



The Role of Internal Audit in the Fight Against Fraud

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A Bad Influence



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Learning Objectives

- **Recognize the control weaknesses that commonly lead to fraud, including the "Terminal Two"**
- **Apply your knowledge of internal controls to sharpen the focus of audits and investigations to make them more productive**
- **Explore the state of internal controls in today's business environment and learn why they so often fail**
- **Identify ways to improve fraud prevention and detect it sooner when it happens**

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Question #1

What is your role?

- A. Public Accountant**
- B. Attorney**
- C. Internal Auditor**
- D. Ethics/Compliance**
- E. Management**
- F. C-Level Executive**
- G. Law Enforcement**
- H. Other**

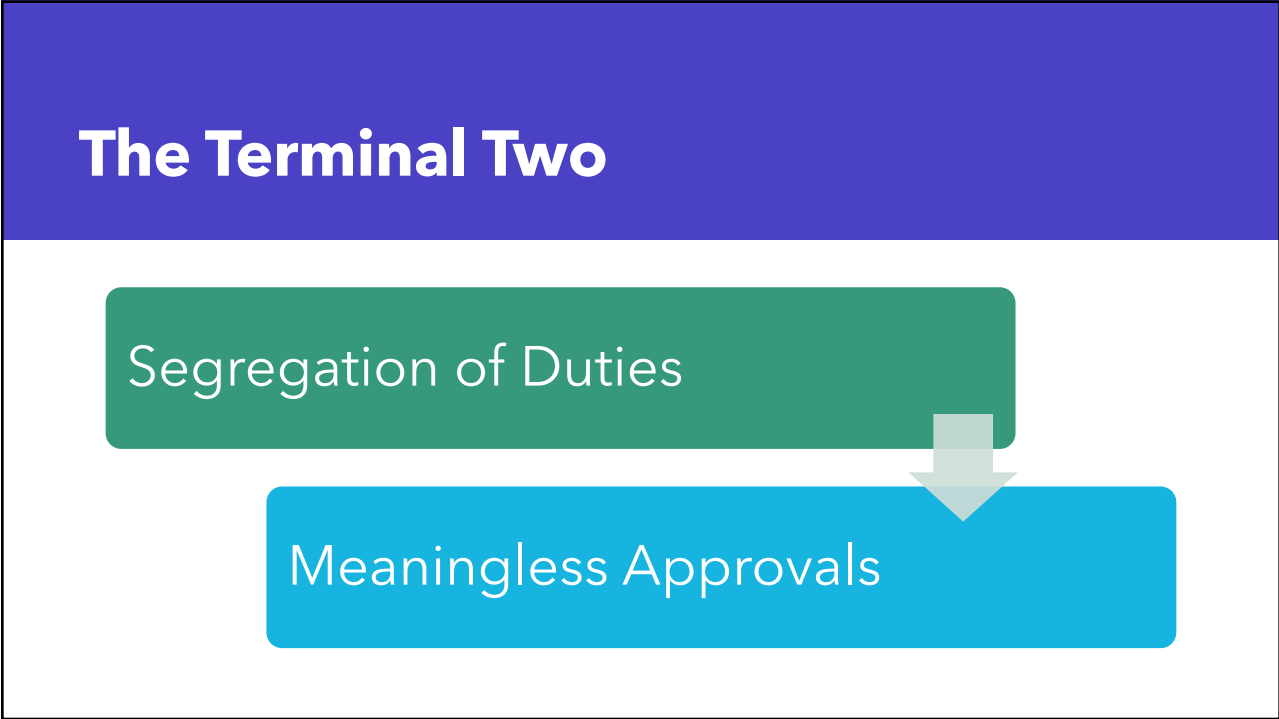
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The Ambitious Payroll Manager

Agricultural Industry

The complex block features a blue background on the left side with the text "The Ambitious Payroll Manager" in white. To the right, there is a photograph of a woman in a black business suit shaking hands with a man in a light blue dress shirt and a striped tie. Further to the right is a landscape photograph of rolling mountains under a blue sky.


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Internal Controls

- Replaced Staff/Moved Payroll to HR
- Sole Authority Over Payroll Master File
- Initiated Transactions
- Posted General Ledger
- Reconciled Payroll Bank Account

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Red Flags



- Spouse
- Home
- Cars
- Clothing and Jewelry
- Private Schools
- Horses

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Sharpen Focus

Unreliable Payroll Records

Third-Party Documentation

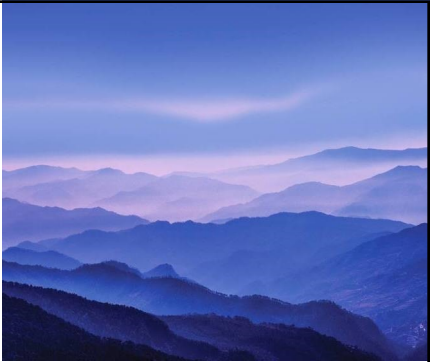
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Sleight of Hand and Misdirection



- **Altered payroll master file**
- **Created phony transaction**
- **Deleted payroll register entries**
- **Created fraudulent journal entries**

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Damage

\$2.25 million

- Fictitious payroll disbursements
- Tax refunds


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**A Charity's
Uncharitable
Controller**

**Regional Chapter
International Humanitarian Organization**

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Red Flags

- Modest Income
- Boat
- New Cars
- Season Tickets
- Vacations
- Gambling

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Internal Controls

- Received Cash
- Made Bank Deposits
- Received and Approved Vendor Invoices
- Signed and Issued Checks
- Payroll
- Posted the General Ledger
- Reconciled Bank Accounts

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Sharpen Focus

Unreliable Internal Records

Third-Party Documentation

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Sleight of Hand and Misdirection



- **Traveler's Checks**
- **Credit Card**
- **Cash Receipts**

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Damage

\$565K in two years

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The Greedy Superstar

Technology Company

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Internal Controls	<ul style="list-style-type: none">ERP with Expense Reporting ModuleCorporate Amex CardCash or Personal Credit Card Permitted in Some CasesNo Receipt for Expenditures Under \$25Supervisor Reviews/Approves
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Question #2	<p>How would you assess these controls?</p> <ul style="list-style-type: none">A. AdequateB. Improvement NeededC. Inadequate
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Sharpen Focus

Personal Credit Card Cash Transactions of \$25 or Less

Third-Party Documentation/Email

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Red Flags



- Numerous cash expenditures without receipts
- Excessive use of personal credit card

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Multiple Expense Reports

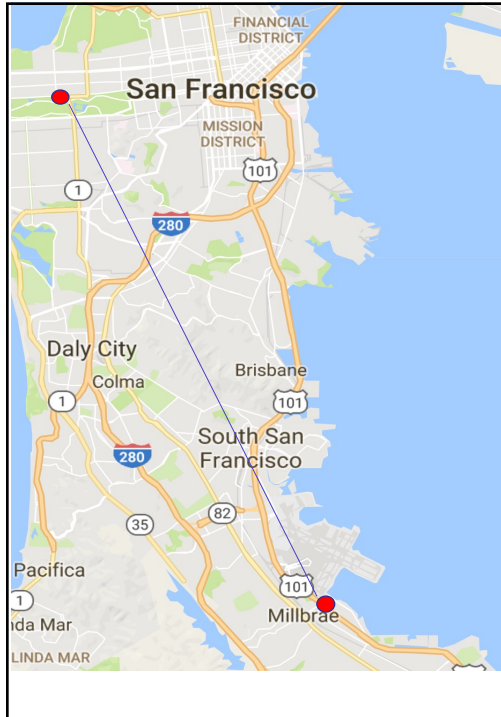
Report Date	Expense Date	Description	Amount
• Expense Report 3/6	3/1	Breakfast at McDonalds	\$24
• Expense Report 3/6	3/1	Lunch at Subway	\$24
• Expense Report 3/6	3/1	Dinner at hotel	\$24
• Expense Report 3/6	3/1	Wi-Fi	\$18

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Multiple Expense Reports

Report Date	Expense Date	Description	Amount
• Expense Report 3/6	3/1	Breakfast at McDonalds	\$24
• Expense Report 3/13	3/1	Breakfast at Starbucks	\$24
• Expense Report 3/20	3/1	Breakfast at hotel	\$24
• Expense Report 3/6	3/1	Lunch at Subway	\$24
• Expense Report 3/13	3/1	Lunch at Starbucks	\$24
• Expense Report 3/20	3/1	Lunch at Local Bistro	\$24
• Expense Report 3/6	3/1	Dinner at hotel	\$24
• Expense Report 3/13	3/1	Client dinner at Alchemy	\$400
• Expense Report 3/20	3/1	Dinner at Local Bistro	\$24
• Expense Report 3/6	3/1	Wi-Fi	\$18
• Expense Report 3/13	3/1	Wi-Fi	\$18
• Expense Report 3/20	3/1	Wi-Fi	\$18

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Saturday Travel for Orlando Conference:

- Cash breakfast at McDonalds - \$24
- Cash lunch at Subway - \$24
- Cash dinner at Local Bistro - \$24
- Car service to SFO - \$150
- Flight to Orlando departed 10:55 PM
- Cash for in-flight Wi-Fi - \$18

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Sleight of
Hand and
Misdirection



- **Personal/fictitious expenditures**
- **Bogus/altered receipts**
- **Multiple expense reports**
- **Personal/unnecessary flights**
- **Fraudulent billing to 3rd parties**

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Damage



- **\$200-300K per year**
- **Effective supervisory review would have prevented it**

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It Often Goes Further



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An Acquisition

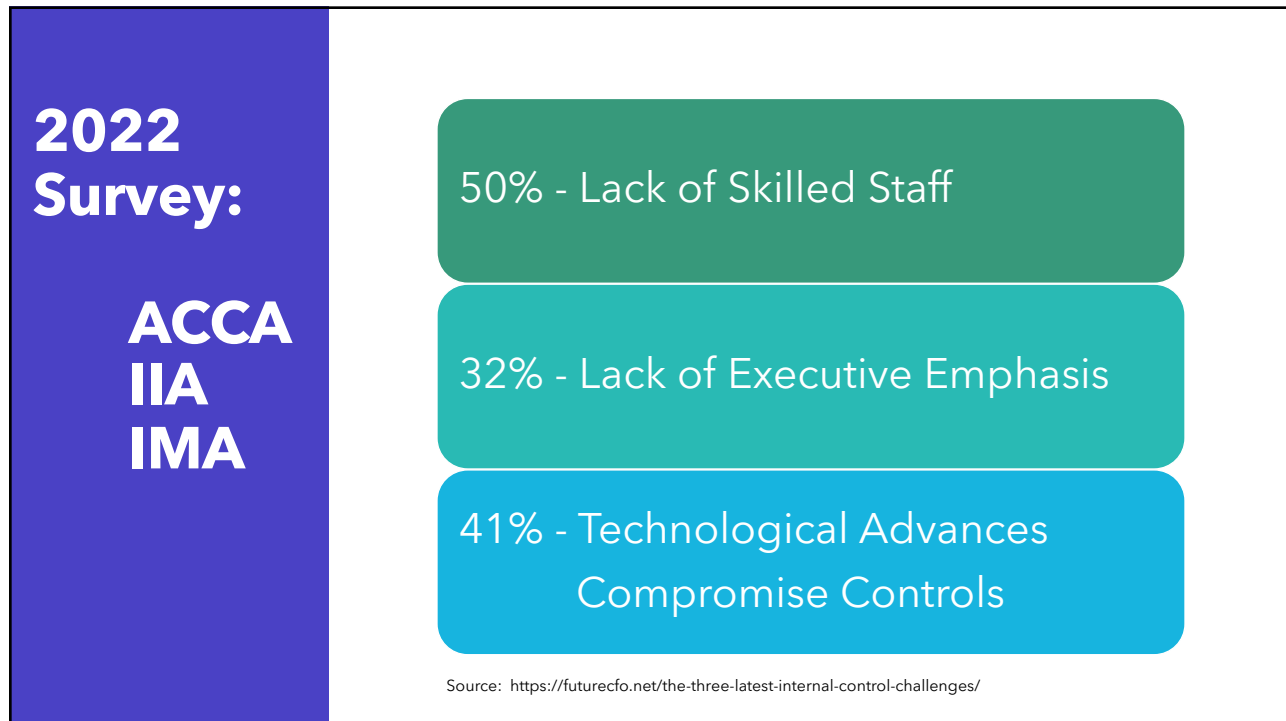


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The State of Internal Controls



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Question #3

What obstacles do you see in implementing effective internal controls?

- A. Lack of skilled staff**
- B. Lack of executive emphasis**
- C. Technological advances**
- D. Other**

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Response to Calamity

Calamity - 1929



Government Response 1933 - 1934



Industry Response 1936

- AICPA Defined Internal Control
- Measures and methods adopted within the organization to safeguard the cash and other assets of the company as well as to check the clerical accuracy of the bookkeeping

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Response to Calamity

Calamity - 1929



Government Response 1933 - 1934



Industry Response 1949

- 1949 - AICPA Revised Definition
- Safeguard assets, check the accuracy and reliability of accounting data, promote operational efficiency, and encourage adherence to prescribed management policies

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Response to Calamity

Calamity - 1972



<https://content.time.com/time/covers/0,16641,19730430,00.html>

Government Response 1977

Foreign Corrupt Practices Act



Industry Response 1985

- The Treadway Commission
- Cited Watergate and FCPA as events that led to the formation

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Response to Calamity

Calamity - 2001



<https://content.time.com/time/covers/europe/0,16641,20020708,00.html>

Government Response - 2002

Sarbanes-Oxley Act



Industry Response

- COSO became the universally accepted standard for SOX Compliance

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Response to Calamity

Calamity - 2008



<https://content.time.com/time/covers/asia/0,16641,20080929,00.html>

Government Response - 2010

Dodd-Frank 2010



Industry Response



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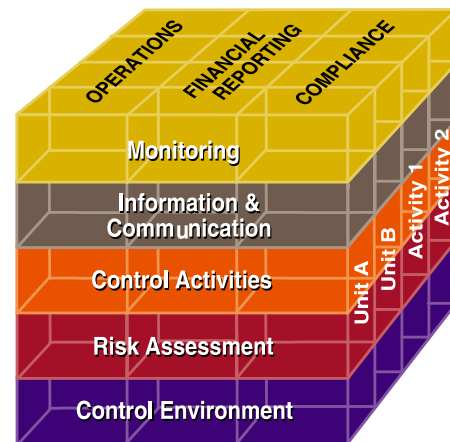
The COSO Pyramid



Source: COSO Integrated Framework - 1992

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COSO Integrated Framework 1992



Source: COSO Integrated Framework - 1992

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COSO Redefined Internal Controls

COSO 1992

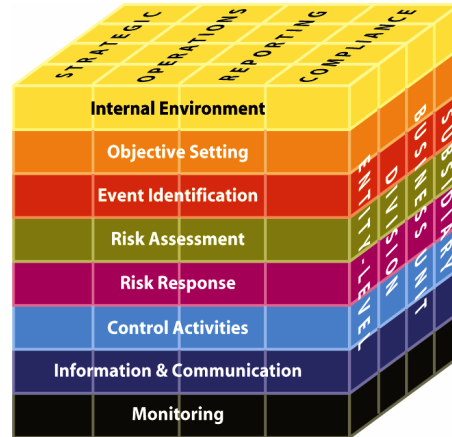
Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

Source: COSO Integrated Framework - 1992

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COSO Enterprise Risk Management 2004



Source: COSO Enterprise Risk Management - 2004

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COSO Integrated Framework 2013



Source: COSO Integrated Framework - 2013

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COSO Enterprise Risk Management 2017




- Governance & Culture
- Strategy & Objective-Setting
- Performance
- Review & Revision
- Information, Communication, & Reporting


Source: COSO Enterprise Risk Management - 2017

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Failures Persist




Elizabeth Holmes
Theranos
2018



Marcus Braun
Wirecard
2020



Sam Bankman-Fried
FTX
2022

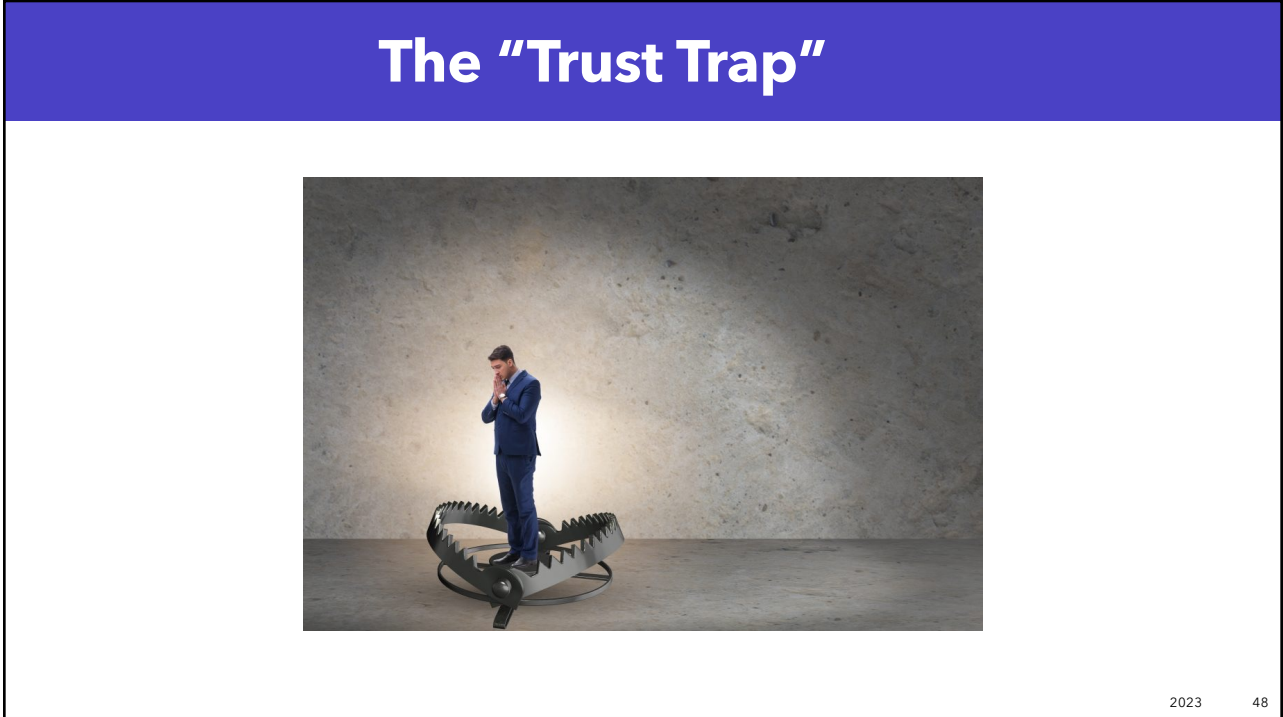


SVB
2023

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2023 48

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What To Do?


- Education
- Risk Assessment
- Pay Attention to the Terminal Two

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Critical Qualities

- Competence
- Curiosity
- Courage

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Questions

