



The Shapes of Fraud

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About Jay Wagner

- Institute of Internal Auditors (IIA):
 - Chapter Relations Committee (CRC), 2017-Present
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 - District Representative, IIA Central 3 and Midwest 2 Districts, 2017-2021
 - Facilitator Program, 2017-Present
 - Three term Chapter President – Springfield
 - Vice President, Secretary, Program Chair, and Webmaster
- Chief Audit Executive, Office of the Illinois Attorney General
- Member Ex-Officio, Illinois State Internal Audit Advisory Board
- Former Adjunct Instructor, University of Illinois at Springfield
- Former Chief Audit Executive, Illinois Department of Veterans' Affairs
- Certified Fraud Examiner (CFE)
- Certified Internal Auditor (CIA)
- Certified Information Systems Auditor (CISA)



Polling Question 1 – Definition of Internal Auditing

What is the definition of Internal Auditing?

1. Internal auditing is precision guesswork, based on unreliable data, provided by people of questionable knowledge.
2. Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations.
3. Prefer not to answer



Definition of Fraud

- Fraud is defined by Black's Law Dictionary as: *"all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get an advantage over another by false suggestions or suppression of the truth. It includes all surprise, trick, cunning or dissembling, and any unfair way by which another is cheated."*
- *"An intentional or deliberate act to deprive another of property or money by guile, deception, or other unfair means."*

2017 Fraud Examiners Manual, page 2.201



Examples/categories of Fraud

- Fraudulent misrepresentation of material facts (or false pretenses)
- Negligent misrepresentation
- Concealment of material facts
- Bribery
- Illegal gratuity
- Economic extortion
- Conflicts of interest
- Forgery
- Theft of money or property
- Breach of contract
- Breach of fiduciary duty
- Gross negligence
- Conspiracy
- Obstruction of justice
- Perjury
- False claims and statements to government agencies



Types of Fraud

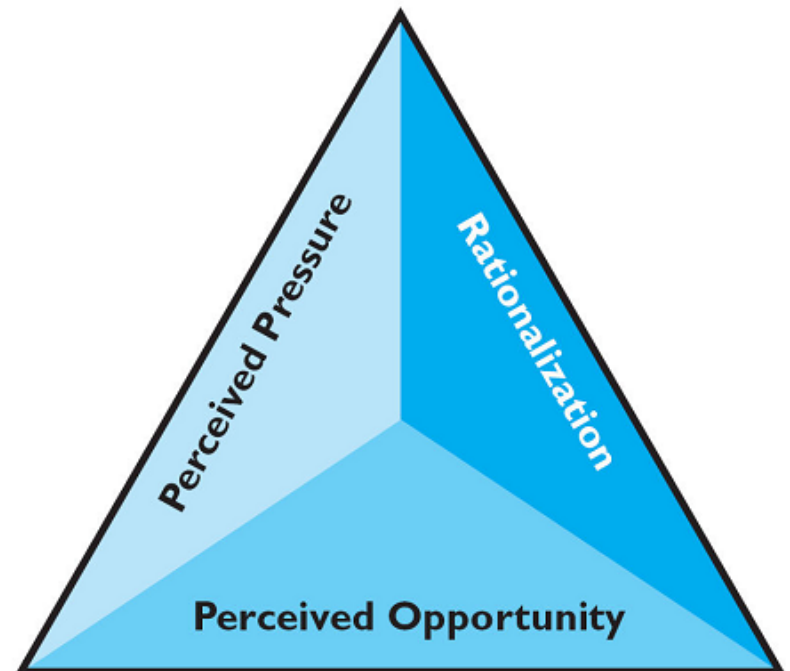
- **Internal Fraud:** the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the organization's resources or assets.
- **External Fraud** covers a broad range of schemes. Vendors might engage in bid-rigging schemes, bill for goods or services not provided, or demand bribes from employees. Customers might submit bad checks or falsified information for payment, or might attempt to return stolen or knock-off products for a refund. Organizations also face threats of security breaches, thefts of intellectual property, hacking, theft of proprietary information, tax fraud, bankruptcy fraud, insurance fraud, healthcare fraud, and loan fraud.
- **Fraud Against Individuals:** Fraudsters have also devised schemes to defraud individuals. Identity theft, Ponzi schemes, phishing schemes, and advanced-fee frauds are just a few of the ways criminals have found to steal money from unsuspecting victims.
- Why does fraud occur? The best and most widely accepted model for explaining why people commit fraud is the Fraud Triangle, developed by criminologist Dr. Donald Cressey.



What are the legs of the Fraud Triangle?

- Perceived Pressure
- Perceived Opportunity
- Rationalization

Developed by criminologist
Dr. Donald Cressey





Many have tried to improve

- Pressure does not always explain the motivations.
 - Example:
 - A company vice president was convicted of embezzling a few hundred thousand dollars.
 - It sounds significant, until you realize he was making **\$6 million** per year.
 - What financial pressure could he have been under?
- This lead one to create....



Many have tried to improve

The Executive Fraud Triangle

SELF is supreme, so...

"I want..."

Money, title, position,
authority, perks, service, etc.

Greed

"I am..."

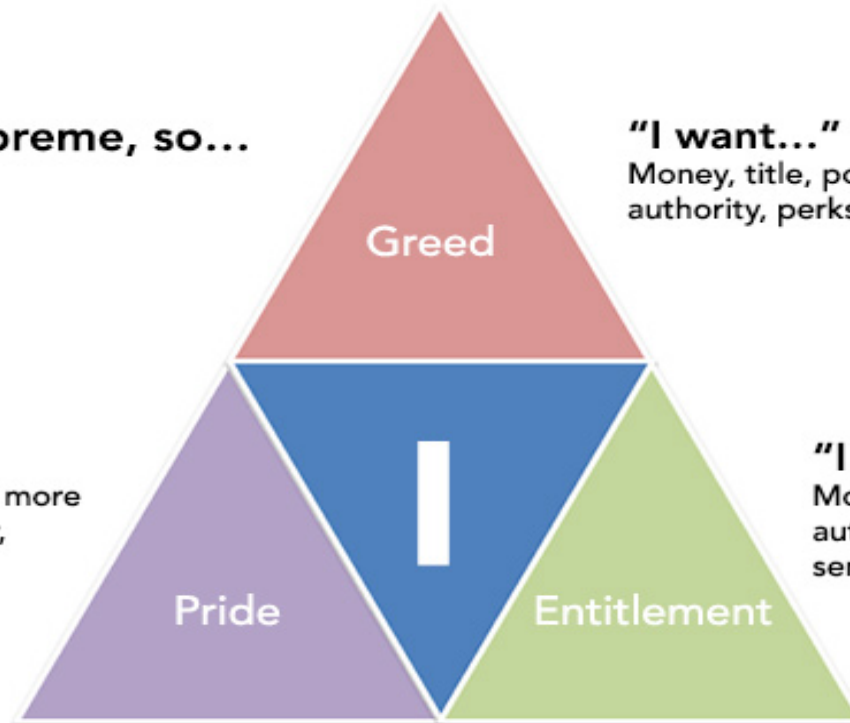
Better, smarter, more
skilled, superior,
above, etc.

Pride

"I deserve..."

Money, title, position,
authority, perks,
service, etc.

Entitlement





Many have tried to improve

- Another has said, it isn't merely enough to have an opportunity, one must then have
 - Capability
- This lead to the....



Many have tried to improve

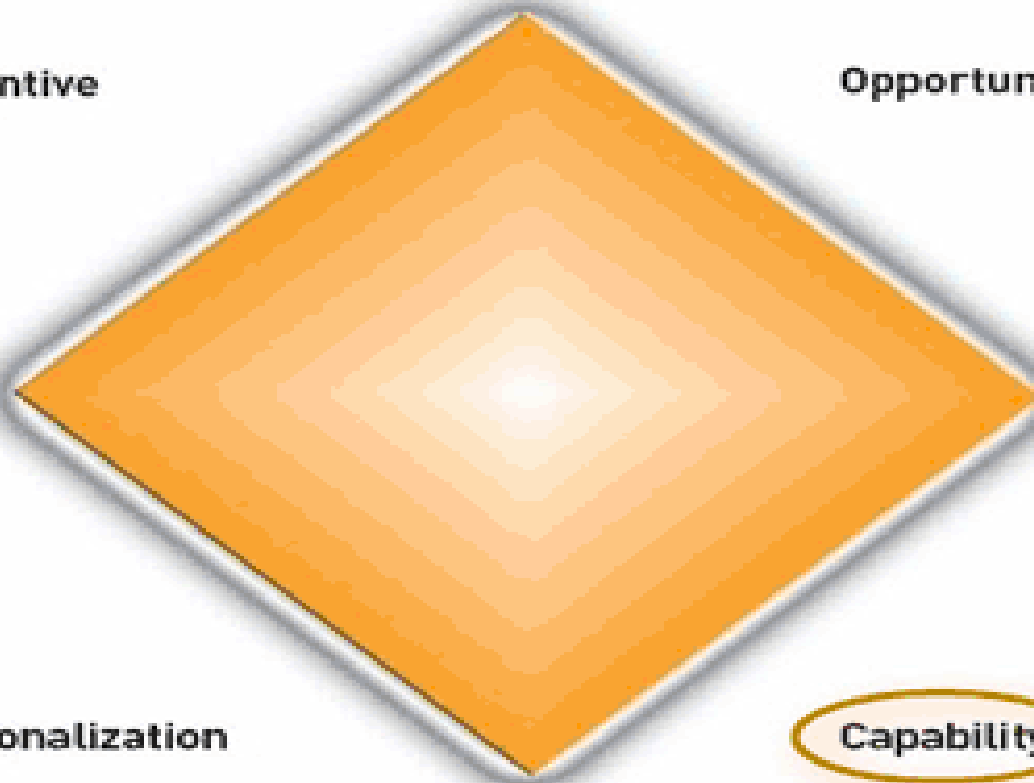
The Fraud Diamond

Incentive

Opportunity

Rationalization

Capability

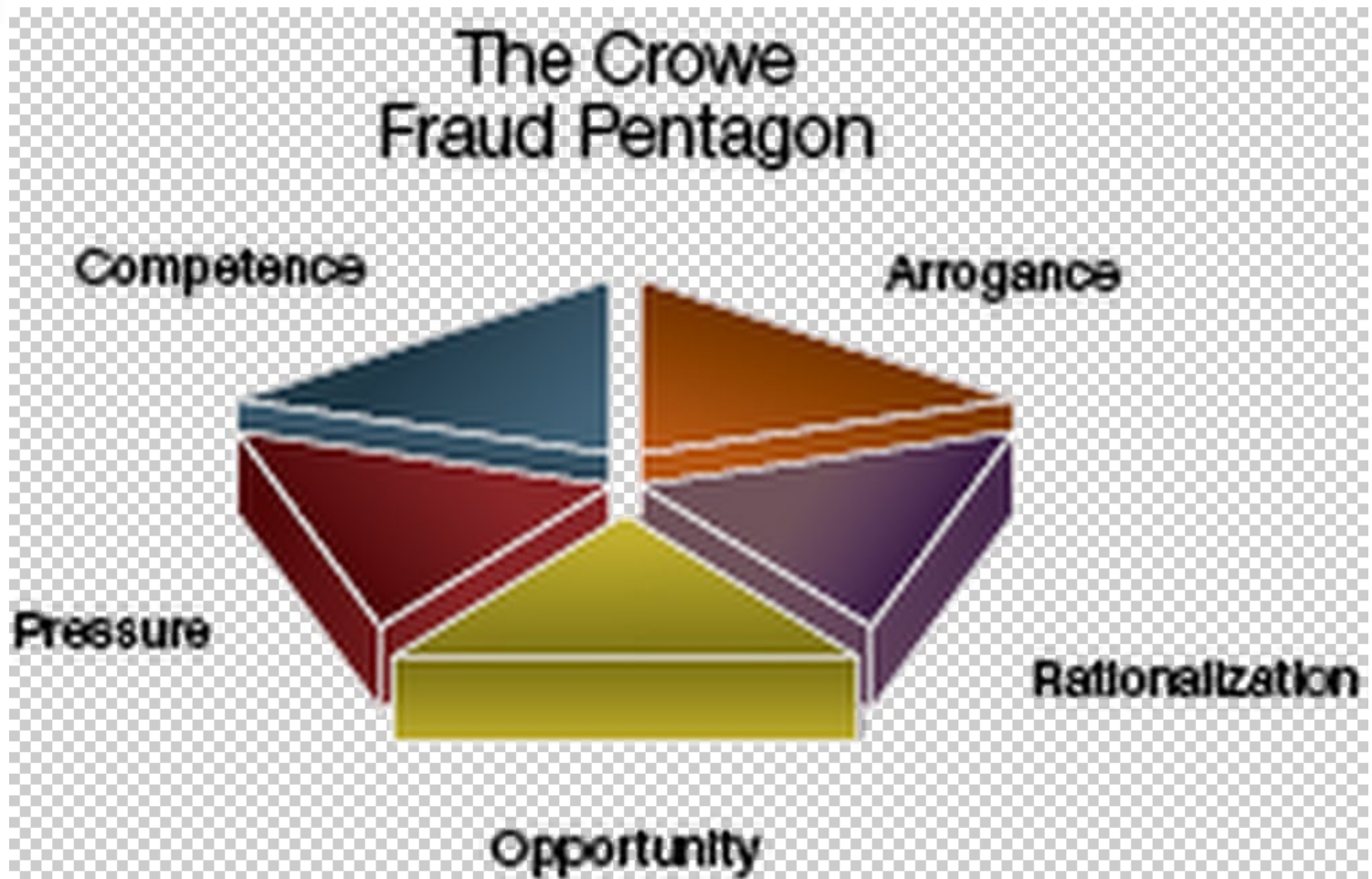




Many have tried to improve

- Still others have stated that it isn't merely enough to have an opportunity, one must then have
 - Arrogance
 - Competence
- This lead to the....

Many have tried to improve





Jay sez....

- The Fraud Triangle is sufficient
 - People are both similar and unique (i.e., similar that they have motivations and rationalizations, unique in how these play out).
- Capability and Competence are important considerations, but they are components of opportunity.
 - No logical mitigation strategies for capability or competence
- Arrogance is a red flag, and may lead to motivation or rationalization.
 - Arrogance is not necessary for fraud. The precise opposite is often true.
 - Limited logical mitigation strategies for arrogance.
- Jay used to prefer the term “motivation” to pressure for the first leg.
 - Pressure cannot explain all motivations (Executive Fraud Triangle)
 - However, 95% of all frauds involve financial or vice-related pressures
 - Much of the other 5% can be attributed to some form of benightedness.
 - Further, pressures are more readily mitigated than other motivations.
 - Therefore, Jay yields to the ACFE choice of pressure.



Polling Question 2 – The Other Fraud Triangle

The **Fraud Triangle**, also known as the **Fraud Motivation Triangle** is the conditions that typically exist *before* a fraud occurs.

There is another very useful shape, a second fraud triangle that explains the components *after* a fraud occurs.

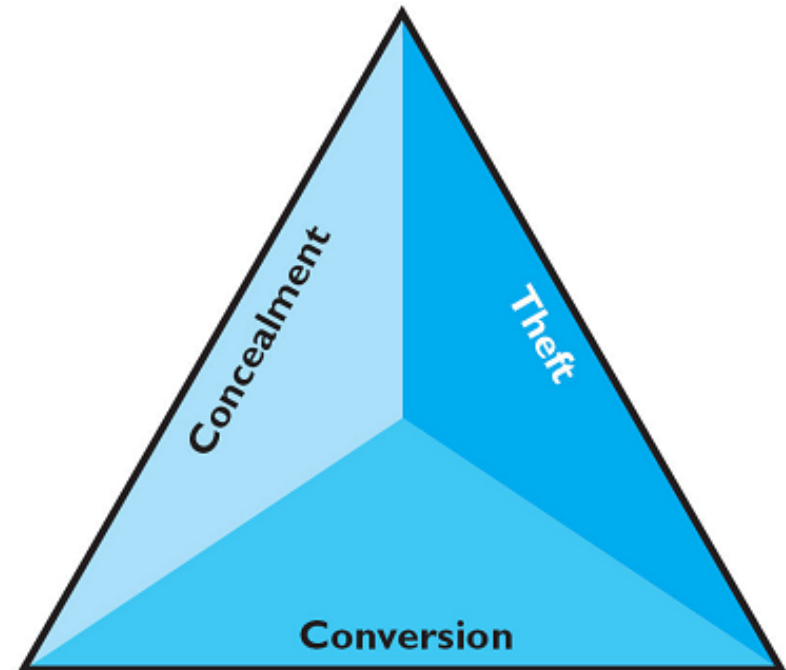
Do you know the legs of the **Fraud Element Triangle**?

1. No, I don't know the legs of the Fraud Element Triangle
2. Yes, the legs are: Identify, Investigate, Implement Correction
3. Yes, the legs are: Commit Theft Act, Convert, Conceal
4. Yes, the legs are: Opportunity, Incentive, Rationalization
5. Prefer not to answer



What are the legs of the Fraud Element Triangle?

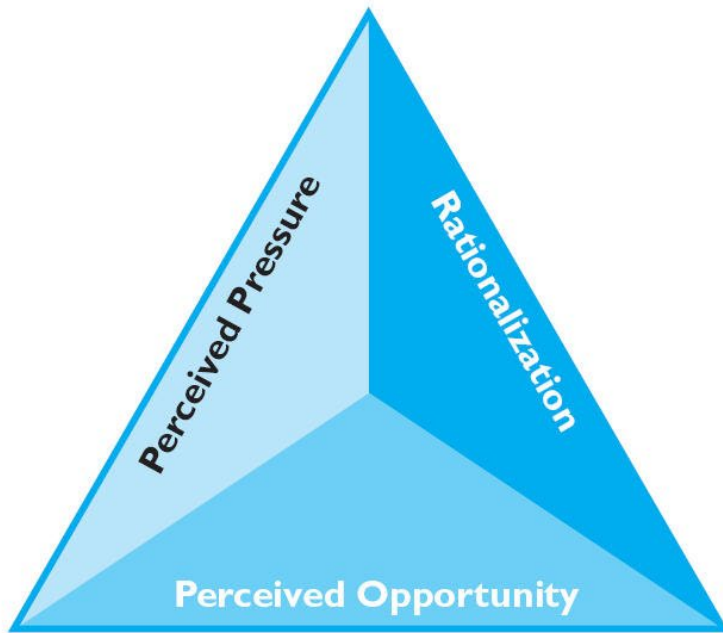
- Theft Act
- Conversion
- Concealment



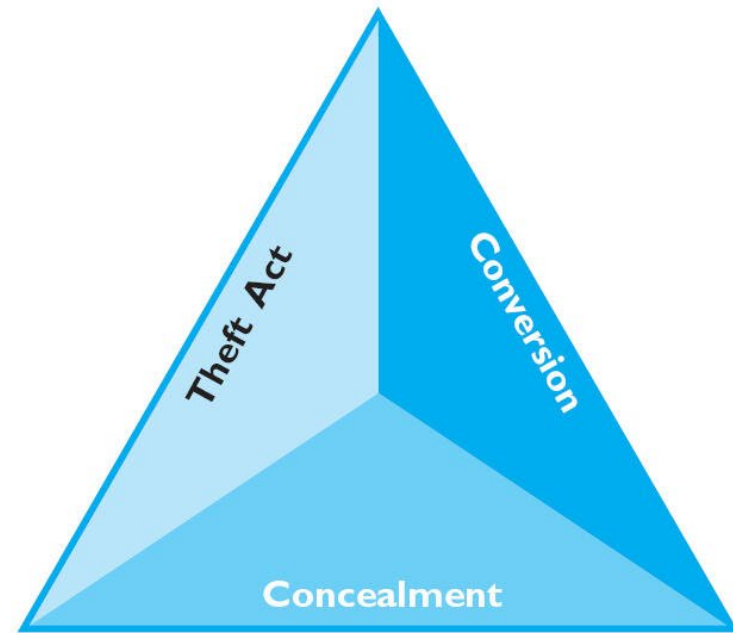
The Fraud Triangles

(before) (after)

Fraud Motivation Triangle



Fraud Element Triangle



- Prevention, detection, and investigation strategies are usually in context of the two fraud triangles.
- Where are the *perceived opportunities* in the Fraud Motivation Triangle? In the legs of the Fraud Element Triangle.



Rationalization

- Considered the “third leg” of the Fraud Triangle
- Starting here because it can start early
 - Formative years
 - Entertainment
- Culture
- What can we do to combat this leg?
 - Background checks (also uncovers pressures)
 - Honesty checks
 - Set an example
 - Culture of honesty, integrity – and hostility to fraud.
 - Tone at the top
 - Consequences

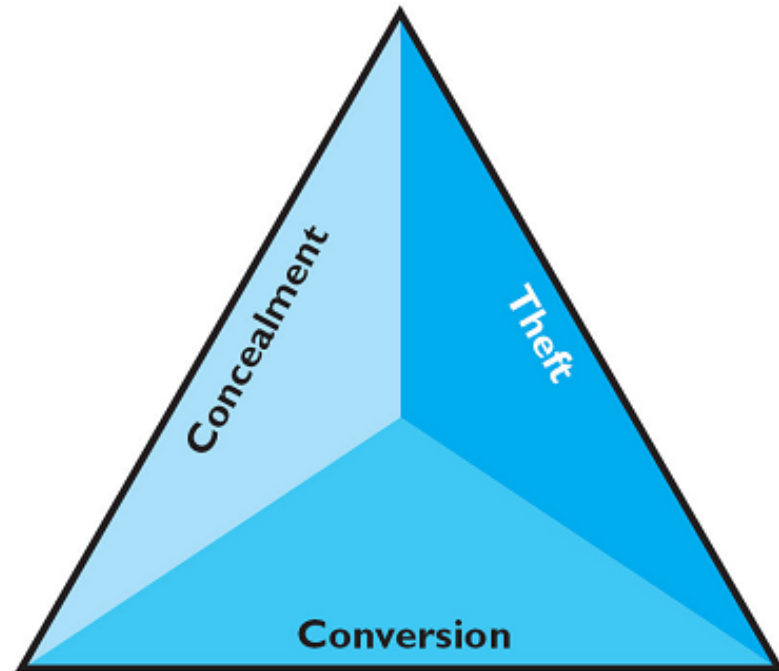


Pressure

- Considered the “first leg” of the Fraud Triangle
- Business Pressures (promotion, goals, boss, commission, etc.)
- Personal Pressures (debt, vices, affairs, family living, etc.)
- What can we do to combat this leg?
- Organizational:
 - Avoid unreasonable or unachievable goals (financial, productive)
 - Training (also addresses personal pressure and rationalization)
 - Clear procedures, avoid or eliminate exception clauses
- Personal:
 - Employee Assistance Programs
 - Training (also addresses organizational pressure and rationalization)
 - Pay, benefits
 - Background checks (also rationalization)
- **Create an environment hostile to fraud**: the pressure of committing fraud must exceed the pressures alleviated by committing the fraud.

Perceived Opportunity

- Considered the “second leg” of the Fraud Triangle
- Where we have the most tangible power
- I believe perceived opportunities coincide with the three legs of the Fraud Element Triangle.
 - Commit (Theft Act)
 - Convert
 - Conceal





Perceived Opportunity to Commit

- Physical safeguards
- Logical safeguards
 - Identification
 - Authentication
 - Passwords, biometrics, tokens, dual authentication, etc.
 - Authorization
 - Least privilege, approval
- Security
- Segregation of duties



Perceived Opportunity to Convert

- Checks
- Cash
 - Depends on what you want to use it for
- Value reducing protocols
 - Dye bombs on clothes, cash
 - Remote wiping of devices
 - Registrations
- Authentication
- Money Laundering
- Short term skim (temporary interest before payment)



Perceived Opportunity to Conceal

- Record Keeping
- Monitoring (also deters committing)
- Whistleblowing
 - Hotlines
 - Whistleblower protection
- Monitor interpersonal relationships
- Mandatory vacations
- Job rotation / Independence checks
- Surprise audits



Polling Question 3 - Detection

What is the most common way fraud and misconduct is detected?

1. Internal Audit
2. External Audit
3. Tips
4. Management detection
5. Prefer not to answer



Red flags – ACFE Report to the Nations

	<u>2020</u>	<u>2016</u>
• Living Beyond Means:	42%	46%
• Financial Difficulties:	26%	30%
• Unusually Close Association with Vendor/Customer:	19%	20%
• No Behavioral Red Flags:	15%	9%
• Control Issues, Unwillingness to Share Duties	15%	15%
• Irritability, Suspiciousness or Defensiveness:	13%	12%
• Wheeler-Dealer Attitude:	13%	15%
• Divorce/Family Problems:	12%	13%
• Addiction Problems:	9%	10%
• Complained About Inadequate Pay:	8%	9%
• Refusal to Take Vacations:	7%	8%
• Excessive Pressure from Within Organization:	7%	7%
• Past Employment-Related Problems:	6%	7%
• Social Isolation:	6%	6%
• Complained About Lack of Authority:	5%	4%
• Past Legal Problems:	5%	6%
• Excessive Family/Peer Pressure for Success:	4%	5%
• Instability in Life Circumstances:	4%	4%
• Other:	4%	6%



Remote Culture

COVID-19 has drastically altered how organizations do business, and how we audit. We must define a remote audit:

- A remote audit is an audit that is conducted partially or completely off site, generally using technology when a site visit is not possible or appropriate.
- COVID-19 accelerated the movement of the auditing profession toward using remote techniques to perform engagements.
- Remote auditing has long been a challenging topic for the profession because of the belief that auditors may be more likely to discover fraud, malfeasance, or simple mistakes when they visit a site.
- Engage IT as early as possible; consider capabilities and limitations in planning
- Use all the technology at your disposal to avoid missing anything.

When performing remotely, auditors have the same obligations to comply with standards and deliver high quality as they would when working on-site.



Polling Question 4 – Current Work Situation

Which best describes your work situation:

1. Working almost entirely remotely
2. Working remotely most of the time
3. Working remotely half the time
4. Working remotely some of the time
5. Rarely working remotely
6. Prefer not to answer



Auditing for an Ethical Culture

From The IIA's *Practice Guide: Auditing Culture*:

“Culture is difficult to define; however, for the purposes of this supplemental guidance, organizational culture and the conduct that occurs within that culture is defined as follows:

Culture represents the invisible belief systems, values, norms, and preferences of the individuals that form an organization. Conduct represents the tangible manifestation of culture through the actions, behaviors, and decisions of these individuals.

This definition captures the complexity of defining and then assessing an intangible organization-wide quality or aspect that comprises human belief systems, social norms, and other psychological factors.



Internal Auditor Ethics

The importance of ethics in internal audit can be summed up in one word:
credibility

It is understandably frustrating to receive ethical advice from a party perceived as unethical. This is true for recommendations made by auditors. As the old saying goes, "first heal thyself."

The intangible value of being regarded as ethical cannot be overstated.

This is true of internal audit, employees, as well as senior management, the Board, and organization as a whole.

We should be more than just internal auditors, we should aspire to be **Trusted Advisors** (former IIA President and CEO Richard Chambers wrote an entire book with this title)



Internal Audit's Role in Culture

The word “culture” does not appear in any of the attribute or performance standards in the IIA's *Standards*. It appears twice in the *Standards* document.

The word *cultural* appears in the first sentence of the *Standards* in the Introduction, although in this context it is not referring to an ethical perspective:

Introduction to the *Standards*

Internal auditing is conducted in diverse legal and cultural environments; for organizations that vary in purpose, size, complexity, and structure; and by persons within or outside the organization.

The other appearance is in the glossary definition of the *Code of Ethics*:

Code of Ethics

The Code of Ethics of The Institute of Internal Auditors (IIA) are Principles relevant to the profession and practice of internal auditing, and Rules of Conduct that describe behavior expected of internal auditors. The Code of Ethics applies to both parties and entities that provide internal audit services. The purpose of the Code of Ethics is to promote an **ethical culture** in the global profession of internal auditing. **[Emphasis Mine]**

The pillars of the Code of Ethics: **Integrity, Objectivity, Confidentiality** and **Competence**



What do the Standards say about Culture?

Though culture is not addressed directly, it is closely tied to ethics, which is frequently mentioned:

- The Code of Ethics must be defined in the Internal Audit Charter (AS 1000)
- The Charter must recognize the mandatory nature of the Code of Ethics (AS 1010)
- A conflict of interests exists even when no unethical acts occur (AS 1120)
- The Quality Assurance and Improvement Program (AS 1300,) requires an evaluation of adherence to the Code of Ethics during internal assessments (AS 1311) and external assessments (AS 1312)
- Noncompliance with the Code of Ethics must be reported to senior management and the Board (AS 1320, AS 1322, AS 2060, and AS 2431)
- An internal audit activity is only considered effectively managed if all auditors adhere to the Code of Ethics (AS 2000)
- Internal Audit must assess governance and make appropriate recommendations that promote appropriate ethics and values within the organization (AS 2110 and AS 2110.A1)
- In addition to the glossary definition of **Code of Ethics** (previous slide), the glossary includes **ethical values** as an element of the control environment (definition of **Control Environment**)



Red Flags and Risks to the Culture's Ethics

The IIA's *Practice Guide on Auditing Culture*, offers examples that are too common:

- Employees are penalized for mistakes (that may or may not be the result of their actions) in an environment of fear and blame
- Management regularly overrides key controls, and challenge is discouraged, bad actors can operate freely until their behavior becomes the norm
- Other employees who behave honestly may leave the organization or become corrupt themselves, resulting in further deterioration of the culture

The 2017 Fraud Examiner's Manual (page 4.620) also discusses a common fallacy regarding ethics:

“A common fallacy in discussions about ethics is: If it's legal, it's ethical. A common defense to charges of unethical behavior is to invoke the law. This legalistic approach to ethics mistakenly implies that actions that are not explicitly prohibited by the law are ethical. The main error in this approach is that legal standards do not establish ethical principles. Although abiding by the law is a part of ethical behavior, laws themselves do not describe how an ethical person should behave. One can be dishonest, unprincipled, untrustworthy, unfair, and uncaring without breaking the law. Ethical people measure their conduct by basic principles rather than rules.”

Takeaway: Just because something is not against the rules does not mean it is ethical.



Auditor Responsibility

Steps to mitigate fraud are *also effective at reducing other forms of misconduct*, and improve ethical culture. Here, the *Standards* assign clear requirements.

Engagement Planning: Assessing Fraud Risks (Practice Guide, released in October 2017)

- The *Standards* require the internal audit activity to assess fraud risks at the organizational and engagement level. To ensure adequate review of the risks relevant to each engagement, internal auditors should conduct a fraud risk assessment as part of engagement planning (AS 2210.A1). The process, while varying, generally includes the following steps:
 - Gather information to understand the purpose and context of the engagement, as well as the governance, risk management, and controls relevant to the area or process under review.
 - Brainstorm fraud scenarios to identify potential fraud risks.
 - Assess the identified fraud risks to determine which risks require further evaluation during the engagement.
- The internal audit activity is responsible for assessing the organization's risk management processes and their effectiveness, including the evaluation of fraud risks and how they are managed by the organization (AS 2120.A2).
- Internal auditors must consider the probability of fraud when they develop the objectives of each engagement (AS 2210.A2).
- While internal auditors must have sufficient knowledge to evaluate the risk of fraud and how it is managed by the organization, they are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud (AS 1210.A2).
- When assessing fraud risks, internal auditors are expected to exercise due professional care (AS 1220.A1) and maintain an impartial, unbiased attitude (AS 1120).



Conclusion

- Questions?
- War Stories?
- Jay Wagner, jay.wagner.ia@gmail.com