

PREVENTION AND DETECTION OF FRAUD A Challenge to the Internal Auditors

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Abstract

Controls are an important element in fraud prevention. Organizations with highest level of controls are least susceptible to fraud. On the other hand,, organizations that go overboard on controls do not necessarily experience less fraud, but they do have more costs.

Besides that, this article also covers problems of controlling and protection against fraud by insiders or outsider must be cost feasible and adequate in relation to the assets they are protecting. Companies must also strive for minimum expenditure while guaranteeing maximum protection.

Fraud : a matter of definition

Fraud is as old as mankind; one can say that when Adam ate the forbidden apple he committed a fraudulent activity. Fraud, if allowed to continue, could destroy organizations and bring countries down into serious financial and economic difficulties.

Moreover, in some countries, fraud has become institutionalized and being practiced by the majority of people. As consequence, if fraud is committed, people and authorities will look the other way.

Fraud in general is defined as this:

The intentional improper usage of resources and the misrepresentation of facts to receive gain

In the UK, the Auditing Practices Board (APB) defines fraud as:

The use of deception to obtain an unjust or illegal financial advantage and intentional misrepresentation affecting the financial statements by

one or more individuals among management, employees or third parties and fraud may involve:

- Falsification or alteration of accounting records or other documents.
- Misappropriation of assets or theft.
- Suppression or omission of the effect of transaction from records.
- Intentional misapplication of accounting policies or willful misrepresentation of transaction or of the entity's state of affairs.

In plain words, fraud is intentional deception; since it includes lying, cheating, embezzlement, stealing and money laundering.

Embezzlement is the improper conversion of assets by persons, who has responsibility to take care the asset for his own purpose. While money laundering is a term used to describe the process of concealing and converting cash that has been earned illegally to another payment medium, there is also the intent of altering the

appearance of the origin of funds from illegal to legal.

Therefore, the Institute of Internal Auditors, Inc. (IIA) defines fraud as:

"An array of irregularities and illegal acts characterized by intentional deception. It can be perpetrated for the benefit of or to the detriment of the organization and by persons outside as well as inside the organization."

The IIA issued in 1985 (continued by its revised in 1988 its standard No. 3 Deterrence, Detection, Investigation and Reporting of Fraud. The Treadway Commission Report provides such a support for the IIA Standard by conforming the auditor's responsibilities to detect and prevent fraud.

A need for the establishment of an effective internal control system has eventually been forwarded to the Commission of Sponsoring Organizations (COSO) in the US and other countries, notably, Canada, the United Kingdom, South Africa and Australia. These countries have all established Commissions and Committees to examine the issue of Corporate Governance ; those institutions are run by independent board encompasses the framework of internal control.

In addition, the act that have given the largest stimulus to the internal audit profession was the Foreign Corrupt Practices Act (FCPA) enacted into law in 1977 in the United States. This was not an Act that addressed fraud in American court powers to the US Government Justice Department and the Securities and Exchange Commission (SEC) to prosecute in a US Court of Law any employee, officer, director or agent of the company acting on behalf of the company regardless of

nationality or citizenship. It would be taken into practice if there were violation of the FCPA anti bribery provisions.

What is fraud

Fraud occurs when all of the following elements exist:

- ✓ An individual or an organization intentionally makes an untrue representation about an important fact or event.
- ✓ The victim believes the untrue representation.
- ✓ It is made with the intent that it should be acted upon.
- ✓ The victim relies upon and acts upon the untrue representation.
- ✓ The victim suffers loss of money and/or property as a result relying upon and acting upon the untrue representation.

Creating the conditions for fraud

Fraud is an act deception. The perpetrator of the fraud hopes that the act of fraud will not be detected and that he will be able to conduct his deception for an unlimited period of time. A fraudulent act is rarely conducted spontaneously but is a result of careful planning.

A fraud does not take place just because an opportunity exists. The individual must be drawn towards committing the fraud and an individual is drawn towards committing fraud through intolerable pressures exerted in his daily life while these pressures may be as a result of his work or external to the organization.

Opportunity is a situation that can be addressed by management and opportunity for fraud is increased when security over access to assets is reduced and attitude may be affected by the tone set by top management or the culture of the organization.

Types of fraud

From an audit perspective fraud can be looked at from the perspective perpetrator.

Looking this was, fraud can be classified as management fraud or employee fraud. Seniors managers of the company commit management fraud, while employees who are at a lower level in the organization commit employee fraud.

Another way is to classify fraud as being committed against the company and frauds that benefits the company.

a) Fraud by top management

Senior managers wish to enhance the financial position of the company by falsely overstating revenue, sales or assets or understating expenses or liabilities.

Normally fraud by top management is made to deceive shareholders, bankers, creditors or the other regulatory authorities.

b) Fraud against the company

Fewer persons may commit fraud against the company and the beneficiary is the person committing the fraud and the victim is always company.

Fraud against company may be committed by persons within the company or by external parties [*sic!*] while fraud by external parties may include vendors, suppliers, contractors, customers, consultant etc.

Fraud through bribery of employees is more difficult to detect through audit procedures as accounting records are not manipulated or altered.

Developing fraud auditing skills

Fraud auditing is more an art than a science and fraud auditors can be compared to detectives as both are after seeking the truth. Fraud auditors are concerned with proper accounting

and business transactions whilst detectives are concerned with behavioral patterns of citizens.

Fraud auditors look for patterns that are unusual or are exceptions or do not fit with the norm. Types of exceptions may be those which are too high, too small, too low, too frequent, too many, too few or occur at odd time, place, location, hour, etc.

Fraud auditor must know the universe of fraud possibilities, the behavior patterns of individuals and where the fraud is most likely to be targeted and he must also to understand some of the investigate techniques such as lapping.

In addition, fraud auditors must examine the nature of work sharing and responsibilities in the organization. An employee taking too much responsibility or delegating too much responsibility to subordinate will create an opportunity to steal.

In essence, a fraud auditor should be able to look fraud from different angles or perspectives, namely:

- organization
- cultural
- economic
- competitive
- motivation
- regulatory
- accounting
- internal control

and should be able to do the following tasks competently:

- Review all the links in the system of internal control
- Observe deviations from accounting standard principles
- Determine the control features that can be bypassed by senior management
- Design scenarios for potential fraud based on known weakness

in the system and test for occurrences

- Review supporting documents for questionable transactions in great detail for originality and support to other dependency documents

and fraud occur among others when the following conditions exist:

- Lack of proper procedures for authorization
- Lack of separation of transactions authority from custody of assets
- No independent check on performance
- No separation of custody over assets
- Department are infrequently audited or reviewed

Improving the odds of detecting fraud

Controls are an important element in fraud prevention. Organizations with highest level of controls are least susceptible [*sic!*] to fraud.

However, organizations that go overboard on controls do not necessarily experience less fraud, but they do have more costs.

Control to protect against fraud by insiders or outsider must be cost feasible and adequate in relation to the assets they protecting and companies must strive for minimum expenditure with maximum protection.

Laws against fraudulent activities must be fair, rational and intended to serve the company's best economic interest. The punishments and prohibitions must be applicable to the crime, any act that can or does result in substantial loss, damage or destruction of the company assets must be prohibited.

Principles in selecting internal control

Controls are also perceived to add a degree of inefficiency in the business process. Too much internal control therefore increases costs as well as makes processes ineffective and inefficient. However, controls are an important element in fraud prevention.

Cost of controls is easier to calculate than the benefits they bring. Costs are quantitative while benefits are qualitative measures. Balancing control needs is important as they impact behavioral patterns of people as too much control may:

- Impair productivity
- Add to employee burden
- Impose unnecessary tasks
- Indicate absence of trust and lead to suspicion
- Impact job satisfaction
- Discourage judgement and discretion

Negative connotation to control can be overcome by:

- Goals and objectives and control standards should be attainable without extraordinary efforts.
- Install controls when they are necessary for prudent management.
- Evaluate the continued need for the control.
- Install tight controls deep down the organization rather than at higher levels of management, otherwise management becomes more like detectives and get too much involved in detail.

Auditors against money laundering

The accounting bodies within the Consultative Committee of Accounting Bodies signed up to the European Commission's initiative to fight organized crime. The profession is particularly sensitive to allegations that it is turning its back on financial crime such as money laundering.

Nevertheless it is hardly reasonable to claim that accountants are turning a blind eye to money laundering. The Auditing Practices Board in May 1997, in their Practice Note 12, has already advised auditors with a Statement of Auditing Standards (SAS 120). It requires that auditors when they become aware of a suspected or actual non compliance with law and regulation which give rise to a statutory duty to report, to make report to appropriate authority without delay.

This guidance points out that failure to report knowledge or suspicions of drug money laundering, or arrangement facilitating the retention, or control of terrorist funds, or the proceeds of terrorist related activities, or the provision of financial assistance for terrorism, constitutes a criminal offence. And that any suspicion of such activities should be reported to the authorities.

The guidance goes on to say that it is therefore critically important that auditors of all entities make careful assessment for matters which put them on notice of money laundering, in order to determine what type of activity may be involved and what obligations or consequences arise.

When auditing the financial statements of a regulated entity undertaking financial business, auditors have statutory duty to report to the regulator. Which are matters that significance to the regulator's function and knowledge, or suspicions by the auditor of involvement by the directors of the client in money laundering, or any failure to comply with money laundering legislation, would normally be examples of this.

Red flags of fraud

Fraud Policy:

Management is responsible for establishing and maintaining a system of internal control that provides reasonable assurance that improprieties are prevented and detected. Each manager should be familiar with the types of improprieties that might occur in his/her area and be alert for any indication that such defalcation, misappropriation or other fiscal irregularity has occurred.

Objective: Introduce the "Red Flags" of Fraud.

How Fraud Occurs: Motive, Opportunity and Justification set the stage for fraud.

MOTIVE

- ✓ Greed
- ✓ Financial crisis
- ✓ Gambling/Drinking/Drugs
- ✓ Living Beyond Means
- ✓ Love affairs
- ✓ Family Problems
- ✓ Mid-life crisis
- ✓ Easy Money

OPPORTUNITY

- ✓ Poor or weak internal control system
- ✓ Lack of monitoring the controls
- ✓ High management turnover

JUSTIFICATION

- ✓ It was so easy
- ✓ They don't pay me enough
- ✓ My daughter is sick
- ✓ True crisis/divorce

What to watch out for:

- Unexplained variances
- Missing reports/documents
- Failure to investigate reconciling items
- Duplicate payments of documentation is not original
- Using "exemption" to use particular vendor over and over

Business tips for deterring white collar crime

Over recent months millions of dollar losses have been reported due to fraudulent behavior at various companies. Even more is the fact that most of these cases involved corruption at the very top of the organizations or involvement of some senior executives in the money laundering of proceeds derived from illegal transactions such as drugs dealings, selling of illegal fire arms, commissions/kick backs, etc.

Such fraud can and should be detected long before irreparable damage is done. Directors and senior executives who insists on an effective system of internal control and a strong corporate governance structure are taking proactive steps to protect shareholder value.

The Institute of Internal Auditors recommends that companies everywhere should:

1. Exhibit an ethical "tone at the top".

If senior management sets an example by demonstrating impeccable ethics in all business dealings then employees will be more likely to follow.

And when on going organizational discipline and structure are maintained and honest and open communications are encouraged, the stage is set for positive results.

2. Hire only the most honest and ethical employees.

Regardless of how many controls are placed within the organization, there is no substitute for hiring good people with only the highest ethics and integrity. Employees should conduct thorough background checks when hiring employees at all levels.

And if internal fraud is detected, employees must press charges as white-collar criminals get off too

easily. Failure to prosecute not only allows the perpetrator the opportunity to strike again, but also fails to send a strong message of deterrence to others who might be contemplating such crimes.

3. Establish an effective risk management program and a strong system of internal control.

For today's organizations, it is not enough to play the reactive game in fighting fraud as the organizations must be able to pinpoint the potential for risk and accurately assess its own vulnerability to fraud in the future.

4. Establish and maintain a competent internal auditing function.

If the organization takes money from investors, the Directors as the governing body are accountable for doing everything within their authority to protect those investment, including ensuring that risk are effectively identified and that controls are carefully monitored. This responsibility can be met by establishing a competent internal auditing function the clearly understand the organization's culture, continuously provides a system for keeping the board aware of problems and helps ensure that the corporate governance process is effective.

5. Continuously monitor the organization's operations, policies and procedures.

Regular internal audits of operation should be conducted to validate independently compliance with established policies and procedures.

Some early warning signs of non compliance or even fraud might include missing documents such as original invoices and sloppy bookkeeping, unexplained

changes in inventory, incoming proceeds without proper documentation and concentration of authority without appropriate checks and balances.

The IIA's Board Directors recently approved a revised definition of internal auditing, that depicts changes in the profession and sets the bar for internal audit practice at the world class level:

"Internal Auditing is an independent, objective assurance and consulting activity designed, to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes."

The revised definition broadens the view of internal auditing with a wider array of value added activities and provides a framework that more closely aligns internal auditing and management in identifying and managing risk within the organization and to protect it from vulnerability fraud, by:

- Provides assurance that the system of internal control is adequate and effective.
- Ensures that appropriate policies and procedures are in place to best achieve the organization's objectives.
- Diligently monitors the organization's processes and control environment.
- Ensures that there is a process to identify, assess and manage risk within the organization.
- Maintain a reporting relationship to the audit committee.

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