

Quick wins in fraud risk management

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Definition and nature of fraud

- **Fraud** – это «the use of one's occupation for *personal* enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets».

Source: Association of Certified Fraud Examiners (ACFE)

- **Fraud (ISA 240)** – is «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».

- Intentions are a derivative of *internal culture* and personal *upbringing*. These are the most important ultimate factors of fraud.
- This is the basis for development a personnel security model, as well as a general fraud risk management framework.

Expectations – Fraud risk management

Management

C-Level Officers

Supervisory Board (Bord of Directors)



- Increasing *control discipline* (vigilance) on the part of managers and performers
- *Protection against* fraud by *unscrupulous* managers and staff
- Anti-fraud procedures fit *seamlessly* into business processes and are perceived as necessary and useful by managers and staff
- Fast *decision making* and effective *coordination* with related departments due to the absence of conflicts of interest
- «Complicated cases» are quickly and effectively *investigated*

- *Improvements* of the internal control system at the level of core processes and below are ensured
- Increasing the effectiveness of the hotline and other *information* channels
- *Fraud* risks are recognized and actions are taken to *manage* them, improving efficiency and management decisions
- Effective *information exchange* and *communication* between departments, creating an atmosphere of trust
- There is an effective mechanism for monitoring the quality and continuous *improvement* of the fraud risk management system

- Management demonstrates the appropriate *tone from the top* regarding fraud and unethical behavior and improves the overall control environment
- Ensuring company (financial) *transparency*
- Full understanding, disclosure and discussion of the company's *key risks*, understanding and discussion of factors
- Management implements the highest *priority improvements* in the anti-fraud system (program)
- Uniform and transparent *protocols* for detecting and investigating fraud events (cases)

“Quick wins” areas in fraud risk management framework

- ▶ Components of defense (protection) against fraud risks

Internal Environment (Ethics)	Internal control system (ICS)	Monitoring of ICS	Whistleblowing	Investigations
<p>Company’s values Tone from Board of Directors and Senior Management</p> <p>Ethical norms Code of corporate rules System for implementing and maintaining the Code of corporate rules and Ethics standards</p>	<p>Fraud risk assessment at mega-process level and below</p> <p>System of procedures and tools for preventing fraud</p> <p>Responsibility Regulations and rules Control activities Regular reviews on signals (indicators) HR</p>	<p>Monitoring of ICS by business process owners</p> <p>Monitoring of ICS by supporting functions</p> <p>Monitoring (diagnostics) of ICS by Security department</p> <p>Internal audit department</p> <p>IT- and information systems (IS) monitoring</p>	<p>Hotline implementation</p> <p>Accountability issues and hotline security</p> <p>Whistleblower protection and signal filtering</p> <p>System for initiating actions based on hotline signals</p>	<p>Management review (of incidents)</p> <p>Investigation by Security department (reporting to CEO)</p> <p>Independent Internal Investigations unit (department)</p> <p>Coordination IT investigations Reporting and informing</p>

Corporate general-purpose means: «quick wins» и «next steps»

«Quick wins»:

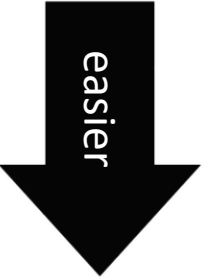
- Ethics code
- Ethics «hotline» launch
- Independent investigation function
- Special personnel exit interviews
- System of proactive employee surveys
- «Introduction» at hiring
- Fraud risk assessment

«Next steps»:

- Effective coordination between different services
- Unified investigation protocols
- Development of audit (diagnostics) practice of internal control over fraud risks

Fraud risk assessments: 2 options

Understanding regarding (risk of) fraud



easier

- Coordinated, company-wide assessment of inherent risks
 - Considering the fraud factor when assessing each risk (“opportunity”, “motivation”, “pressure”)
- Reflection (or appearance) of risk in processes or special projects – «mapping» risks onto processes/projects
 - Risk appearance level - «high», «medium», «low»
 - Saturation of processes/projects with risk events
 - Organizational complexity of processes/projects: «internal complexity» and «capacity»
 - Considering the effectiveness of universal anti-fraud tools
- *Preparatory work (preparation of a standard risk map, preliminary interviews, confirmation of risk narratives)*
 - *Introductory presentation and supporting handouts*
 - *Voting with further discussion*
 - *Focus on expert opinions*
 - *Distribution of materials and follow-up interviews*

TRANSITION TO THE NEXT LEVEL

Application of a polygraph

In 2003, the US National Academy of Sciences published the report “The Polygraph and Lie Detection.”

The Academy of Sciences found that most polygraph research was «scanty, scientifically weak and biased». After conducting experiments, it was found that polygraph testing of a large number of people in relation to various events (for example, when applying for a job) gives a result *no better than random guessing*.

At the same time, specific-incident testing of a small number of people (in relation to a specific event that has occurred, for example, a specific crime) makes it possible to distinguish lies and truth *at a level slightly higher than random guessing*.

The «error» factor of methods applying a polygraph:

Subject's bias - the body's reactions do not reflect the truth of the facts, but only the subject's belief in their truth or falsity. The subject may think that his knowledge is true, although in fact it was instilled or imposed on him.

Raising the efficiency of the hotline

- ▶ Simple, clear “channels” and communications
- ▶ Providing personnel resources for the hotline support
- ▶ Assurance of independence
- ▶ Hotline awareness campaign (plan)
- ▶ Continuous improvement program

Roles of internal audit in counter-fraud activities

- ▶ Assessing counter-fraud systems – KEY
- ▶ Fraud risk assessment – KEY
- ▶ Identification of fraud (“red flags”, indicators) – KEY
- ▶ Servicing counter-fraud «hotline» – RELEVANT
- ▶ Detection of fraud – PROBABLE
- ▶ Investigation of fraud cases – PROBABLE
- ▶ Reporting on consequences of fraud – PROBABLE
- ▶ Participation in decision-making based on results of investigations – FORBIDDEN
- ▶ Implementation (on behalf of management) of counter-fraud tools – FORBIDDEN

Example: place of Internal Investigation Unit within an independent Internal Audit Division (IAD)

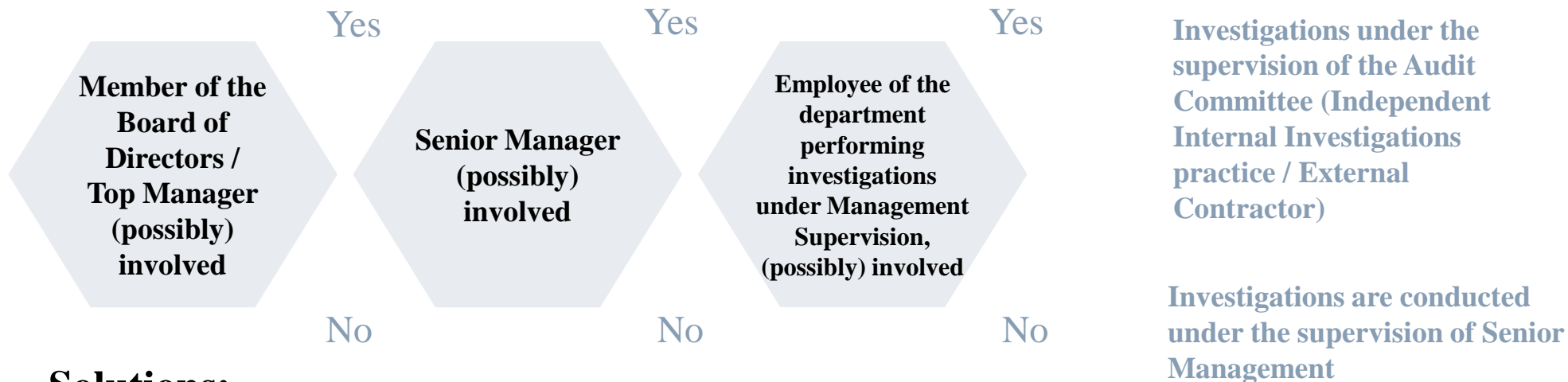


Relation to time dimension / Type of an offense	To the future – “Perspective” * Event (risk) may occur	Back to the past – “Retrospective” * (Negative) event occurred
Error (no intention)	Internal audit	IAD doesn't have a permanent role
Fraud (intention exists)	Internal audit	Fraud investigation

Internal audit vs. Investigations

<u>Item of compare</u>	<u>Internal audit</u> (in relation to risks and counter-fraud systems)	<u>Fraud investigation</u>
«Signal»	There is no specific «signal»	There is a «signal»: a complaint, a (reasonable) stated suspicion of someone, etc.
Subject	Identification of fraud indicators	Collect evidence or refute the “signal”
Approach	Fraud risk assessment and identification of fraud indicators	Investigation of a specific case
Focus	Understanding the reasons why a fraud event occurred/may occur, identifying the internal control system deficiencies	Analyze, interpret and present observations as if they were being tried in court
Competence	Skills and knowledge of how fraud schemes can act and what key indicators of fraud schemes are. Understanding when an investigation is necessary.	Skills and knowledge on how to conduct investigations

Coordination of fraud detection and investigation practices (business case)



Solutions:

- ▶ No investigation may be assigned to anyone with absence of necessary competencies (i.e., in particular, to anyone other than the specialists of the dedicated independent fraud investigation unit, security specialists or competent specialists of the relevant external contractor).
- ▶ The investigation methodology must be uniform and consistent with the protocols approved by the Board of Directors.
- ▶ The role of internal auditors may be to evaluate the effectiveness of investigation procedures and their compliance with given protocols and uniform methodology. In general, internal auditors may only be involved in an investigation after the approval of the Chief Audit Executive, and only as assisting experts.
- ▶ The Chief Audit Executive should be kept informed of all significant investigative reports.

Example: statistics of *qualified* «signals» and actions taken

Approximate statistics of the distribution of qualified “signals” about (possible) fraudulent activities between the unit (department) carrying out *independent internal investigations (I.I.I.)* and other inspection unit(s).

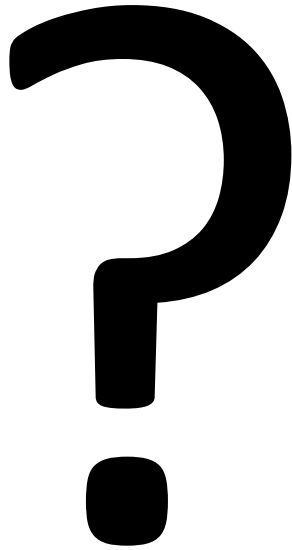
A “signal” is considered qualified under the following terms:

- it is registered in a special journal
- (if necessary) a preliminary assessment of the “signal” was carried out, based on the results of which conclusions about the need for investigation were formulated

Q # 20XX	No. of qualified «signals»	Assigned to investigation	Delegated ...		Independent (I.I.I.*) ...		Completed / Confirmed	
			Entirely	with Participation	with Coordination	Entirely	Delegated	I.I.I.*
“Big”	4	4	-	-	2	2	-	3/3
“Lesser”	17	16	8	2	1	5	7/6	6/5
Total number of “signals”	21	20	8	2	3	7	7/6	9/8
Reports with “S” criterium	5	4	-	2	1	1	2/2	2/1
Ethical issues not related to fraud	22	Assignment and completion of non-fraud ethical “signal” reviews are not tracked						

I.I.I. – Independent Internal Investigations

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