Fraud Detection Brainstorming for the Auditor:
Designing Fraud Protocols As Part of Audit Plan

TUESDAY, DECEMBER 22, 2015, 1:00-2:50 pm Eastern

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Fraud Detection Brainstorming for the Auditor

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Fraud Detection Brainstorming: Designing Fraud Protocols as Part of the Audit Plan

Roger Siefert
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December 22, 2015
Agenda

- Common internal fraud schemes
- Auditor’s fraud-related responsibilities
- Designing a fraud brainstorming protocol
- Assessing processes to review during the audit
Speakers

- **Roger Siefert**
  
  Roger has more than 30 years of experience in assisting clients and counsel with forensic accounting, business litigation support and audit services, as well as consulting on various accounting issues. Roger has led multiple investigations of alleged financial statement fraud and other misappropriations in various industries, including financial services, insurance, broker / dealer, healthcare, high-tech, manufacturing and real estate, and has participated on the defense teams of multi-million dollar securities class action lawsuits.

- **Jamal Ahmad**
  
  Jamal Ahmad specializes in accounting and forensic investigations, and disputes related to complex financial issues, Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS). Jamal has more than 16 years of combined forensic accounting and litigation consulting experience. He has assisted leading law firms and corporations with forensic accounting, litigation consulting and corporate compliance matters, including compliance monitoring, fraud investigations, damage analysis, business interruption consulting, post-closing purchase price disputes and other litigation support matters.
Common Internal Fraud Schemes
Common Internal Fraud Schemes

- Fraudulent Financial Reporting
  - Fraud by the company (management, employees)
  - Legal risk

- Misappropriation of Assets
  - Fraud against the company (employees, third parties)
  - Financial risk
Earnings Management Versus Fraudulent Financial Reporting

- Fraud
  - The *intentional manipulation* of financial or non-financial information (data, footnotes and analyses) to present a desired result inconsistent with actual results

- Earnings management
  - Reasonable and *legal* management decision making and reporting to achieve stable and predictable financial results
  - Does not always involve outright violations of GAAP

- Distinguish between earnings management techniques:
  - that are aggressive in nature but otherwise permitted by GAAP, and
  - those that clearly violate GAAP

- The line between aggressive and fraudulent behaviour hinges on management ‘s intent
Fraudulent Financial Reporting

- Intentional misrepresentation of financial or non-financial information required for users of the financial statements:
  - Manipulation, falsification, or alteration of accounting records or supporting documentation from which financial reports are prepared
  - Misrepresentation in or intentional omission from financial reports of events, transactions or other significant information
  - Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation or disclosure
Fraudulent Financial Reporting

- Revenue recognition schemes
- Asset overstatement schemes
- Expense manipulation / liability schemes
- Improper disclosures
Improper Revenue Recognition Schemes

- Recording fictitious revenues
  - Transactions with no economic substance
  - Questionable quality

- Recording revenue to soon (“timing differences”)
  - Recording of revenue generated through legitimate means, at any time prior than would be allowed under GAAP

- Using one-time gains to boost income

- Shifting expenses to a later period

- Other
Asset Overstatement Schemes

- Creation of fictitious assets
- Overstatement of asset values
  - Inventory
  - Fixed assets Accounts
  - receivable
  - Marketable securities
- Misclassification of assets
  - Long-term vs. current (a/k/a “window dressing”)
  - Misclassification of investments
Expense manipulation/liability schemes

- Understatement of liabilities or expenses
- Improper capitalization of expenses
- Failing to record or improperly reducing liabilities (e.g., failing to record or deliberately under estimating accrued expenses and liabilities)
Improper Disclosures

- Footnote Disclosures
- Management’s Discussion and Analyses
- Non-GAAP Financial Disclosures
Improper Disclosures

- Overall misrepresentations about the nature of the company or its products, usually made through:
  - News reports, interviews
  - Management discussions and other non-financial statement sections of annual reports, 10-Ks, 10-Qs, and other reports
  - Footnotes to the financial statements
Misappropriation Of Assets
Misappropriation of Assets

- External – by third parties outside the organization (vendors, customers)
- Internal – by employees and others within the organization
Misappropriation of Assets

- Cash Schemes
  - Cash skimming
  - Fraudulent disbursements
    - Billing schemes
    - Payroll schemes
    - Expense reimbursement schemes
    - Check theft and tampering of checks

- Inventory Misappropriation
  - False write-offs and other debits to inventory
  - False sales of inventory
Red Flags

White-collar crime cases soar by 75%
Red Flags and Conditions for Fraud

- Perceived Opportunity
- Perceived Pressure
- Rationalization
Red Flags and Conditions for Fraud

- **Accounting System (Books and Records) Symptoms**
- **Analytical Symptoms**
- **Control and Policy Symptoms**
- **General**
Red Flags - Improper Revenue Recognition Schemes

- **Analytical Red Flags**
  - Aged receivables
  - Excessive write-offs and “returns”
  - Significant increases in or excess levels of inventory in a distribution channel
  - Unusual fluctuations in sales - High sales in month of quarter-end or year-end
  - Sales and income are decreasing, while accounts payable and receivable increase
  - Increased inventory not accompanied by increased revenues
  - Operating income significantly exceeds cash flows
  - Revenues not correlated with balance sheet items (e.g., cash)
Red Flags - Improper Revenue Recognition Schemes

- **Books and Records Red Flags**
  - Lack of timely payments
  - Unsupported or unauthorized revenue-related balances or transactions
  - Missing documents in the revenue cycle
  - Photocopies where original should exist
  - Unusual journal entries
  - Revenue-related ledgers (sales, cash receipts, etc.) that do not balance
  - Sales with no offsetting inventory adjustment(s)
  - Cash receipts not matching to sales invoices
  - Significant or unusual sales and adjustments after period close (Credit memos, Returns)
Other Red Flags

- Limited or seemingly incomplete disclosures
- Lack of disclosure of impact of new accounting rules
- Aggressive accounting policies
- Management compensation predominantly linked to short-term performance
- Significant related-party transactions with minimal disclosure
- Management override of significant internal control activities related to the revenue cycle
- New, unusual, or large customers that appear not to have gone through the customer approval
**Red Flags - Improper Revenue Recognition Schemes**

- **Other Red Flags [continued]**

  - Weaknesses in the cutoff processes or other key accounting processes
  - Denied access to facilities, employees, records, customers, vendors, or others from whom revenue-related audit evidence might be sought
  - Undue time pressures imposed by management to resolve contentious or complex revenue related issues
  - Major sales of company stock around earnings releases or other unusual dates
  - Significant bonuses tied to meeting earnings forecasts
  - Executives’ personal net worth tied up in company stock
Red Flags – Asset Overstatement Schemes

**Analytical**

- Unusual change in the relationship between fixed assets and depreciation
- Reported inventory balances that appear too high or are increasing too fast
- Reported cost of goods sold balances that appear too low or are decreasing too fast
- Reported purchase returns that appear too high or are increasing too rapidly
- Reported purchase discounts that appear too high or are increasing too rapidly
- Reported purchases that appear too low for sales or inventory levels
- Unusual growth in the number of days’ purchases in inventory
- Allowances for obsolete inventory, and so on that are shrinking in percentage terms or are otherwise out of line with industry peers
- Capitalized inventory that looks as if it should be expensed
- Accounts Payable or COGS Balances appear too low
- Payables or other accrued liabilities are low
- Unearned liability balances appear too low and revenue accounts appear too high
Red Flags – Asset Overstatement Schemes

- **Controls and Policies**
  - Lack of adequate policies and procedures to determine whether property and equipment have been received and properly recorded
  - Lack of adequate written policies and procedures concerning the recording, retirement, and disposition of fixed assets
  - Management override of significant internal control activities related to purchases, inventory, or cost of goods sold
  - New or unusual vendors that appear not to have gone through the regular vendor-appraisal process
  - Ineffective cutoff procedures
  - Weaknesses in the inventory counting process
Books and Records

- Fixed assets on the books and records that do not have an apparent relation to the business
- Lack of a subsidiary ledger to record additions and retirements
- Sub-ledgers that do not reconcile to the general ledger
- Inventory or cost of goods sold transactions that are not recorded in a complete or timely manner or improperly recorded as to amount, accounting period, classification, or entity
- Unsupported or unauthorized accounts payable, inventory or cost of goods sold-related transactions
- End-of-period inventory or cost of goods sold adjustments that significantly change the entity’s financial results

- Missing documents related to inventory and / or cost of goods sold
- Unusual shipping and receiving reports
- Inclusion of goods in inventory when they have already been sold for which sales have not been recorded
Auditors’ Responsibilities with Respect to Fraud / Illegal Acts

- Professional Standards
  - AU 316 (SAS 99 - Consideration of Fraud in a Financial Statement Audit)
  - AU 317 (SAS 54 - Illegal Acts by Clients)

- Legal
  - Exchange Act Section 10A (Illegal Acts)
  - Exchange Act Rule 13b2-2 (Improper Influence on Auditors)
Auditors’ Responsibilities with Respect to Fraud

- Plan and perform the financial statement audit to obtain reasonable assurance that the financial statements are free of material misstatement caused by:
  - Errors (unintentional misstatements or omissions)
  - Fraud (intentional misstatements or omissions)
  - Noncompliance with laws and regulations

- **AUC Sec. 200.06 (SAS No. 1, No. 78, No. 52)**
Auditors’ Responsibilities with Respect to Fraud

- Auditor’s “Fraud” Objectives In A Financial Statement Audit
  - Identify and assess the risks of material misstatement of the financial statements due to fraud
  - Design and implement appropriate responses to the assessed risks of material misstatement due to fraud and obtain sufficient appropriate audit evidence
  - Appropriately respond to identified or suspected fraud
Auditors’ Responsibilities with Respect to Fraud – SAS 99

- Exercise professional skepticism at all times during the course of the audit
- Brainstorm about fraud
- Gather information related to existence of fraud
- Identify fraud risks
- Assess fraud risks that may result in a material misstatement
- Develop response to fraud risks
- Evaluate audit evidence and identified misstatements for indication of fraud
- Communicate
- Document
Auditors’ Responsibilities with Respect to Illegal Acts – Sec. 10A and SAS 54

Section 10A

- Each audit . . . shall include
  - Procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts...

- Required response to audit discoveries:
  - Determine whether it is likely that an illegal act has occurred and consider the possible effect of the illegal act on the financial statements, including any contingent monetary effects, such as fines, penalties, and damages
  - Inform the appropriate level of the management of the issuer and assure that the audit committee or the board of directors is adequately informed
Auditors’ Responsibilities with Respect to Illegal Acts – Sec. 10A and SAS 54

SAS 54

- Same as responsibility for detection of misstatements due to error or fraud—to design the audit to provide reasonable assurance that the financial statements are free of material misstatement.
- Responsible for “indirect effect” illegal acts only when information comes to the auditor’s attention that suggests an illegal act might have taken place.
- Communicate to audit committee or its equivalent is informed about illegal acts unless they are clearly inconsequential.
- Notify persons not associated with the client about illegal acts (e.g., in response to a subpoena or in response to inquiries of a successor auditor).
Developing a Brainstorming Protocol As Part of the Audit Plan
Developing a Brainstorming Protocol
As Part of the Audit Plan

- Exchange of ideas among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud

- Two objectives:
  - Obtain an understanding of the client and how a fraud could be perpetrated or concealed
  - Establish a “tone at the top” for the rest of the audit

- Identify incentives/pressures and opportunities - Why would management want to falsify its f/s?

- Discussion should emphasize the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence
Developing a Brainstorming Protocol As Part of the Audit Plan

- Do’s and Don’ts of an effective brainstorming session

  - Do:
    - Have experienced personnel lead the session
    - Split session into multiple parts
    - Establish a time limit
    - Assign “homework”
    - Include ALL key members to discussion
    - Exercise professional skepticism – think like a fraudster
    - Incorporate forensic specialists
    - Consider information from prior audits

  - Don’t:
    - Allow criticism of ideas
    - Overly rely on checklists
    - Establish a hierarchy
    - Take notes
    - Try to solve identified problems at the meeting
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Designing a fraud brainstorming protocol as part of audit plan

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Designing a fraud brainstorming protocol as part of audit plan

(Continued)

1. Ask the “Fraud Interview Question” in the following order,
   • **Have you heard of** any fraudulent activities, embezzlement, etc.
   • **Have you seen** anyone, any activities, . .
   • **Do you know anyone** Including yourself . .
2. Brainstorming by Dollar Signs

• Ask Ourselves Questions by Dollars, such as
  – What scenarios will cause the entire income false
  – What scenarios will cause the entire expense false
  – What scenarios will cause a $1 B difference?
  – What scenarios will cause a $100 M difference?
  – Auditors may not be best in detecting criminal human minds and behaviors but we are good at talking and thinking in monetary terms.
3. Interview the Tax Accountant

• Interview the Tax Accountant – For larger entities, public traded companies, etc.

• In the Enron Case, according to Congressional Joint Committee on Taxation Staff Investigation of Enron Report, in 1997, Enron filed 1,002 federal tax returns and by year 2000 - 2,486 tax returns.
Types of Enron Tax Returns

• Pro-forma Returns for Check-the-box, accounting, and legal branches
• Approximately 15-20 separate companies and consolidated returns
• Foreign entities
• Partnerships
Enron’s Tax Department and Tax Return Preparation

• In year 2000, internally, about 250 employees majorly in Houston
• According to Attorney Philip Cook’s written testimony before the Senate Finance Committee in 2003, the Tax Transactions entered into by Enron distorted its financial statement net income in violation of GAAP. Enron could not have implemented the Tax Transactions without the assistance it received from investment banks, its accounting firm and the law firms that issued the opinions.
• To record the accounting benefits, Enron and Andersen generally relied on tax opinions from a small groups of law firms. The professional staff of the law firms rotated between the investment firms which promote the transactions and the law firms.

• In total, Enron created $886.5 million of net income benefits from the Tax Transactions through September 2001, and it was projecting in excess of $1.7 billion of net income benefits over the lifetime of the transactions. In addition, these transactions were disclosed in Enron’s financial statements in a misleading manner.
Schedule M-3 of Form 1120

Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More – About 80 Items

- Part I, Financial Information and Net Income (Loss) Reconciliation
- Part II, Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable Income per Return
- Part III, Reconciliation of Net Income (Loss) per Income Statement of Includible Corporations With Taxable, Income per Return—Expense/Deduction Items
Put the Tax Accountants to the Test

• Anyone who can prepare the M-3 Schedule and consolidated the tax returns knows the true picture.
• Put them into the fraud question test. Have them sign questionnaire answers even without penalty phrase.
• Not following GAAP is a crucial criterion to ask.
• Ask questions from tax return items to financial statement.
• Ask if SEC comes, what are some items may not stand SEC inquiries.
• The Point is they don’t know what you know. Just ask.
IV. Assessing processes to review during audit

Q1. How can audit professionals mitigate their own risk and exposure after identifying potential fraud in a financial statement?

Fight or Flight
Several Strategies

• Disengage if necessary
• Budgeting sufficient hours in the engagement for SAS 99 compliance
• Develop the Fraud Case and Issue Conclusion
• Use Auditor’s Adjustments
• Issue Disclaimer if necessary and proper – when no hours to develop fraud case
• Use Auditor’s Opinion
• Learn from languages above, “distorted financial statements”; “not following GAAP”
Difference Between Auditing and Forensic Accounting and Fraud Exam

90%-95% v. 5%-10%
The Basic Difference

- Difference between Forensic/Fraud Exam with Auditing
  - 90%-95% v. 10%-5%
  - Outliers; LUQ Items; No stone unturned
  - Auditors hired to verify the financial statements
  - Forensic Accountants hired to find intentional mistakes
    - Should never conclude there is no fraud
  - For example, sample failed 3/30 items – 27 is auditor’s standard to pass; 3 is the forensic accountant’s clue to follow
Q2. What is the difference between accounting error and financial statement fraud—and how should auditors approach these situations?

• According to IRM 25.1.6, Civil Fraud, Section 25.1.6.1 (10-30-2009), “Intent is distinguished from inadvertence, reliance on incorrect technical advice, honest difference of opinion, negligence or carelessness.”

• Use multi-approach and angles to prove fraud
Example 1- A Privately Held Company

• Income statement (yearend) with gross receipt of 20M and net income of less than 200,000, and balance sheet of cash $40,000 -daily expenses need about 54,000--

• Cash bled out of the company purely through balance sheet items and not affecting income statement

• Using the other side (debit/credit) of balance sheet items to transfer cash out the company
• Issue W-2s to related persons higher than the actual salary paid out – to get company higher than actual deductions. The individuals can get from IRS refunds and higher future SS.

• Activities in accounts only in between periods. That is, no periodical financial statements can show these accounts. We have to use, e.g., FS as date of October 17, year XXXX to see the account and its activities.

• The CFO/owner claims to be CPA and AICPA member, but not state registered or licensed;
• We use the person’s own written statements and emails claiming certain activities would be fraudulent. Then, we prove from the financial transactions, to show the person performed these activities he said would be fraudulent.

• Using multiple examples to show how far each of the accounting and financial transactions deviated from GAAP.

• Each year, the questionable accounting journal entries are done on different account names in about a ten-year period.
Privately Held Companies are Harder to Identify Fraud than Public Traded or Non Profit and Governmental Entities

- Checks issued to owners or for related parties can be interpreted as owner’s draws and/or distributions even if they were never disclosed
- Make sure to exhaust all related parties including the corporations owned by the owner’s current partners and relatives
- Do background check, field observation, and personal interview
Internal Control Audit – The Most Risky Audit

• Similar to never say that there is no fraud, never stamp an internal control system

• Make Suggestions:
  • Employee theft insurance
  • Bonded, insured key officers and financial officers – cannot cover fraud but may be applicable when malpractice in supervising employees who committed fraud
• Required, mandated time off (vacation) for financial employees
• Surprised, periodic rotation of job responsibilities among financial employees
• Regular background checks of financial employees
• Separation of persons and roles in
  – Authorization transactions
  – Recording transactions
  – Custody of assets
• Inquiry into the software use. When the journal entries will be permanently registered.

• View/glance over entire general journals if possible. Look for LQU items. If possible, use Excel equivalent software to Sort by Title or Description to get summaries.

• Observe internal control procedures in operation at varied time slots in the day, in a week, etc.

• Ask again and again about cash income and petite cash handling – how are we going to find out that they are selling recycle materials for own benefit

• Hand out your business cards – hope for tips
Pension Fund, Investment Fund Audit
Another Risky Audit

• Rely heavily on outside (Third party) valuation
• Suggest to the client:
  – to increase the professionalism of the staff, CPAs, Financial Advisors, Fraud Examiners, and to maintain sufficient number of employees
  – Rotate (surprised and routinely) investments
  – Periodic sales of (cash in) large portion of the holdings
    • This could be the only way to avoid institutional fraud such as Maddof