Targets.

Fraudulent Financial Reporting
* Attitude/Rationalization *

1) Support for Ethical Behavior;
2) Aggressive Approaches;
3) Resort to "Materiality"; and
4) Strained Relationships.

Misappropriation of Assets
(Detailed on Next 3 Slides)



Misappropriation of Assets
* Opportunities *

1) Ease of Misappropriation; and
2) **Inadequate Internal Control.**

Misappropriation of Assets
* Incentives/Pressure *

1) Personal Financial Obligations; and

1) Adverse Employee Relationships.

Misappropriation of Assets
* Attitude/Rationalization *

1) Disregard for Internal Controls;
2) Employee Morale; and
3) Lifestyle Changes.

Auditors Responsibilities to the Risk of Material Misstatements

An auditor should respond to the identified risks of material misstatement due to fraud in the following ways:

1) Auditor response should consider how the risk will have an overall effect on how the audit is conducted.
2) Response should involve the nature, timing, and extent of the auditing procedures to be performed.
3) Response should include additional procedures to further address risk of material misstatements due to fraud involving management override of controls (given the unpredictable ways in which such override could occur. Examples include revenue recognition, inventory quantities and valuation, and management estimates.

In Addition, The Auditor should * DILIGENTLY *

1) Present examples of responses to identified risk of misstatements arising from misappropriation of assets;
2) Evaluate responses to further address the risk of management override of controls;
3) Examine journal entries and other adjustments for evidence of possible material misstatements due to fraud;
4) Review management's accounting estimates for biases that could result in material misstatements due to fraud; and
5) Evaluate the business rationale for significant unusual transactions.

Evaluating the Audit Test Results and Risk Assessment

The following conditions may be identified during fieldwork that support or change a judgment regarding the assessment of risks:

1) Discrepancies in accounting records;
2) Conflicting or missing evidential matter; and
3) Problematic or unusual relationships between the auditor and the client.

Further Evaluations by Auditor (1 of 2 Slides)

1) Consider the implications for other aspects of the audit;
2) Discuss the matter and approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and the audit committee.
3) Attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements and the auditor's report thereon;

Further Evaluations by Auditor (2 of 2 Slides)

4) Consider the need and timing of discussions with the audit committee or board of directors; and
5) If appropriate, suggest that the client consult with legal counsel.

Disclosure of Possible Fraud To The Appropriate Parties

The disclosure of possible fraud to parties other than the client's senior management and its audit committee **ordinarily is not the auditor's responsibility.**

*** * * HOWEVER * * ***

There are circumstances which present the auditor with a **Duty to Disclose.**

Conditions Presenting Auditor with a Duty to Disclose

1) To comply with certain legal and regulatory requirements;

2) To a successor auditor;

3) In response to a subpoena; and

4) To a funding agency or other specified agency in accordance with requirements for the audits of entities that receive governmental financial assistance.

In Conclusion

Remember that the auditor's work papers should thoroughly document:

1) **all procedures, tests, observations, outcomes, and conclusions, and**

2) **all communications with any and all internal/external parties to the audit.**