

Fraud Prevention and Deterrence

Fraud Risk Assessment

What Is Fraud Risk?

- The vulnerability that an organization faces from individuals capable of combining all three elements of the fraud triangle is *fraud risk*.
- Fraud risk can come from sources both internal and external to the organization.
- Risks that are present before management action are described as *inherent risks*.
- The risks that remain after management action are described as *residual risks*.
- Objective: make residual risks significantly smaller than inherent risks.

What Factors Influence Fraud Risk?

- Factors influencing an organization's risk:
 - Nature of the business it is in
 - The environment in which it operates
 - The effectiveness of its internal controls
 - The ethics and values of the company and its employees

Effectiveness of Internal Control

- Preventive controls:
 - Manual or automated processes that stop something bad from happening before it occurs
- Detective controls:
 - Can be manual or automated, but are designed to identify something bad that has already occurred
- No system of internal controls can fully eliminate the risk of fraud
 - But well-designed and effective controls can deter it

Fraud Risk Assessment

- Process aimed at proactively identifying and addressing an organization's vulnerabilities to internal and external fraud
- The objective of a fraud risk assessment is to help an organization identify what makes it most vulnerable to fraud

Why Should Organizations Conduct Fraud Risk Assessments?

- Improve communication and awareness about fraud.
- Identify what activities are the most vulnerable to fraud.
- Know who puts the organization at the greatest risk.
- Develop plans to mitigate fraud risk.
- Develop techniques to determine if fraud has occurred in high-risk areas.
- Assess internal controls.
- Comply with regulations and professional standards.

What Makes a Good Fraud Risk Assessment?

- Collaborative Effort – share ownership
- The Right Sponsor
 - Senior in organization; ideally, an independent board or audit committee member
- Independence/Objectivity
 - Whether conducted by internal or external resources
 - Be mindful of personal biases
- Access to People at All Levels
- The Ability to Think the Unthinkable
 - Think like a fraudster

Assembling Fraud Risk Assessment Team

- Made of individuals with diverse knowledge, skills, and perspectives
- Includes members from internal and external resources
 - Accounting and finance personnel
 - Management teams
 - Legal department
 - Compliance department
 - Internal auditors
 - External consultants

Determine the Best Techniques to Use to Conduct the Fraud Risk Assessment

- Interviews
- Focus groups
- Surveys
- Anonymous feedback mechanisms

Educate the Organization and Openly Promote the Process

- The fraud risk assessment process should be visible and communicated throughout the business.
- Openly promote the process.
- The more personalized the communication, the more effective it will be.
- Aim toward eliminating reluctance to participate.

Fraud Risk Assessment Frameworks

- Structured, rational, tailored
- Identify Potential Inherent Fraud Risks
 - Incentives, pressures, and opportunities
 - Risk of management's override of controls
 - Population of fraud risks
 - Fraudulent financial reporting
 - Asset misappropriation
 - Corruption
 - Regulatory and legal misconduct
 - Reputation risk
 - Risk to information technology

Responding to Residual Fraud Risks

- Avoid the risk
 - Eliminate asset or activity if controls are too expensive
- Transfer the risk
 - Purchase fidelity insurance policy
- Mitigate the risk
 - Implement countermeasures, such as prevention and detection controls
- Assume the risk
 - If probability of occurrence and impact of loss are low
- Combination approach

Reporting the Results

- Report should be delivered in a style that is most suited to the language of the business.
- Report objective—not subjective—results.
- Keep it simple.
- Focus on what really matters.

Audit Process

- Risk assessment should play a significant role in influencing the annual audit process.
- Should drive awareness in development of audit programs for areas identified as having a moderate to high risk, including:
 - Identifying and mapping the existing preventive and detective controls
 - Designing and performing tests to evaluate whether controls are operating effectively
 - Identifying risk of management override of internal controls
 - Developing reports that incorporate results of validation and testing of fraud risk controls

Sample Prep Question

1. A well-designed and effective system of internal controls can fully eliminate the risk of fraud.
 - A. True
 - B. False

Correct Answer: B

- No system of internal controls can fully eliminate the risk of fraud, but well-designed and effective internal controls can deter the average fraudster by reducing the opportunity to commit the fraud and increasing the perception of detection. With the right balance of preventive and detective controls, a good system of internal controls can greatly reduce an organization's vulnerability to fraud.

Sample Prep Question

2. In response to a risk identified during a fraud risk assessment, management may decide to purchase fidelity insurance or a bond to help protect the company against the associated risk of loss. This response is known as:
- A. Avoiding the risk
 - B. Transferring the risk
 - C. Mitigating the risk
 - D. Assuming the risk

Correct Answer: B

- When management chooses to transfer some or all of an identified fraud risk by purchasing fidelity insurance or a fidelity bond, this is called *transferring the risk*. The cost to the organization is the premium paid for the insurance or bond. The covered risk of loss is then transferred to the insurance company.

Sample Prep Question

3. Which of the following influences the level of fraud risk faced by an organization?
- A. The geographic regions in which it operates
 - B. The effectiveness of its internal controls
 - C. The ethics of its leadership team
 - D. All of the above

Correct Answer: D

- Many factors influence how at-risk an organization is to fraud. Some of the main factors are:
 - The nature of the business in which it is engaged (i.e., its industry and operations)
 - The environment in which it operates (e.g., storefront or Internet, geographical location)
 - The effectiveness of the internal controls within the business processes
 - The ethics and values of the company and the people within it

Fraud Prevention and Deterrence

Fraud Risk Management

Risk Management

- Involves the identification, prioritization, treatment, and monitoring of risks that threaten an organization's ability to provide value to its stakeholders
- More specifically, it balances risk appetite with the ability to meet the organization's strategic, operational, reporting, and compliance objectives

Risk Management Frameworks

- Risk management program must be **tailored** to the specifics of the organization
- *COSO Enterprise Risk Management—Integrated Framework* components:
 - Internal environment
 - Objective setting
 - Event identification
 - Risk assessment
 - Risk response
 - Control activities
 - Information and communication
 - Monitoring

Who Is Responsible?

- Personnel at all levels have responsibility
- Board of Directors' Responsibilities
 - Setting an appropriate tone and realistic expectations of management to enforce an anti-fraud culture
 - Raising awareness of the risks of fraud throughout the organization
 - Developing a strategy to assess and manage fraud risks that aligns with the organization's risk appetite and strategic plans
 - Monitoring the organization's fraud risk management activities

Who Is Responsible?

- **Audit Committee's Responsibilities**
 - Receiving regular reports on the status of reported or alleged fraud
 - Meeting regularly with key internal parties
 - Understanding how internal and external audit strategies address fraud risk
 - Providing external auditors with evidence that the committee is dedicated to effective fraud risk management
 - Engaging in candid and open conversations with external auditors about suspected fraud

Who Is Responsible?

■ Staff Members' Responsibilities

- Have a basic understanding of fraud and be aware of the red flags.
- Understand their roles within the organization's internal control framework, how their job procedures are designed to manage fraud risks, and when noncompliance might create an opportunity for fraud.
- Read and understand policies and procedures.
- Participate in creating a strong control environment, including designing/ implementing controls.
- Report suspicions or incidences of fraud.
- Cooperate in investigations.

Objectives of a Risk Management Program

- Must incorporate policies and procedures designed to do all of the following:
 - Prevent fraud
 - Detect fraud
 - Respond to identified fraud
 - Fraud prevention
 - Identifying and assessing fraud risks
 - Fraud detection
 - Identify quickly to limit damage
 - Fraud response
 - Punish perpetrators, rebuild stakeholders' confidence

Steps in Developing a Program

- Detailed objectives of the fraud risk management program should be tailored to the organization's specific needs and goals
- Management must balance the following factors in determining objectives:
 - The investment in anti-fraud controls
 - The prevention of frauds that are material in nature and/or amount
 - Management's risk appetite

Steps in Developing a Program

- Define risk appetite
 - How much risk those charged with governance are willing to accept
- Examine previous fraud incidents
 - What would have prevented them
- Ensure compliance
 - Include mechanisms specifically designed to monitor, identify, and address breaches in compliance
 - Formal sanctions must be well-publicized and consistent

Fraud Risk Management Program Components

- Commitment
- Fraud awareness
- Affirmation process
- Conflict disclosure
- Fraud risk assessment
- Reporting procedures
and whistleblower
protection
- Investigation process
- Corrective action
- Process evaluation and
improvement (quality
assurance)
- Continuous monitoring

Fraud Risk Management Program Components

- Commitment
 - The board of directors and senior management should communicate, in writing, their commitment to proactively preventing, detecting, and addressing fraud.
- Corrective Action
 - Organizations should enact policies that reflect the consequences and processes for individuals who commit or condone fraudulent activity.

Sample Prep Question

1. According to COSO, _____ is a process that is designed to identify potential events that may affect the entity and manage risk to be within its risk appetite in order to provide reasonable assurance regarding the achievement of the entity's objectives.
 - A. Internal control
 - B. Enterprise risk management
 - C. Fraud prevention
 - D. Corporate governance

Correct Answer: B

- Among the numerous available definitions of *risk management*, perhaps the most broadly recognized is that provided by the Committee of Sponsoring Organizations (COSO) for *enterprise risk management*: “a process . . . designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.”

Sample Prep Question

2. Of the following parties, who is responsible for developing a strategy to assess and manage fraud risks that aligns with the organization's risk appetite and strategic plans?
- A. The legal department
 - B. The internal audit department
 - C. The board of directors
 - D. The shareholders

Correct Answer: C

- To ensure that the fraud risk management program is effective in both operation and design, it must be fully embraced by those charged with governing and overseeing the organization. Specifically, the board of directors must recognize the true and specific risks of fraud to the organization, as well as their potential impact, and respond by:
 - Setting an appropriate tone and realistic expectations of management to enforce an anti-fraud culture
 - Raising awareness of the risks of fraud throughout the organization
 - Developing a strategy to assess and manage fraud risks that aligns with the organization's risk appetite and strategic plans
 - Overseeing the organization's fraud risk management activities

Sample Prep Question

3. Which of the following is among the audit committee's responsibilities for fraud risk management?
- A. Receiving regular reports on the status of reported or alleged fraud
 - B. Understanding how internal and external audit strategies address fraud risk
 - C. Engaging in open conversations with external auditors about any known or suspected fraud
 - D. All of the above

Correct Answer: D

- As a sub-group of the board of directors, the audit committee is often delegated oversight of the organization's financial, accounting, and audit matters. As part of this responsibility, the committee must take an active role in overseeing the assessment and monitoring of the organization's fraud risks. This involves:
 - Receiving regular reports on the status of reported or alleged fraud
 - Meeting regularly with key internal parties (e.g., the chief audit executive or other senior financial persons) to discuss identified fraud risks and the steps being taken to prevent and detect fraud
 - Understanding how internal and external audit strategies address fraud risk
 - Providing external auditors with evidence that the audit committee is dedicated to effective fraud risk management
 - Engaging in open conversations with external auditors about any known or suspected fraud