Auditor Responsibilities to Detect and Deter Fraud

Presented to APIPA 2010
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Outline: How can auditing detect/deter fraud?

I. **What do the Standards Say?**

II. **Audit Planning/Risk Assessment (Detect)**

III. **Audit Fieldwork and Reporting (Confirm)**

IV. **Audit Assistance to Management and the Board (Prevent or Deter)**

V. **Audit Services to Support Investigations**

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Exercise #1: How do you currently identify fraud issues as they pertain to your audit environment?

(List or describe 2-3 processes, tools, techniques, etc.)

I. Standards and Guidance Provided by IIA and GAO for the United States

- **IIA provides Code of Ethics, Attribute and Performance Standards, and new Practice Guide "Internal Auditing and Fraud"**

- **GAO provides Ethical Principles, General Standards, and Specific Audit Project Level Standards for Fieldwork and Reporting**

What do the IIA Standards Say About Fraud Audit Work at the Engagement Level?

- **1220.A1 – Exercise due professional care ("skepticism") by considering the probability of significant errors, fraud, or noncompliance.**

- **2120.A2 – Evaluate the potential for the occurrence of fraud and how the organization manages fraud risk.**

- **2210.A2 – When establishing audit objectives, consider the probability of significant errors, fraud, or noncompliance.**

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What do the GAO Standards say?

- **7.32 – Professional Judgment – Exercise reasonable care and professional skepticism.**

- **7.28 – Noncompliance – Assess risk of violation of laws, regulations, contracts, grants within context of audit objectives.**

- **7.30 – Fraud - In planning the audit, assess risks of fraud occurring that is significant within the context of the audit objectives.**

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What do the GAO Standards Also Say?

- **7.32 – Throughout the audit, if information comes to auditors' attention that fraud may have occurred, auditors should extend the audit steps and procedures to determine whether fraud has likely occurred.**

- **7.34 – Abuse - During course of audit, if auditors become aware of abuse, ascertain the potential effects within the context of the audit objectives.**

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Requirements of Law, Reg., Contract, Grant –Design Audit to Detect Non-Compliance

- **Determine provisions of laws, regulations, contract or grant applicable to audit objectives.**

- **Assess risk that illegal acts or violations of those provisions could occur.**

- **Based on that risk assessment, auditors should design and perform procedures to provide reasonable assurance of detecting violations that are significant within the context of the audit objectives. (par 7.28)**

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Identify Potential Illegal Acts and Significant Abuse

- **Consider risks due to fraud that could significantly affect the audit objectives and the results of the audit**

- **Be alert to situations or transactions that could be indicative of fraud or significant abuse**
  - Be aware of inherent risk areas
  - Be alert to "red flag" indicators
  - Design planning process to provide reasonable assurance of detecting potential fraud that is within the audit objectives and scope

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Some Indicators of Potential Fraud (See Yellow Book A.08)

- **Unsupported costs**
- **Inventory shortages**
- **Unexplained overruns**
- **Contracts not documented or monitored**
- **Defective materials**
- **Altered documents**
- **Unauthorized subcontracting**

- **Bid rigging**
- **Mischarged costs**
- **Unallowable costs**
- **Excessive overtime**
- **Conflicts of interest**
- **No duties separation**

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Performance Audits – Planning

Auditors' responsibility for abuse

If auditor becomes aware of indications of significant abuse, auditors perform audit procedures to determine

    1. whether abuse has occurred, and

    2. the potential effect on the subject matter of the audit.

However, because the determination of abuse is subjective, auditors are not required to provide reasonable assurance of detecting abuse.
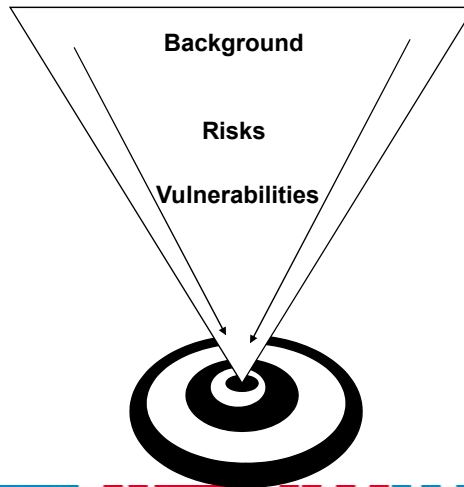

December 2009 IIA Practice Guide on Internal Auditing and Fraud

- **Auditing management controls over fraud (auditing the fraud risk management system)**

- **Auditing to detect fraud by testing high risk processes (fraud audit)**

- **Considering fraud as part of every audit (focus here because Yellow Book does and can incorporate auditing internal controls)**
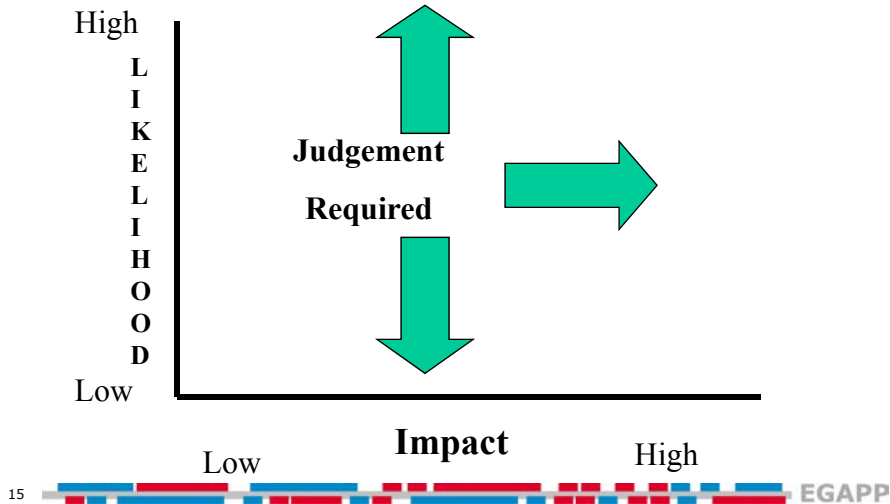
II. Planning the Audit (Detect)

Background

Risks

Vulnerabilities

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Performance and Internal Audit Planning (see Handout Appendix A)

- Office/Entity Level R/V
- Audit Project Level R/V

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Evaluating Risk and Selecting Programs to Audit

High

L
I
K
E
L
I
H
O
O
D

Low

Judgement

Required

Impact

Low

High

15

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Critical Factors

- **Judgment & courage**
  - Some people consistently identify the right programs to audit the high risks & the high impact issues
  - Others develop mediocre issues - avoid controversy, do not take on the tough issues, no insight, limited experience or knowledge, and ultimately audit the wrong programs.

16

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Three Key Questions to Ask About Vulnerability to Fraud

- **Where are the opportunities for fraud?**

- **What is the level of pressure management is under that would lead it to override internal controls?**

- **Are there any consequences if management fails to reach goals?**

Source: IIA's Practice Guide on IA and Fraud

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Exercise #2: Which police program do we select for in depth audit work?

- **SWAT Team Response To Emergency Incidents**

- **Police Motorcycle Patrol During Rush Hour**

- **Inventory of Drugs, Cash, and Other evidence**

--**Where are we more likely to find performance risks? Why?**

--**Where are we more likely to find fraud risks? Why?**

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Audit Planning – Identify Performance and Fraud Issues; Develop Audit Objectives and Fieldwork Plan Based on Risk and Vulnerability Assessment

- **Assess inherent risk (significance, sensitivity, and susceptibility)—see Handout Appendix B**

- **Assess vulnerability (control risk)**

- **Assess auditability**

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Five Key Steps Per New IIA Practice Guide

1. **Identify relevant fraud risk factors.**

2. **Identify potential fraud schemes and prioritize them based on risk.**

3. **Map existing controls to potential fraud schemes and identify gaps.**

4. **Test operating effectiveness of fraud prevention and detection controls.**

5. **Document and report the fraud risk assessment.**

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**Austin's Approach Over the Years
(Customized to the Audit Objectives)**

Consult with investigators in determining:

- **Fraud risks for City functions**

- **Common red flags of fraud for City functions affected by the audit objectives**

- **Prior fraud-related findings related to audited area**

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Austin's Approach Over the Years (Cont.)

- **Types of fraud questions to ask**

- **Who and in what order to conduct interviews**

- **Techniques and procedures most effective in detecting fraud in the audited area**

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Risk/Control Relationships

Relationships Between Inherent Risks, Internal Controls and Control Risks

Inherent Risk	Internal Controls	Control Risk
High	Weak	High
	Adequate	Moderate to High
	Strong	Low to Moderate
Moderate	Weak	Moderate to High
	Adequate	Low to Moderate
	Strong	Low
Low	Weak	Low to Moderate
	Adequate	Low
	Strong	Very Low

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Criteria for Judging Internal Controls

- **Weak = controls missing, management unaware or management aware, but no action**

- **Adequate = controls exist but may not be best practice, or action is insufficient**

- **Strong = controls effective or best practice**

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Vulnerability Table—see Handout Appendix C

Inherent Risk	High/Low	High/High ★
	Low/Low	Low/High

Control Risk

Auditability

Auditability is determined by:

- **Audit skill**
- **Audit power**
- **Audit hours**
- **Audit morale**
- **Availability of Evidence/Information**
- **Timeframe**

Audit Planning Grid

```
                    QII         QI

        Vulnerable


                    QIII        QIV

           Not
        Vulnerable


                    Not        Auditable
                   Auditable
```

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Develop Fieldwork Plan

- **Assess Vulnerability/Final Risk**
  - Inherent Risk
    - **Risk without controls**
  - Control Risk
    - **Risk with controls**
- **Assess Auditability**
- **Propose Risks/Vulnerabilities for audit and develop fieldwork plan**

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Case Study Exercise #3: Identify the H/H Performance Issue and the H/H Fraud Issue
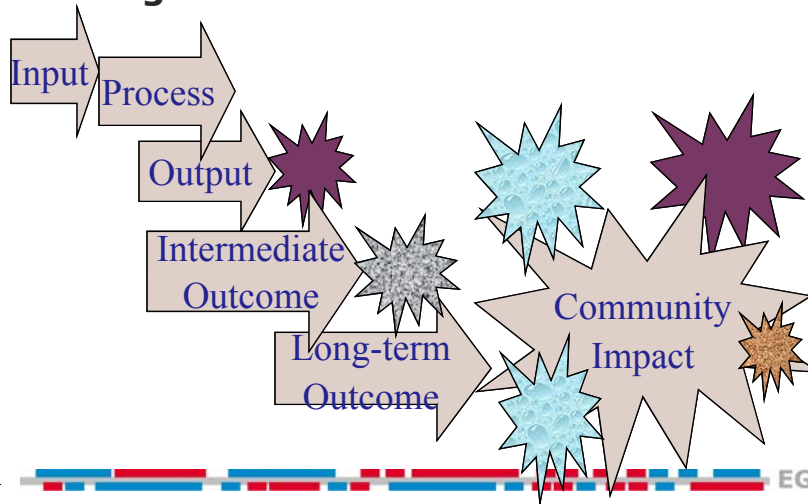
State Program to License and Regulate Foster Homes

See Handout Appendices D and E

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What Audit Planning Success Looks Like

- **Select the most important programs to audit**

- **Select the most important risks and vulnerabilities within the programs**

- **Develop significant effects through measurement based performance auditing**

- **Base recommendations on underlying causes**

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III. Measurement Based Approach:

Define Government Program or Private Sector Activity Before Assessing Fraud Risk and Measuring Performance

Input

Process

Output

Intermediate Outcome

Long-term Outcome

Community Impact

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Fieldwork and Reporting: How to Conduct a Measurement Based Audit

- **Identify the program's inputs, processes, outputs, and outcomes**

- **Identify program's performance expectations**

- **Develop performance audit objectives based on risk and vulnerability assessment or client request**

- **Assess existing performance measurement system including relevance and reliability of measures**

- **Develop and implement "ad hoc" performance measurement system**

- **Using selected performance expectations as "criteria" and measures as "condition," analyze program performance**

- **Identify causes of variances and develop audit recommendations**

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Exercise #4: How might you detect fraud during the fieldwork phase of the audit?
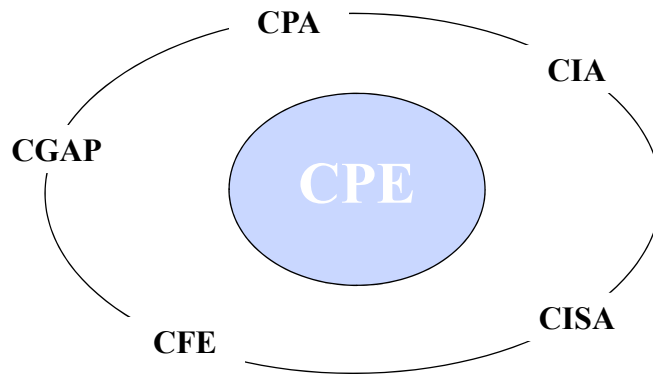
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IV. Audit Assistance to Management and the Board

--Prevent (Advise on COSO/ERM especially ethics and other "soft controls")

--Deter (Auditing Organization's Fraud Risk Management System)

--Detect (HR and Technology Tools)

--Resolve (Advice on I/C Improvements, Training, and Reporting)

--Analysis of lessons learned (prevention)

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Certifications Provide Credibility to Advise and Assist

CPA

CIA

CGAP

CPE
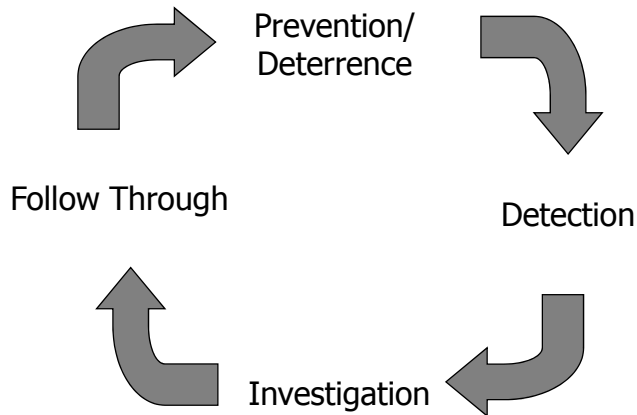
CFE

CISA

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Technology Tools Increase Auditability

- **ACL**
- **SAS**
- **GIS**

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V. Audit Support of the Integrity Services System and Investigations

Prevention/Deterrence

Detection

Investigation

Follow Through

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EXAMPLES FROM THE CITY OF AUSTIN

--Performance Auditors Work with Investigators

--Management Integrity Committee

--Citywide Administrative Bulletin on Fraud, and Other Integrity Violations

--Training and new employee orientation from the City's Ethics Officer

--Detection mechanisms including hotline, posters, and Citywide Annual Employee Confidential Survey

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Conclusion: Audit and Investigative Environment Becoming Increasingly Complex

- Human Capital

- Knowledge/Information Management

- Economic and Financial Sustainability

- Globalization

- Accounting and Reporting

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Conclusion: Internal/Performance Auditing to Optimize Performance and Discourage Fraud

- Auditing ethics and corruption

- Auditing governance structures

- Auditing through intergovernmental and global partnerships

- Auditing with "worldwide best practices"

- Auditing organizational culture and values

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