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Fraud Control Theory

Using a variation of a saying from the 1960s, fraud happens. Like all costs of doing business, fraud must be managed. Management must recognize that people commit fraudulent acts because of the pressures and rationalization aspects of the fraud theory. The control opportunity provides people with the ability to commit the acts. Due to the concealment or trickery aspect of the fraud theory, fraud occurs in both poorly managed and well-managed departments. Organizations need to talk about fraud, not merely hope that it will not happen. The antifraud program in all organizations needs to remain alert and diligent to fraud.

A key element of the control environment theory is commitment to competence. It is interesting that management is responsible for fraud prevention but most likely has never received training in fraud or internal controls. To achieve the commitment to competence, management needs to be trained in fundamental fraud theory and fraud prevention strategies.

Control inhibitors provide the illusion that a control is operating. However, the perpetrator has circumvented the control, thereby committing the fraud scheme without detection. The control inhibitors are real and do occur. These examples illustrate the concept of internal control inhibitors:

- Management override is most likely the number-one reason for major frauds. Management override consists of both the act of override and the lack of scrutiny in the performance of their control responsibilities.
- Collusion among employees, customers, and vendors does occur. In fact, many fraud schemes require collusion. The act of bribery is the perfect example. People do not bribe themselves.

- Nonperformance or lack of understanding of internal controls negates the value of the internal controls.
- Falsified documents conceal fraud.

ANTIFRAUD PROGRAMS

The cornerstones of managing the cost of fraud are recognizing the need for an antifraud program and ensuring that the identified fraud risks have the appropriate balance of internal controls to manage the fraud cost.

The best practice for fraud prevention is for an organization to have an effective and visible antifraud program. The program should be linked to the control model used by the organization. Using the COSO (Committee of Sponsoring Organizations) model, the components of the antifraud program are:

- Performing fraud risk assessments
- Creating a control environment adverse to fraud
- Designing and implementing antifraud control activities
- Sharing information and communication
- Monitoring activities
- Responding to fraudulent activities

Statement of Auditing Standards No. 99 provides a 14-point antifraud program as an attachment to the standard. The framework centers on these three principles:

1. Creating a culture of honesty and high ethics
2. Evaluating antifraud processes and controls
3. Developing an appropriate oversight process

Performing Fraud Risk Assessments

The first step in creating an antifraud program is to ensure that management understands where the organization is vulnerable to the risk of fraud. Management is clearly responsible for the overall effectiveness of the fraud risk assessment. The risk assessment should document the inherent fraud risks, describe the exposures, and link the internal control strategy to the fraud risk.

Creating a Control Environment

The control environment should set the proper tone at the top. The control environment, or soft controls, influences the effectiveness of the control procedures. Employees quickly understand which internal controls are important to management and which internal controls receive less attention from management. Therefore, the control environment should:

- Create and maintain a culture of honesty and ethical business standards
- Provide discipline for violations of the code of conduct (In other words, there should be consequences for employees' actions.)
- Communicate the appropriate tone regarding tolerance toward fraudulent activities
- Establish control procedures and policies to prevent, detect, and deter fraud
- Establish an assertive policy regarding auditing and investigating fraud

Remember, it must be more than just a policy statement. Management must walk the talk. Actions speak more than the words of a policy statement.

Designing and Implementing Antifraud Control Activities

Internal control procedures should be linked to the fraud risks identified in the fraud risk assessment. The goal is to mitigate the fraud risks consistent with management's goal and desire to minimize fraud to an acceptable level. The controls are referred to as preventive and detective controls. The system of controls should also consider managing the control inhibitors, which often override the fundamental control activities.

Sharing Information and Communicating

The company's code of conduct and the organization fraud response policy are the keys to communicating the organization's no-tolerance attitude toward fraudulent and unethical business practices. It is more than just having a policy. The company's position must be communicated on a regular basis using company newsletters and handbooks, online messages, and training and management presentations. Fraud awareness is an important aspect of the antifraud program.

Monitoring Activities

A key component of an antifraud program is to increase the perception of detection of fraudulent activities. Fraud monitoring systems and reports are

effective tools to accomplish the goal. The systems should be built around the inherent fraud schemes identified in the fraud risk assessment. In chapters one through five, we discussed the use of red flags to identify various fraud schemes. Using the red flag approach, management can develop reports to identify transactions consistent with the fraud data profile.

A second aspect of the program consists of annual independent evaluations of the antifraud program. A consistent and credible antifraud program becomes a deterrent to individuals who are contemplating committing fraudulent activities.

Responding to Fraudulent Activities

When allegations of fraud occur, management needs the ability to respond to the allegations. The use of a fraud response policy is the cornerstone of the program. Chapter 15 covers the components of the policy. The organization also needs access to auditors with specialized skills to identify fraudulent activities within the normal course of audits and to properly investigate fraud allegations. The use of internal auditors, an external accounting firm, or specialized consultants are critical to the ongoing effectiveness of the program.

FRAUD CONTROL AND COSO

According to the COSO model, control procedures are a key element to mitigate risks. A control matrix is an effective tool to document the fraud control procedures. The process starts with the identified fraud risk and links the fraud prevention, fraud detection, and deterrence controls to the fraud risk.

Fraud Prevention and Control Procedures

Preventive controls are designed to minimize the likelihood of a fraud risk from occurring in a business system. The Control Activities section of the COSO model provides for the completeness and authorization of internal control procedures. Although found in older internal control theory, the concept of disciplinary controls is vital to fraud prevention. Disciplinary controls are internal controls that are intended to ensure that the control procedures are operating as intended by management. The appropriate separation of duties is the perfect example for disciplinary controls. No one individual has responsibility for all aspects of the business process. At the organizational level, the internal audit department functions as a regulator of the internal controls process.

Fraud Detection Procedures

Detective controls are designed to alert management that a fraud risk is occurring on a timely basis. The Monitoring, Supervision and Information

and Communication section of the COSO model provides for the fraud detection procedures. Properly designed fraud monitoring controls can act as both a deterrent and detection control. Auditors use the red flag theory for fraud identification. Logically management should use the same fraud theory to increase its ability to monitor business transactions.

In many systems, a transaction reporting listing all changes is produced and reviewed. A manager initials the monitoring report indicating review and approval. The problem with the report is the volume of changes and the cursory review performed by many managers.

Monitoring controls, built around the fraud scheme, function as deterrents by making fraud schemes visible. Monitoring reports should not be kept secret. Employees in the processing function should be advised of the reports. The reports should be reviewed by someone other than the processing employee's immediate supervisor. This procedure diminishes the exposure to logical collusion.

In bid avoidance schemes, a false representation regarding sole-source decision is a fraud strategy to influence the awarding of a contract. Requiring all sole-source contracts exceeding a predetermined dollar amount to be reported outside the decision-making department would make the transaction more visible. In the payroll function, false payroll adjustment schemes can be identified. A periodic report identifying all employees receiving more than one payroll adjustment would reveal the scheme and deter the payroll clerk from committing the act.

Fraud Deterrence Procedures

Deterrence controls are designed to discourage individuals from committing fraud. The Control Environment section of the COSO model creates the environment for fraud deterrence.

A key control concept in fraud prevention is the concept of increasing the perception of detection. Convincing individuals that their scheme will be discovered might be the best fraud prevention strategy. The fear of detection is a psychological factor that causes people not to commit a fraud scheme. A fundamental tenet of fraud theory is that once pressures or rationalization exceeds the fear of detection, a person is more apt to commit the fraud scheme. Therefore, logic dictates that the higher the fear of detection, the higher the pressure and rationalization factor must be for fraud to occur.

Fraud Prosecution Procedures

Fraud prosecution controls is a new concept in the antifraud environment. The concept has evolved from the investigative process. In many instances, we know that a fraud has occurred and the losses are real. Unfortunately, because of how the control procedures are managed at the location, the investigators cannot identify exactly which person committed the act.

When analyzing the internal controls, focus should be on the likelihood of fraud occurring. If the fraud scheme occurs, can the fraud auditors establish, with a reasonable degree of certainty, which individual committed the fraud scheme? An audit trail allows for the documentation to re-create events or the management decision process.

Separation of duties allows for establishing accountability for the transaction, which correlates to fraud deterrence. The adequacy of documentation allows for proving accountability and proof that the fraud scheme occurred. The disciplinary measures ensure the internal controls operate in the manner intended by management.

Example

In one fraud case, a controller of a company was arrested for embezzling currency from the revenue cycle. At her trial, she was found not guilty. One reason for this verdict was that the firm's cash-handling procedures gave the opportunity for several different employees to steal the money. Specifically, in the sales and cash receipts business system, one of six individuals received cash receipts from customers, and all six had access to the cash drawer. At the end of the day, the funds were totaled and kept in the controller's office overnight. At least four individuals had keys to the controller office, including the two business owners. The sales work order system or the sales invoice system were not reconciled on a daily basis. With one of eight individuals having the opportunity to steal funds, the organization could not be successful in prosecuting the controller or anyone else.

The internal controls should have been designed to restrict each individual's access to the cash drawer. The funds should have been reconciled to the sales system. The money should have been counted, and the deposit slip prepared at the close of business each day. Clearly, this example shows that fraud prosecution controls are a key element to responding to fraud allegations.

IDENTIFIED FRAUD RISK CONTROL STRATEGY

The fraud risk assessment process starts with identifying the inherent fraud risk. Then, the internal controls are linked to the fraud risks. Due to the intentional effort to conceal the true nature of the transaction, most fraud risks often require a preventive and detective internal control. Auditors should follow this four-step process in developing a fraud control matrix:

1. Identify the inherent fraud scheme or the fraud scenario and the concealment strategies associated with the fraud scheme.

Exhibit 13.1 Internal Control for Front Companies/False Billing

Company Name
Matrix Fraud Internal Control Matrix
Risk Unit: Internal Control for Front Companies/False Billing

Control Opportunity	Preventive Control	Approval Control	Detective Controls	Deterrence/ Prosecution Controls	Fraud Risk Mitigation
Accounts payable	Separation of duty between invoice processing and vendor administration; Match purchase order and receiving report to invoice; New vendor registration procedures	Changes to master file report reviewed and approved daily; All invoices must be approved prior to payment; Accounts payable compares approval to authorized approver list	Monthly review of department responsibility statements; Review of changes to accounts payable master file changes	Fraud response policy; Annual audit of expenditures	Controls deemed adequate to prevent, detect, and deter fraud
Operating management	Operating management does not have access to input or process invoices for payment	Invoices over $25,000 require second approval	Comparisons of budget to actual by vice president and finance function	Fraud response policy; Annual audit of expenditures	Controls deemed adequate to prevent, detect, and deter fraud
Collusion: Accounts payable and operating management	None Collusion overrides preventive controls	Matching of required documents by accounts payable	None	Fraud response policy; Annual audit of expenditures	Fraud could occur with collusion; Rely on fraud deterrence

2. Link step one to the opportunity to commit the fraud scheme.
3. Link the fraud internal control strategies to the identified fraud risk.
4. There should be two conclusions:
   a. Is the fraud risk mitigation consistent with management's risk tolerance?
   b. If the fraud risk occurs, do we have the right fraud prosecution internal controls to successfully investigate the occurrence of the fraudulent event?

The internal fraud control matrix links the specific controls to the identified fraud risk. In preparing the matrix, identify the fraud risks at the inherent fraud risk level of the fraud scenario. Exhibit 13.1 illustrates the concept at the inherent fraud risk level.