FOCUS ON FRAUD
Professional Development Meeting
September 2011

EXPERIENCE SUMMARY
Ted Vaughan has more than 14 years of audit and assurance experience and has developed extensive experience in the retail, consumer products, distribution, and service industries. His clients are primarily publicly-held, including two of the largest publicly held engagements in the Dallas office. Ted’s clients also include several long-standing, high-profile private companies and private companies developing plans to enter into initial public offerings. He also serves as the engagement partner overseeing internal control audits of numerous public companies.

As leader of the Retail Industry Practice Group, Ted focuses on the accounting and reporting issues facing companies in the retail industry and develops numerous retail-specific audit programs for audits of internal control over financial reporting. He developed the BDO Retail Breakfast Series, which provides periodic updates on multiple issues for the Dallas-Ft. Worth retail community.

Ted also manages various areas of quality control for the Dallas office, including advising on technical accounting and reporting matters, monitoring the office’s internal inspection process and serving as the director of continuing professional education for the Dallas office.

PROFESSIONAL AFFILIATIONS
American Institute of Certified Public Accountants
Dallas Challenge, Board of Directors, Member
Texas Society of Certified Public Accountants

EDUCATION
B.B.A., Accounting, Texas Tech University

Today’s Presenters
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Experience Summary

Lee Dewey is a Certified Public Accountant with over thirty years of public accounting experience. He is a Practice Area Leader in the Litigation and Fraud Investigation Practice for Financial Reporting Disputes. Mr. Dewey has led a number of corporate investigations involving revenue recognition, earnings management through inappropriate reserve accounting, stock option backdating, asset misappropriation and inaccurate disclosures to independent auditors. He has served as an expert witness on matters involving complex accounting and auditing issues and insolvency issues in connection with alleged fraudulent transfers. He has also served as a neutral arbitrator in arbitration proceedings involving purchase price adjustment disputes pertaining to the application of generally accepted accounting principles in a number of industries.

Prior to joining BDO Consulting, Mr. Dewey served as an Audit Engagement Partner at BDO USA, LLP for assurance services. His experience includes services to traditional and Internet-based service companies, manufacturers, banks, international trading, and wholesale and retail distribution businesses. He has also served as an Audit Engagement Partner for clients in industries including oil and gas exploration, pharmaceuticals and chemicals, construction subcontracting, commodity trading, international primary and secondary steel trading, fashion footwear and accessories manufacturing, heavy industrial material handling manufacturing, hardware manufacturing, and automotive parts manufacturing.

His experience also includes six years in Europe with secondments to Milan, Italy and London, England. During his secondments as well as subsequent to his return to the U.S., he was heavily involved in international mergers and acquisitions, audits of international companies and the related financial reporting by Foreign Private Issuers. His audit clients included companies that were involved in hundreds of acquisitions during the period of his engagement.

In connection with his engagement responsibilities, Mr. Dewey has presented to the Boards of Directors of publicly traded companies on the findings of corporate internal investigations, auditing topics, perceived corporate misconduct, internal control violations, and other matters of interest. Mr. Dewey has provided consultation and advice to clients engaged in complex transactions including business combinations, spin-offs, and management buy-outs. Mr. Dewey is an instructor in the Firm’s internal training programs and has spoken to various external groups on domestic and international accounting matters.

Professional Affiliations

- American Institute of Certified Public Accountants - past Member, International Practice Committee
- New York State Society of Certified Public Accountants - past Member, International Operations Committee
- Association of Certified Fraud Examiners
- American Bar Association-Associate Member

Education

- BS, Accounting, Virginia Polytechnic Institute and State University

Today’s Presenters

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Learning Objectives

Upon completion of this course, participants should have gained a heightened awareness of:

• Identifying current sources and manifestations of fraud - particularly areas of financial reporting that tend to be more susceptible to fraud
• Executing effective fraud brainstorming and risk assessments
• Recognizing fraud red flags
• Defining fraud responsibility
• Evaluating management’s action plans to deter, detect and prevent fraud as well as plans to address alleged fraud
• Selecting audit procedures to address risk of misstatements due to fraud
Today’s Agenda

- Understanding Fraud
- Fraud Brainstorming and Identifying Risk
- Action Plan To Deter, Detect and Prevent Fraud
- Action Plan To Address Alleged Fraud
- Fraud Responsibilities
- Additional Audit Considerations
- Fraud Resources
Fraud: Definition

“Fraud refers to an intentional act by one or more individuals among management, those charged with governance, employees or third parties involving the use of deception to obtain an unjust or illegal advantage. As auditors, we are concerned with fraud, be it alleged, suspected or proven, which results in a material misstatement in the financial statements. We do not, however, make a legal determination as to whether fraud has actually occurred.”

Source: BDO Assurance Manual Ch. 16

Fraud in the Headlines

February 2011: SEC v. DBH Industries, Inc. (aka Pont Blank Solutions) and SEC v. Krantz, Chasin and Nadelman name outside directors and audit committee members due to their lack of independence and oversight. “Willfully blind to red flags”

April 2011: SEC suspends trades in Rino International amid fraud allegations (Chinese Reverse Merger)

April 2011: SEC v. DBH Industries, Inc. (aka Pont Blank Solutions) and SEC v. Krantz, Chasin and Nadelman name outside directors and audit committee members due to their lack of independence and oversight. “Willfully blind to red flags”

January 2011: Merrill Lynch settles SEC Fraud Case for $10M for misuse of private customer information

April 2011: Satyam Computer Services fraud uncovered in 2009 has resulted in the SEC and PCAOB fining PWC’s Indian affiliate $7.5M for routinely failing to follow the most basic auditing procedures.

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April 2011: Goldman was accused of steering investors toward mortgage investments without telling the buyers that the securities had been crafted with input from a client that was betting on them to fail.

June 2011: J.P. Morgan to pay $153.4M in fraud case that is misled buyers of complex mortgage investments just as the housing market was collapsing.

August 2011: SEC brings fraud case against Angell Biotechnologies LLC for misleading investors (faulty disclosures) and insider trading.

July 2011: Matthew Beau La Madrid, a principal in real investment groups, sentenced for his role masterminding $30M Ponzi Scheme and mortgage fraud.
Fraud: Common Misconceptions

• Handling alleged instances of fraud committed within an organization is solely the responsibility of company management.

• Fraud is primarily found in large, multi-national organizations.

• It is not possible to predict potential fraud before it happens, so creating a plan in advance to deal with suspected fraud would be a waste of time and resources.

Fraud: De-Mystified

Myth: Handling alleged instances of fraud committed within an organization is solely the responsibility of company management.

Truth: Establishing effective mechanisms for the reporting, investigating and remediating of fraud is a shared responsibility with the company’s audit committee.
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Myth: Fraud is primarily found in large, multi-national organizations.

Truth: Fraud is not limited to companies of a certain size and composition.

Myth: It is not possible to predict potential fraud before it happens, so creating a plan in advance to deal with suspected fraud would be a waste of time and resources.

Truth: While not every instance of fraud may be predictable, companies and audit committees are best served by gaining an understanding of fraud risk factors and establishing a plan in advance to deal with suspected fraud expeditiously if and when it arises rather than scrambling to identify and pull together adequate resources in the midst of a crisis.
Review Question

Which of the following is NOT an element of the Fraud Triangle
1. Opportunity
2. Capability
3. Rationalization
4. Pressure

Consideration of the Fraud Diamond

**Motive / Pressure / Incentive**
- Meets expectations
- Avoid criticism
- Cover a mistake

**Opportunity**
- Poor internal controls
- Lack of oversight

**Rationalization**
- Low compensation
- Company is profitable

**Capability**
- Position / Function
- Brains
- Confidence / Ego
- Coercion Skills
- Effective Lying
- Immunity to Stress

Source: Beyond the Fraud Triangle, The CPA Journal, July 1, 2010 - BDO Ac'sense 2010 Focus on Fraud: The Series Continues at: http://www.bdo.com/acsense
Contributing Factors to Fraud

Organizational Conditions That Create “Fertile” Environments for Fraud

- Lack of awareness of fraud risk factors and warning signs
- Inadequate control activities to mitigate identified fraud risk
- Inadequate screening practices (for employees, vendors, customers and/or business partners)
- Insufficient understanding of ethical duties at all levels
- Ineffective mechanisms for reporting and investigating fraud
- Ineffective board and audit committee oversight
- Lack of awareness of impact of regulations: e.g., Foreign Corrupt Practices Act, U.K. Bribery Act 2010, SEC Whistleblower Final Rule 34-64545 (Dodd-Frank), etc.
Review Question

Scenario: Ms. Overextended worked in the payroll department of a medium-sized company ABC, Inc. Ms. O had a prior record for forgery which was not identified by ABC via a simple background check and she had considerable personal debts outstanding. Ms. O felt that she was underpaid in her current role with ABC. Her supervisor was recently promoted and was now responsible for and pre-occupied with the oversight of both the A/P department and the payroll department. After working at ABC for six months, Ms. O devised a ghost employee scheme whereby she set up fictional employees with the company and proceeded to route electronic payroll disbursements to dummy accounts she set up for herself using the ghost employees’ information.

Which of the following elements of the fraud diamond would be represented by her boss’ preoccupation with performing dual roles?

1. Opportunity
2. Rationalization
3. Incentive
4. Capability

Review Question

Scenario: Peter Paul was employed by SkimThis, Corp. as their accounts receivable manager. Mr. Paul received an annual bonus based upon the number of A/R accounts that made their payments on time. Mr. Paul devised a lapping scheme that enabled him to credit delinquent accounts by “skimming” money from other up-to-date accounts. At the end of the year, Mr. Paul achieved a 95% “current payment status” on all of his A/R accounts. SkimThis paid him a bonus of $10,000 as of 12/31/201X.

Which of the following, even if implemented, may NOT prevent this lapping scheme from occurring?

1. Increasing controls over A/R by having another layer of supervision/review
2. Change the bonus structure so as to reward quality of A/R maintained and not quantity A/R accounts that are current
3. Communicate a no tolerance policy to all employees
Common Fraud Scenarios
The following is not a complete list:

**Fraudulent financial reporting - intentional misstatements/override of controls**
- Earnings management
- Improper revenue recognition
- Overstatement of assets
- Understatement of liabilities
- Fraudulent journal entries
- Round-trip or “wash” trades

**Fraudulently obtained revenue and assets and/or avoidance of costs/expenses**
- Concealment
- Scams
- Tax Fraud

Common Fraud Scenarios
The following is not a complete list:

**Expenditures and liabilities incurred for improper or illegal purpose**
- Bribes
- Conflicts of interest
- Kickbacks
- Money laundering

**Misappropriation of assets (theft)**
- Billing schemes
- Collusion
- Concealment
- Forgery
- Ghost employees
- Payroll fraud
Review Question

Employee X worked for Telecom ABC. X set up barter trades to sell unused capacity to Telephonisis, Inc. while concurrently agreeing to buy back the same capacity. X would book the value of the incoming capacity as revenue and the value of the outgoing capacity as an investment. This scheme is an example of which of the following?

1. Turnaround or Flip Sale
2. Skimming
3. Round Tripping
4. Lapping

Fraud in Financial Statements

• Improper revenue recognition
• Overstatement of assets/capitalization of expenses
• Understatement of expenses/liabilities
• Other techniques such as acquisitions, joint ventures, netting of amounts
• Disguised through use of related parties
• Misappropriated assets
Areas of Fraud Opportunity/Examples

- Revenue recognition
  - Complex high value transactions
  - Multi-party agreements
  - Multiple deliverables

- Accounting Estimates
  - Restructuring reserves
  - Contingency reserves
  - Asset impairments
  - Revenue accrual estimates
  - Expense accrual estimates

- Disclosures
  - Failure to disclose a significant loss contingency that is probable but not subject to reasonable estimation
  - Failure to disclose significant off-balance sheet liabilities

Red Flags

- Significant topside adjustment recorded in consolidation
- Transactions recorded late (e.g., back-dating)
- Complex transactions and calculations
- Unsupported or unauthorized transactions
- Frequent correcting entries
- Significant unexplained reconciling items in reconciliations
- Unreasonable explanations for variations in reported results from expectations
- Unusual subsequent events
- Significant related party transactions
Red Flags

• Accounting changes - Changes in accounting principles/estimates may be indication of manipulation to achieve a desired F/S effect
• Behavioral -
  - Domineering management
  - Excessive lifestyles
• Ineffective board or audit committee oversight over financial reporting process and internal control
• Ineffective communication, implementation, support, or enforcement of entity’s values or ethical standards by management or communication of inappropriate values or ethical standards
• Non-financial management’s excessive participation in or preoccupation with selection of accounting principles or determination of significant estimates

Review Question

Connie Controller routinely adjusted assumptions used by Annie Assistant Controller to record the company’s warranty accrual to ensure that quarterly accruals were in line with forecasts provided to the board of directors. This may be an example of which of the following?
1. Misappropriation of assets
2. Override of controls
3. Collusion
4. Forgery
Brainstorming Basics: Fraud
Questions to Ask

Consider the opportunities, the incentives, the rationalizations and capabilities:

• What areas of the Company’s financial reporting are susceptible to misstatement?
• What operational areas are susceptible to misappropriation of assets?
• How might a fraud perpetrator exploit weaknesses in the system of controls?
• How could a perpetrator override or circumvent controls?
• What could a perpetrator do to conceal the fraud?
Brainstorming Basics: Fraud

Focus on how and where F/S may be susceptible to material misstatements due to fraud, including how fraud might occur

• Do your homework - research current fraud trends, industry practices, etc.
  • Avoid the “blank stares” during brainstorming session
• Exercise professional skepticism
• Involve a broad group - internal/external auditors, legal counsel, operational and financial professionals, etc.
• Don’t allow discussion to be dominated - ALL in the room should be active participants and allowed to voice suggestions
• Don’t allow discussion to be “narrowed”
  • Don’t just discuss those with high likelihood - consider ALL potential fraud!!!
• Don’t permit criticism - No suggestion should be considered stupid
• Emphasize understanding of business - look to recent/proposed changes
• Consider having fraud expert present to group on current trends

Review Question

Effective fraud brainstorming as part of overall risk assessment involves all of the following activities except for which?

1. Advance preparation
2. Detailed review of preventative controls to ensure they are working properly
3. Acceptance of all ideas and suggestions with respect to potential fraud within an organization
4. Consideration of the incentives, opportunities and rationalizations that may come into play in determining where potential fraud may be
Action Plan To Deter, Detect, and Prevent Fraud

Elements of a Fraud Prevention Program
Assessing Key Elements - From An Auditor’s Perspective

- Understand significant fraud risks faced by the company via fraud risk assessment and education
- Understand programs and controls established by the company for managing fraud risks, including relevant policies and procedures
- Develop alternative sources of information about what is happening in the company with respect to fraud risks
- Seek supporting documentation and be willing to ask difficult questions
- Ensure company has mechanisms in place for both reporting and conducting independent investigations of fraud
- Determine whether those charged with governance independently assess and monitor effectiveness of those mechanisms
After the Brainstorming Session...
Assess Likelihood and Significance

After the risks have been identified, the risks should be assessed for likelihood and significance from following perspectives before consideration of controls:

- Monetary
- Financial Reporting
- Operations
- Reputation/Brand
- Legal
- Regulatory Compliance

Consider using a fraud risk assessment framework!

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Fraud Risk Assessment Framework

<table>
<thead>
<tr>
<th>Identified Fraud Risks</th>
<th>Likelihood</th>
<th>Significance</th>
<th>People/Dept.</th>
<th>Existing Anti-Fraud Controls</th>
<th>Controls Effectiveness Assessments</th>
<th>Residual Risks</th>
<th>Fraud Risk Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rev Rec: Backdating</td>
<td>Possible</td>
<td>Material</td>
<td>Sales</td>
<td>Controlled contract admin system</td>
<td>Tested by Internal Audit (IA)</td>
<td>N/A</td>
<td>Periodic testing by IA</td>
</tr>
<tr>
<td>Rev Rec: Late shipments</td>
<td>Possible</td>
<td>Significant</td>
<td>Shipping dept.</td>
<td>Integrated system linked to invoicing and sales register</td>
<td>Tested by IA</td>
<td>Risk of mgnt override</td>
<td>Cut off testing by IA</td>
</tr>
</tbody>
</table>

Source: AICPA, IIA and ACFE *Managing the Business Risk of Fraud: A Practice Guide*
After the Brainstorming Session...
Establish Relevant Controls/Procedures to Prevent/Detect Fraud

- Management has the ability to establish specific preventative and detective controls in a focused manner
- The design of such controls should include the following:
  - Description of what the intent of the control is
  - Who should perform the control (e.g., segregation of duties, execution by appropriate individual)
  - Who is to monitor and assess the effectiveness of the control
- Controls should be formally documented by management

Prevention and Detection Techniques

Prevention encompasses policies, procedures, training and communication;
Detection involves activities/programs designed to identify fraud or misconduct that is occurring or that has occurred.
Prevention and Detection Techniques

Effective preventative measures serve as strong deterrents:
• Raise awareness organizationally and provide adequate and on-going training
• Communicate ramifications of fraud
• Reinforce system of controls
• Segregate duties
• Evaluate performance and compensation programs
• Background checks - Not a one time exercise!
• Review related party transactions
• Continual monitoring
• Periodic update of assessment process
• Perform exit interviews

Detective controls used in conjunction with preventative controls should be flexible and adaptable:
• Anonymous reporting mechanisms - e.g., “Whistleblower Hotlines”
• Process controls - e.g., reconciliations, independent reviews/internal audits, physical counts, analysis
• Procedures - e.g., data analytics and manipulation, continuous auditing techniques, review of journal entries, review of e-mail/correspondence
**Ability to Detect Fraud**
Detection of fraud involves the ability to recognize timely whether fraud has occurred or is occurring.

However, a properly designed and executed audit may still NOT detect material fraud, especially one involving:
- Forgery
- Deliberate failure to record transactions
- Intentional misrepresentations
- Collusion

Ability to detect fraud depends on:
- Skillfulness of perpetrator
- Frequency and extent of manipulation
- Degree of collusion
- Relative size of individual amounts manipulated
- Seniority of individuals involved

**Review Question**
Which of the following would be an example of a preventative control to deter fraud?

1. Perform background checks upon hiring and periodically during the employee’s term of service
2. Review expense reports and consulting fees to determine potential violations of the foreign corrupt practices act
3. Performance of routine reviews by internal audit of subjective management estimates
4. Implement an additional level of review of cash receipts and A/R processing
Practices Being Adopted by Companies

- Board-appointed high level executive responsible for coordinating fraud risk management and directly reporting to the Board
- Independent “risk and/or compliance committees”
- Comprehensive fraud program which includes policies and procedures clearly outlining responsibilities for:
  - Fraud risk assessment
  - Fraud awareness and education for all levels of the organization
  - Reporting mechanisms and whistleblower protections
  - Investigation/response process
  - Board and audit committee oversight
  - Conflict resolution
  - Communications
  - Continuous monitoring

Review Question

Which of the following may be both a strong preventative measure as well as a detective measure in assisting in the understanding of whether or not fraud may be occurring?

1. Perform a comprehensive fraud risk assessment
2. Continually communicate to all employees about the ramifications of perpetrating fraud
3. Make inquiries of multiple levels of employees internal to the organization as well as key external contacts regarding awareness of fraud or the potential for fraud
4. Periodically provide fraud education programs to all employees
Action Plan To Address Alleged Fraud

Sources for Reported Fraud

- Whistleblower hotlines and continued marketing of such hotlines
- External and internal auditor reporting to appropriate levels
- Consultants
- Customers
- Vendors
- Anonymous tips
- SEC inquiries
- Regulatory agencies
Effective Mechanisms for Investigating Fraud
Management/Governance Protocol

- Identify who should be involved, internally and externally
- Define specific roles and responsibilities of individuals
- Perform an initial assessment to gather evidence and determine the potential scope/magnitude of the fraud
- Identify individuals to interview and conduct thorough interviews
- Determine additional procedures required (e.g., CAAT, customer calls/confirmations, etc.)
- Ensure regulatory or statutory requirements are appropriately met
- Evaluate results and remediate
- Determine whether disciplinary actions are appropriate or criminal charges should be brought
- Ensure proper disclosures are made
- Document findings
- Take preventive measures for the future, including enhancements to internal controls

Protocol should further include the following:

- Categorizing of issues
- Confirmation of validity/significance of issue
- Timing and extent of escalation - When, how and to whom
- What to do with identified issues outside the scope of an anti-fraud program
  - E.g., Non-fraudulent matters, but other matters of significance that have been reported such as harassment
- Steps to conducting the investigation
- Designation of responsibility for documenting
- Retention policies/practices for gathered information
Review Question

While performing a quarterly review of GotFraud?, Inc., the external auditor Barry D’Orio discovered that the CFO George Fudge had made significant adjustments to several key accrual accounts that were unsubstantiated and were misleading in the 10Q scheduled to be submitted to the SEC the next day. Barry immediately notified both the CEO and audit committee chair. What should be the logical next step that GotFraud? should take?

1. Issue a press release announcing the fraud
2. Have the controller head an investigation into the matter along with his accounting staff
3. Have the audit committee along with the internal audit staff begin an immediate investigation into the matter

Example - Sales Person Entering Into Side Agreements Causing F/S Inaccuracies

Protocol:
- Escalate to management/governance/legal
- Consider engaging forensic accountants
- Determine scope of issue - Which transactions? Pervasiveness?
- Determine scope of procedures - Interviews, computer-assisted techniques, customer calls/confirmations, etc.
- Ensure proper communications and disclosures are made (internally/externally)
- Identify root causes and effects, resolve specific issue, design preventive/detective controls for future
Auditors have the responsibility to consider the risk of fraud in planning and performing their audits—specifically as it relates to misstatements arising from fraudulent financial reporting and misappropriation of assets. Management, along with those who have responsibility for oversight of the financial reporting process (such as the audit committee, board of trustees, board of directors, or the owner in owner-managed entities), should set the proper tone, create and maintain a culture of honesty and high ethical standards and establish controls to prevent, deter, and detect fraud. When management and those responsible for oversight of the financial reporting process fulfill those responsibilities, the opportunities to commit fraud can be reduced significantly.

CAQ’s Top Ten Questions All Skeptics Need to Ask!

1. What are the potential sources of business influence on the accounting staff’s judgments or determinations?
2. What pressures for performance may potentially affect financial reporting?
3. What about the way the company operates causes concerns or stress?
4. What areas of the company’s accounting tend to take up the most time?
5. What kind of input into accounting determinations does nonfinancial management have?
6. What are the areas of accounting about which you are most worried?
7. What are the areas of recurring disagreement or problems?
8. How does the company use technology to search for an unnatural accounting activity?
9. If a Wall Street Journal article were to appear about the company’s accounting, what would it most likely talk about?
10. If someone wanted to adjust the financial results at headquarters, how would they go about it and would anything stop them?

Source: Center for Audit Quality “Deterring and Detecting Financial Reporting Fraud – A Platform for Action”

Additional Audit Considerations
Exercising Skepticism

Conduct audits with the mindset that fraud could be present, regardless of any past experience with the entity and regardless about your belief about management’s honesty and integrity... Do NOT be satisfied with less-than-persuasive evidence because you believe management is honest!

- PCAOB/AICPA AU 316

Avoid Checklist Mentality!

An auditor who brainstorms the risk for fraud and/or employs horizontal and vertical analyses to identify unusual patterns of financial activity is better positioned to identify fraud than someone who follows a strict program or checklist approach!

Source: “Auditors - Watchdogs or Bloodhounds?”

“...It can be concluded that to describe the audit role as that of a ‘watchdog, not a bloodhound’ is no longer valid in the context of the requirements of the redrafted and revised ISAs¹; these negate the traditional ‘passive philosophy’ towards auditor responsibility for fraud detection, marking a significant shift away from a ‘monitoring’ role and towards the requirement for a very keen ‘sense of smell’.

Source: “ISA 240 (Redrafted), Auditors and Fraud - And the End of Watchdogs and Bloodhounds”

¹ ISA - International Statement on Auditing
Designing Responses to Identified Risks of Material Misstatements Due to Fraud

- Test appropriateness of J/E (management override)
- Review accounting estimates for bias
- Understand business rationale for significant transactions outside of “normal course of business”
- Consider susceptibility for management override of controls - introduce unpredictability in testing!
- Ensure underlying sources of data are audited
- Consider complexity of transactions and adjust audit approach accordingly
- Evaluate discrepancies, completion of audit evidence

Refer to Ch. 16 of the BDO USA Assurance Manual and PCAOB/AICPA AU 316

Designing Responses to Identified Risks of Material Misstatements Due to Fraud

- Make inquiries of non-management: Operations; HR; internal audit; etc.
- Perform procedures at locations on a surprise/unannounced basis - e.g., inventory observations on unexpected dates; “surprise” cash counts
- Request inventories be counted at end of reporting period to minimize risk of manipulation
- Make oral inquiries of major customers and suppliers in addition to written confirmations
- Perform SAPs using disaggregated data - e.g., compare gross profit or operating margins by location, line of business or month to auditor-developed expectations
- Reminder: Revenue, inventory and management estimates continue to be highly susceptible areas for fraud

Refer to Ch. 16 of the BDO USA Assurance Manual and PCAOB/AICPA AU 316
Designing Responses to Identified Risks of Material Misstatements Due to Fraud

Revenue:
- Compare sales volume with production capacity
- Perform trend analysis: revenues and returns by month (before/after reporting period)
- Confirm with customers (as well as internal employees: e.g., sales, marketing) relevant contract terms and absence of side agreements

Inventory:
- Use computer-assisted audit techniques to test compilation of counts (e.g., sort by tag to test controls)
- Compare current vs. prior period quantities by class or category; location
- Compare key ratios to industry norm

Management Estimates:
- Compare with independent estimate (may need to engage 3rd party “expert”)

Review Question

In testing appropriateness of journal entries, Bob Auditor considered transactions that were complex in nature, contained significant estimates, and period-end adjustments along with areas that have been prone to errors in the past. Bob chose a sample of accounts and asked for period-end transaction activity. All of the following represent additional procedures Bob may have performed to satisfy his responsibility with respect to fraud except for which?

1. Consider his knowledge of internal controls to determine where management override may occur
2. Expand scope to look at J/E applied to accounts that are unusual or seldom used
3. Focus solely on larger account balances
4. Review entries made outside the normal course of business
Lessons Learned from Fraud Litigation -
What NOT To Do

- Client representations:
  - Fail to pursue analytical review explanations that are inconsistent your expectations
  - Accept client representations without validating with indirect audit evidence when direct audit evidence is not available
  - Be overly reliant on management representations
  - Thoughtless completion of checklists
  - Lack of exhibited professional skepticism - poor documentation of identified and assessed fraud risks and audit approach
  - Not follow firm policy/procedures

Lessons Learned from Fraud Litigation -
What To Do

- AVOID ineffective audit procedures:
  - READ FULL agreements!!!
  - Ensure performance of strong analytical reviews
  - Do NOT rationalize results of predictive testing
  - Ensure confirmations are performed for significant third party transactions
  - Use alternative procedures to validate audit evidence
    - E.g., Do NOT accept photocopies of checks
    - E.g., Ensure invoices are supported through examination of shipping docs or subsequent cash receipts
  - Related parties
    - E.g., Perform searches for unidentified related parties
    - E.g., Consider performing Google searches or background checks
    - E.g., Use IDEA to compare key information in Customer Master File to Employee Master File and Vendor Master File to identify potential round trip transactions, unidentified related parties and fictitious vendors
Lessons Learned from Fraud Litigation -
Continue to Be On Your Toes!

• Recognize “expectation gap”
  • “Juries are easily convinced that the “P” in CPA standards for Public
    Watchdog!
  • Without much convincing, juries believe that auditors are responsible for the
detection of fraud!
• Failure to identify/dispose of identified red flags: Typical opposing
  expert assessments-
  • “It was right under their noses but they never pursued it”
  • “All they had to do was pick up the phone and call the customer and they
    would have found it--They didn’t even follow their own audit manual.”
  • “All they had to do was find one out of thousands of fraudulent
    transactions”
  • “The audit manager recognized the problem and reacted appropriately but
    the partner was too concerned about future business opportunities to hold
    his ground and insist on receiving the necessary documents”

Lessons Learned from Fraud Litigation -
Continue to Be On Your Toes!

• Finally, consider that fraudsters play to egos and fears
  • Scenario: “The CFO explained that ABC Corp decided not to pursue
    the transaction because it might jeopardize the auditor’s ability to
    continue to act as independent auditors… Sounds reasonable”
  • Does it? Something is not adding up here - Check your ego at the
door!
  • Scenario: [Partner to Junior Auditor] “Junior, don’t push the client
    too hard to provide that document, we don’t want to get them
    angry…”
  • Savvy clients are well aware of an audit firm’s fear of losing
    clients but don’t let that fear replace good judgment!
  • Subordination of an auditor’s judgment to that of the client is
    an independence violation!
Auditor Responsibility for Communicating Fraud

- Upon becoming aware of alleged or potential fraud, the auditor needs to communicate immediately to the appropriate level of management and to those charged with governance.
- Includes both fraud affecting F/S AND any other fraud we become aware of.
- Assess and document related material weakness/significant deficiencies and whether additional areas may be impacted that would require additional audit procedures.
- Involve legal counsel, as required or necessary (both company’s as well as ours).
  - E.g., Determine whether auditor needs to report occurrence or suspicion outside of the organization (regulatory authority).
- Consult RTD/SEC Department.

Fraud Resources
Fraud Resources

- BDO’s Ac’sense Focus on Fraud Series and other archived webinars: [http://www.bdo.com/acsense/archive.aspx](http://www.bdo.com/acsense/archive.aspx)
- CAQ Anti-Fraud Initiative: [http://thecaq.org/Anti-FraudInitiative/index.htm](http://thecaq.org/Anti-FraudInitiative/index.htm)
- AICPA Fraud Prevention, Detection and Response: [http://www.aicpa.org](http://www.aicpa.org)

Evaluation

- We continually try and improve upon our programming and appreciate constructive feedback
- Following the program, please type in the following to your web-browser and complete the brief evaluation: [http://www.zoomerang.com/Survey/WEB22CLYQPPGMV/](http://www.zoomerang.com/Survey/WEB22CLYQPPGMV/)
- The link to the evaluation may also be accessed from the PDM Learning Community Session Page.
- Thank you in advance for your consideration!
FOCUS ON FRAUD
Thank you for attending!