INTERNAL AUDIT EFFECTIVENESS

- **Conducting Fraud Investigations**
- **Conducting Internal Audit**

Conducting Fraud Investigations

Why Fraud?

Fraud is the product of three factors:

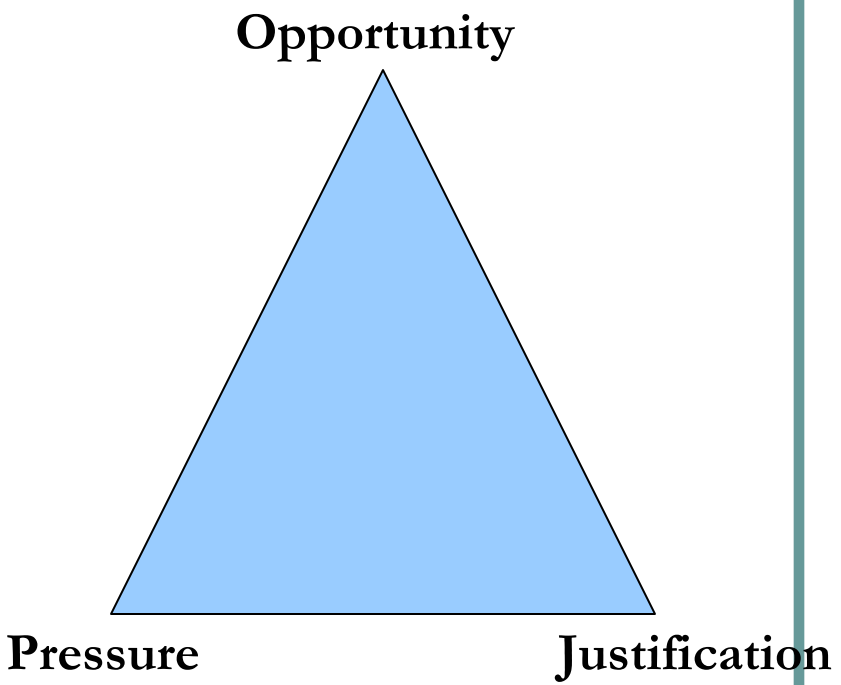
- Supply of motivated offenders;
- The presence of a prospective victim or target
- The absence of a capable guardian

(Australian Institute of Criminology, Trends & Issues in Crime and Criminal Justice)

The Fraud Triangle

Factors contributing to fraud

- Poor internal controls
- Management override of internal controls
- Collusion between employees
- Collusion between employees and third parties



Some Facts about the Fraud

Individual Profile:

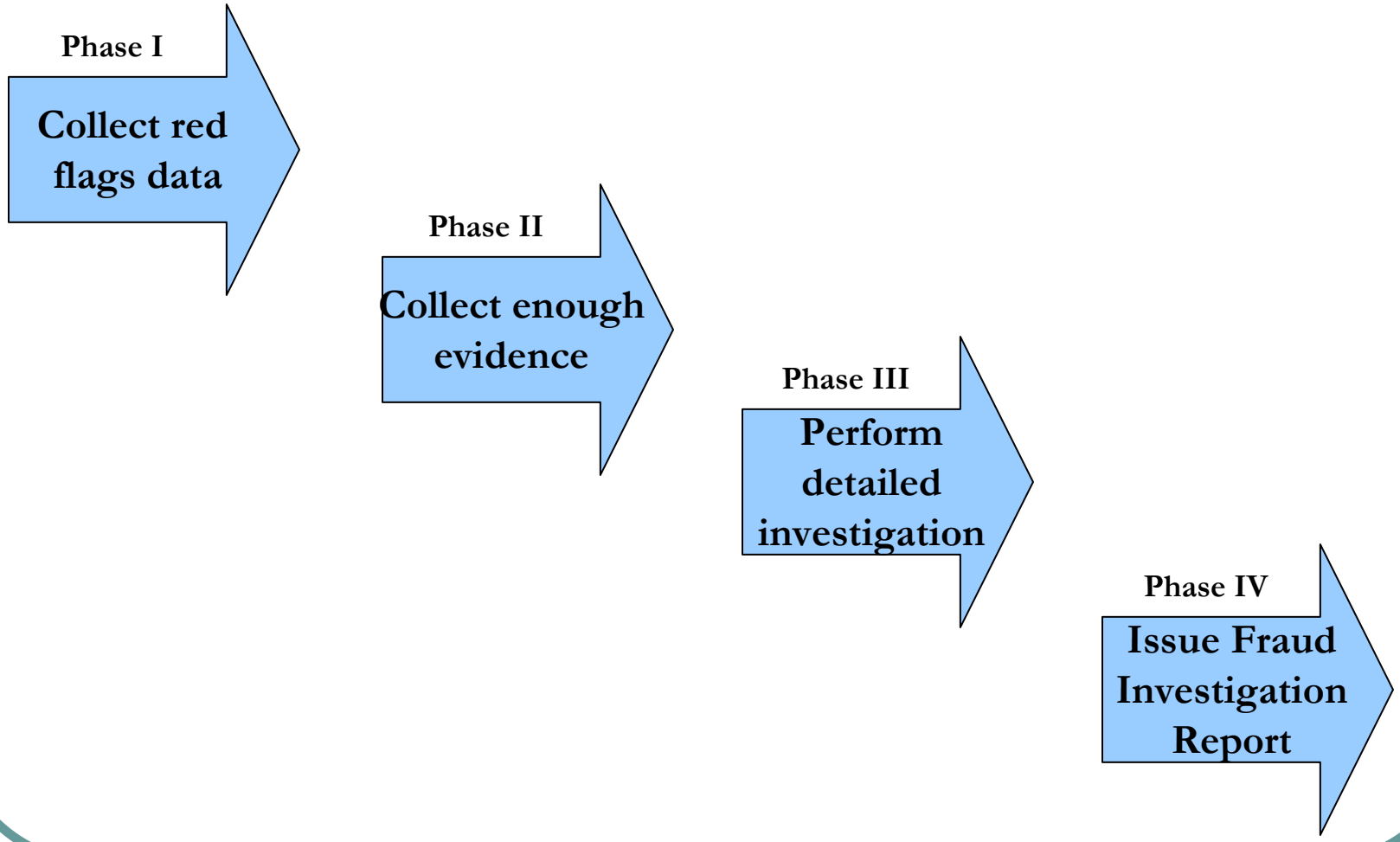
- The majority of occupational fraud cases (41.2 percent) are committed by employees. However, the median loss for fraud committed by managers was almost three times greater than the loss resulting from an employee scheme.
- Approximately 61 percent of the fraud cases were committed by men.
- Most fraud perpetrators (87.9 percent) have never been charged or convicted of a crime. This supports previous research which has found that those who commit occupational fraud are not career criminals.
- Nearly 40 percent of all fraud cases are committed by two or more individuals.
- The median loss attributable to fraud by older employees is greater than that of their younger counterparts.

Organizational Profile:

- Most costly abuses occur within organizations with less than 100 employees.
- Mostly frauds occur in the organizations where:
  - Management ignores irregularities.
  - High turnover with low morale.
  - Staff lacks training.

(AFCE Survey 2006)

Fraud Investigation Process



Red Flags (Employee Fraud)

- Employee lifestyle changes: expensive cars, jewellery, homes, clothes
- Significant personal debt and credit problems
- Behavioural changes: these may be an indication of drugs, alcohol, gambling, or just fear of losing the job
- High employee turnover, especially in those areas which are more vulnerable to fraud
- Refusal to take vacation or sick leave
- Lack of segregation of duties in the vulnerable area
- Carrying unusually large sums of money
- Easily annoyed at reasonable questioning
- Borrowing money from co-workers

Red Flags (Management Fraud)

- Reluctance to provide information to auditors
- Managers engage in frequent disputes with auditors
- Management decisions are dominated by an individual or small group
- Managers display significant disrespect for regulatory bodies
- There is a weak internal control environment
- Accounting personnel are lax or inexperienced in their duties
- Decentralization without adequate monitoring
- Excessive number of checking / suspense accounts
- Frequent changes in bank accounts
- Frequent changes in external auditors
- Company assets sold for less than market value
- Significant downsizing in a growing economy
- Continuous rollover of loans

Red Flags (Management Fraud)

- Excessive number of year end transactions
- High employee turnover rate
- Unexpected overdrafts or declines in cash balances
- Refusal by company or division to use serial numbered documents (receipts)
- Compensation program that is out of proportion
- Service Contracts result in no product
- Photocopied or missing documents
- Excessive number of voids, discounts and returns
- Large number of write-offs of accounts
- Bank accounts that are not reconciled on a timely basis
- Employees with duplicate Social Security numbers, names, and addresses
- Employees with few or no payroll deductions

The Next Steps

Collect enough evidence to initiate detailed investigation:

- Perform analytical procedures
- Observe the suspected persons
- Do not disclose that you are conducting an investigation
- After gathering enough evidence, provide the information to appropriate level of management to grant detailed investigation.
- Conduct investigation with specialized fraud consultants e.g. forensic auditors, security personnel
- Be careful! The suspected person can sue the organization for false imprisonment, libel or slander.

Conducting Internal Audit

Why Internal Audit?

- Independent assurance
- Reduced losses caused by inefficient and ineffective operations
- Improved business processes and controls
- Enhanced control over the business
- Fewer surprises
- Effective decision making
- Facilitates Corporate Governance and its implementation
- Increased awareness about controls

Independence of Internal Auditor

- The internal audit activity should be independent, and internal auditors should be objective in performing their work.
- The chief audit executive should report to a level within the organization that allows the internal audit activity to fulfil its responsibilities.
- The internal audit activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results.
- Internal auditors should have an impartial, unbiased attitude and avoid conflicts of interest.
- If independence or objectivity is impaired in fact or appearance, the details of the impairment should be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment.

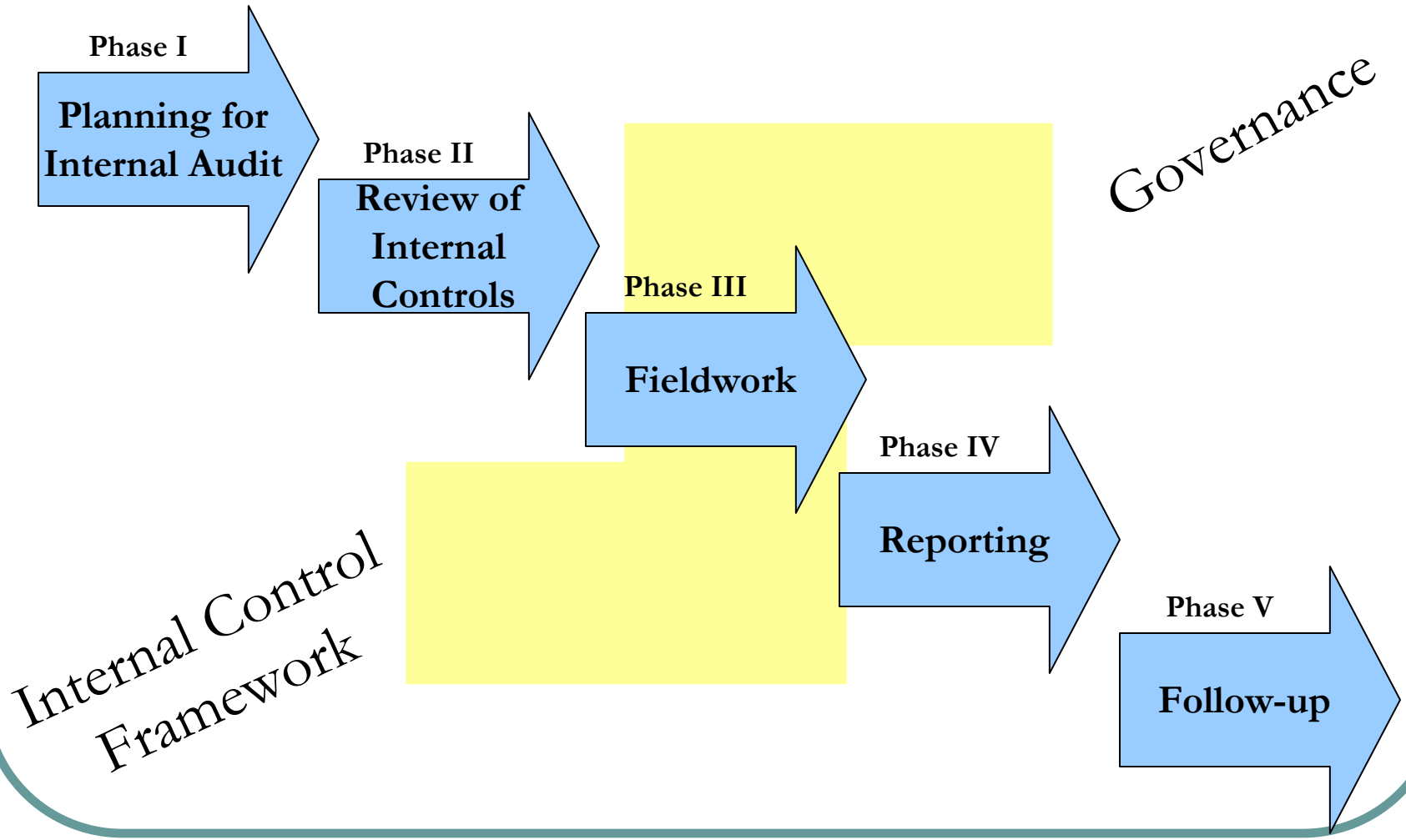
Independence of Internal Auditor

- Internal auditors should refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an internal auditor provides assurance services for an activity for which the internal auditor had responsibility within the previous year.
- Assurance engagements for functions over which the chief audit executive has responsibility should be overseen by a party outside the internal audit activity.
- Internal auditors may provide consulting services relating to operations for which they had previous responsibilities.
- If internal auditors have potential impairments to independence or objectivity relating to proposed consulting services, disclosure should be made to the engagement client prior to accepting the engagement. *(IIA Attribute Standards 1100-1130)*

Threats to Auditor's Independence

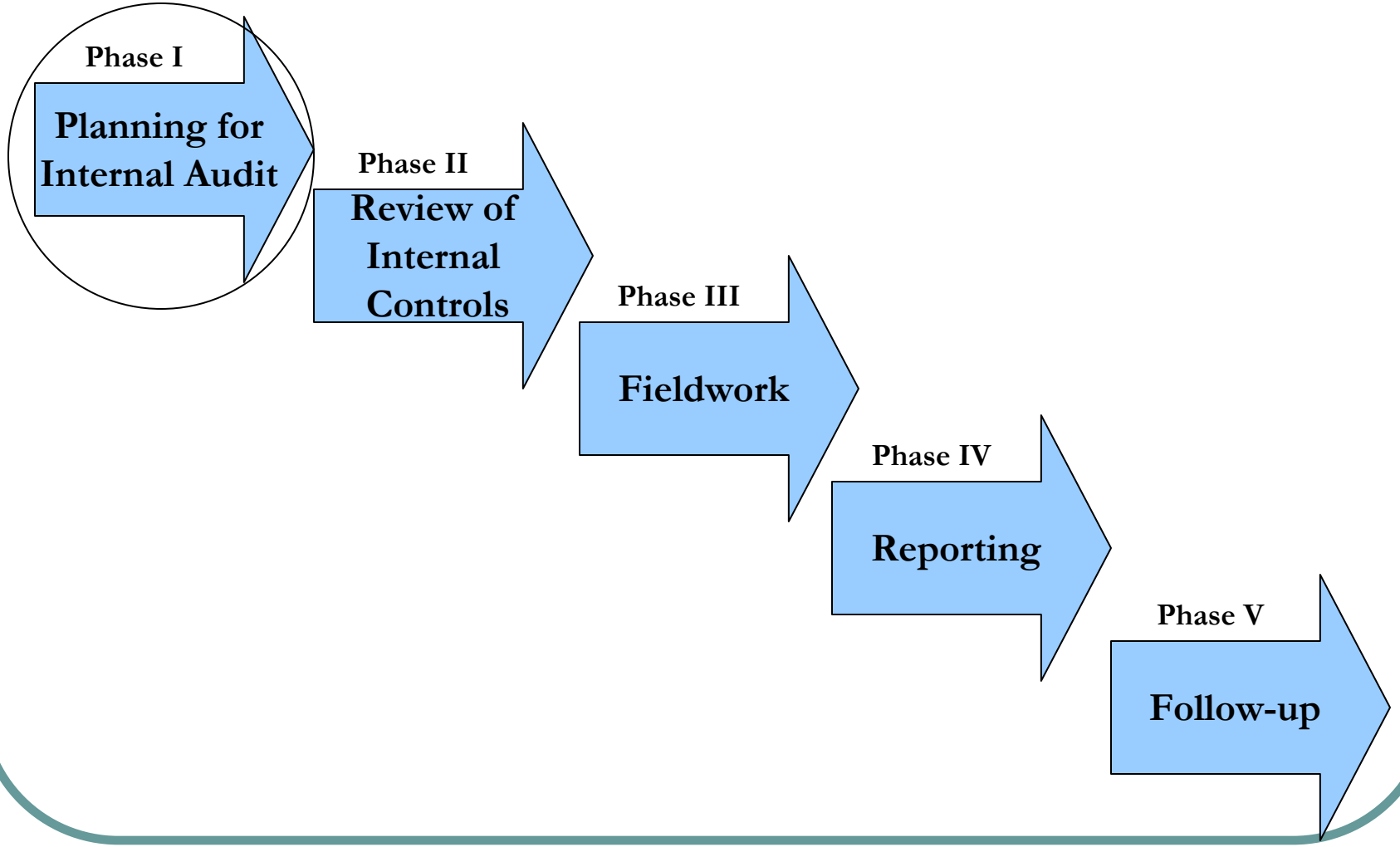
- Providing non-auditing services along with audit
- Improper organization's structure
- Appointment of auditors as auditee's personnel or vice versa
- Employment of close relatives or friends of auditor in the auditee organization
- Threats by the auditee to auditor to terminate
- Scope limitation imposed by the auditee
- Expensive gifts to auditors by the auditee
- Physical threats to the auditor

Internal Audit Process



Phase I: Internal Audit Planning

Internal Audit Process



Internal Audit Planning

- Perform Risk Assessment
- Identify and select Internal Audit Engagements with highest risk
- Arrange Human Resources
- Perform initial meeting
- Issue or get Engagement / Announcement Letter
- Perform Preliminary Review
- Develop the Audit Program

Key Considerations in Risk Assessment

- Materiality of transactions for each business process
- Susceptibility of errors or frauds
- Nature of the process (for example, reconciliation of suspense accounts generally warrant greater attention)
- Accounting and reporting complexities associated with the account
- Exposure to losses represented by the process (for example, loss in while dealing in cash transactions)
- Likelihood (or possibility) of significant contingent liabilities arising from the activities represented by the process
- Existence of related-party transactions in the process
- Changes in the processes attributes since the previous period (for example, new complexities, subjectivity, or types of transactions)

Engagement / Announcement Letter

The auditee is informed of the audit through an announcement or engagement letter from the Chief Audit Executive. This letter communicates the scope and objectives of the audit, the auditors assigned to the project and other relevant information.

Preliminary Review Checklist

- Review policies & procedures of the auditee
- Identify unusual activities.
- Review external factors affecting the business (economy, competition, technology regulation, and accounting practices).
- Review internal factors affecting the business (change in ownership, significant changes in operating revenue, expense or debt, restructuring, new lines, products, or activities).
- Review and document the accounting and computer operations for transaction flow, change in personnel, new technology, controls.
- Review the aspects of sampling from transactions (disbursements, payroll, sales, receipts) or year-end balances (accounts receivable, accounts payable) if you are performing financial audit.
- Review previous audit / other assurance reports

Audit Program

- Audit program is the sequence of steps required to meet the audit objectives. While developing audit programs, following factors must be considered
  - Nature & extent of the audit
  - Results of preliminary survey
  - Sampling method selected
  - Audit coverage of auditee's locations, processes etc.
  - Results of initial evaluation of control environment

Audit Program - Sample

	Audit Steps	Auditor Initials	W/P REF
A	**AUDIT REPORT** 1. Prepare the audit report including introduction, business objectives, procedures and scope, audit issues and recommendations. 2. Discuss the report with the audit customer and document the exit meeting.		
B	**ADMINISTRATIVE & WRAP-UP** 1. Prepare audit checklist. 2. Prepare work papers for records management. 3. Send out the customer satisfaction survey. 4. Update final budget. 5. Perform and complete work paper review. 6. Hold lessons learned meeting and complete questionnaire.		

Audit Program – Sample

Control Objective	Expected Results
Audit Step 2. Review and determine if the policies and procedures are consistent with industry standards and good business practices.	At a minimum the following topics should be included: --Mission statement --Security policies --Risk assessment --Information classification --Recovery process --Prosecution --Handling publicity --Regular monitoring CERT advisories --Glossary (e.g., incident, event, types of incidents) --Contacting law enforcement --How incidents or emergencies are detected and resolved --Maintaining evidence --Establishing secure communications --Contact information (names, telephone numbers, fax numbers) for response team --User training --Handling information that results from an incident, intrusion or emergency
Audit Step 3. Review and evaluate how updates (additions, modification, and deletions) to the policies and procedures are performed.	A process to determine who, when, and how updates to the policies and procedures are performed should exist. Management must have the assurance current, accurate information is maintained.
Audit Step 4. Select a sample of updated policies and procedures. Determine if the selected policies and procedures have followed the procedures defined in Audit Step 3.	The sample should follow the process provided in Audit Step 3 for updating policies and procedures.
Audit Step 5. Determine if a periodic review of policies and procedures is performed	A process to periodically review (i.e., quarterly or semi-annually) policies and procedures helps management ensure updates have

Audit Program – Sample

Electronic Funds/ Wire Transfer Audit

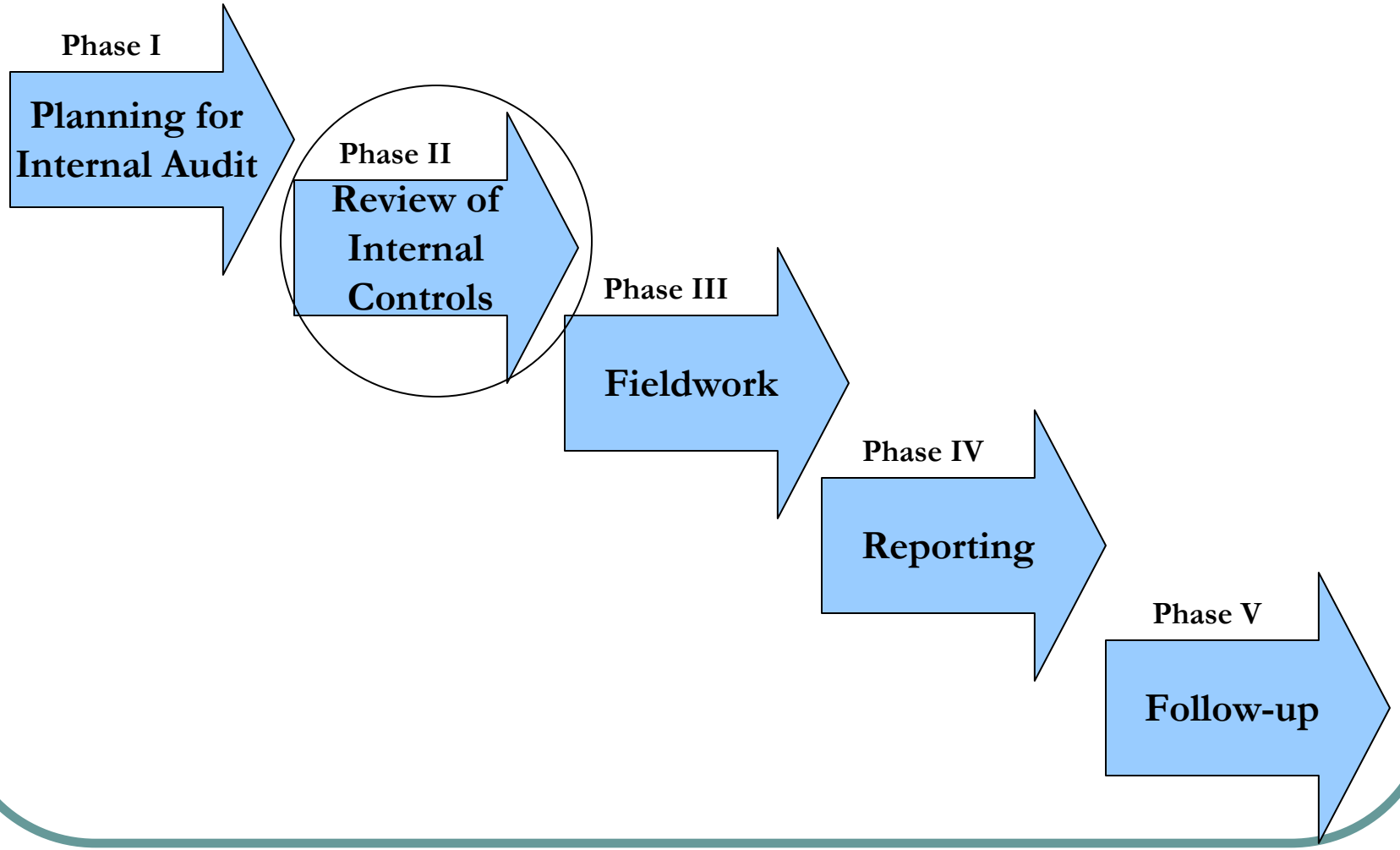
F-1	Several types of transactions are performed. Document, as applicable, understanding of each type of transaction and the policies and procedures in place to maintain proper control.		
F-2	Test a sample of transactions in the following areas:		
	• Paying Agent Transactions		
	• Overnight Investments		
	• Loan Advances		
	• ACH Transactions		
	• Swaps		
F-3	Review the reconciliation's performed for all of the above transaction types ensuring proper calculation, segregation of duties, and timeliness.		
F-4	Inquire if transactions are encrypted		
	• Are all messages transmissions encrypted?		
	• Are all messages received encrypted?		
	• Are log file details on the hard disk encrypted?		
	• Are other history files encrypted?		
	• Does the local terminal allow dial-in?		
F-5	Compare processes documented above to known best practices and document. Examples of considerations include: • Written Policies • Appropriate Authorization Levels • Segregation of Duties		

Audit Sampling

- Simple Random Sampling
- Stratified Random Sampling
- Cluster Sampling
- Convenience Sampling
- Judgement Sampling
- Probability Proportional to Size Sampling
- Multi-stage Sampling
- Systematic Sampling

Phase II: Review of Internal Controls

Internal Audit Process

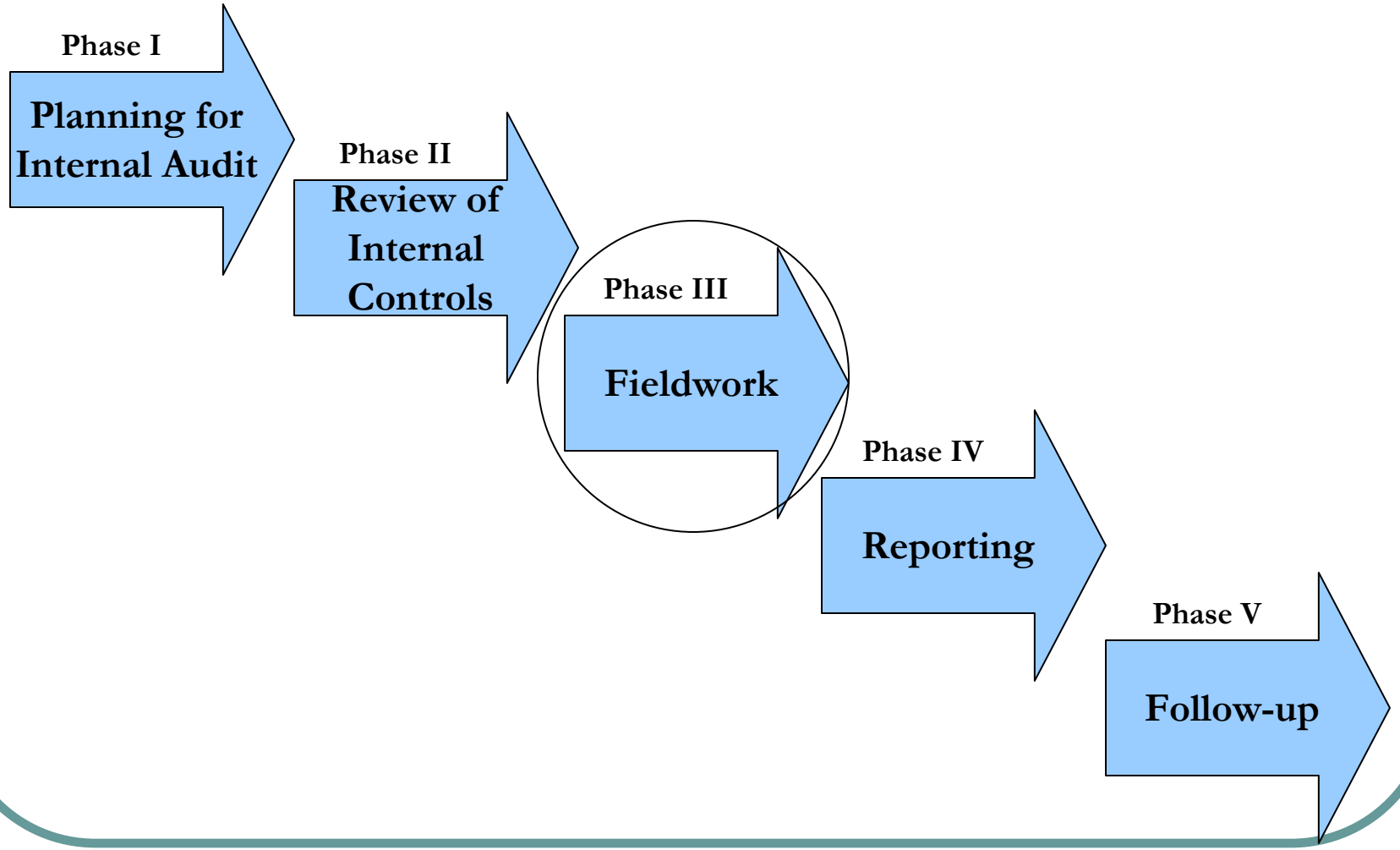


Review of Internal Controls

- Document the business processes and controls
- Test the controls
- Identify the control deficiencies

Phase III: Fieldwork

Internal Audit Process



The Fieldwork

Fieldwork is the process of gathering evidence and analyzing and evaluating the evidence collected.

The purpose of fieldwork is to accumulate sufficient, competent, relevant, and useful evidence to reach a conclusion concerning our performance expectations, and to support our audit comments and recommendations.

Audit evidence is sufficient when it is factual and would convince an informed and prudent person to reach the same conclusion.

Evidence is competent if it consistently produces the same outcomes. It is relevant when it is directly related to the audit comments, recommendations, and conclusions.

The Fieldwork

- Perform Walkthroughs
- Test Internal Control
- Test Transaction
- Develop Working Papers

Walkthroughs

A walkthrough is a term describing the consideration of a process at an abstract level. The term is often employed in the audit to describe the process of examining a process by following paths through the process flow as determined by input conditions and choices made along the way.

The purpose of such walkthroughs is generally to provide assurance of the fitness for purpose of the process; and occasionally to assess the competence or output of an individual or team.

Testing

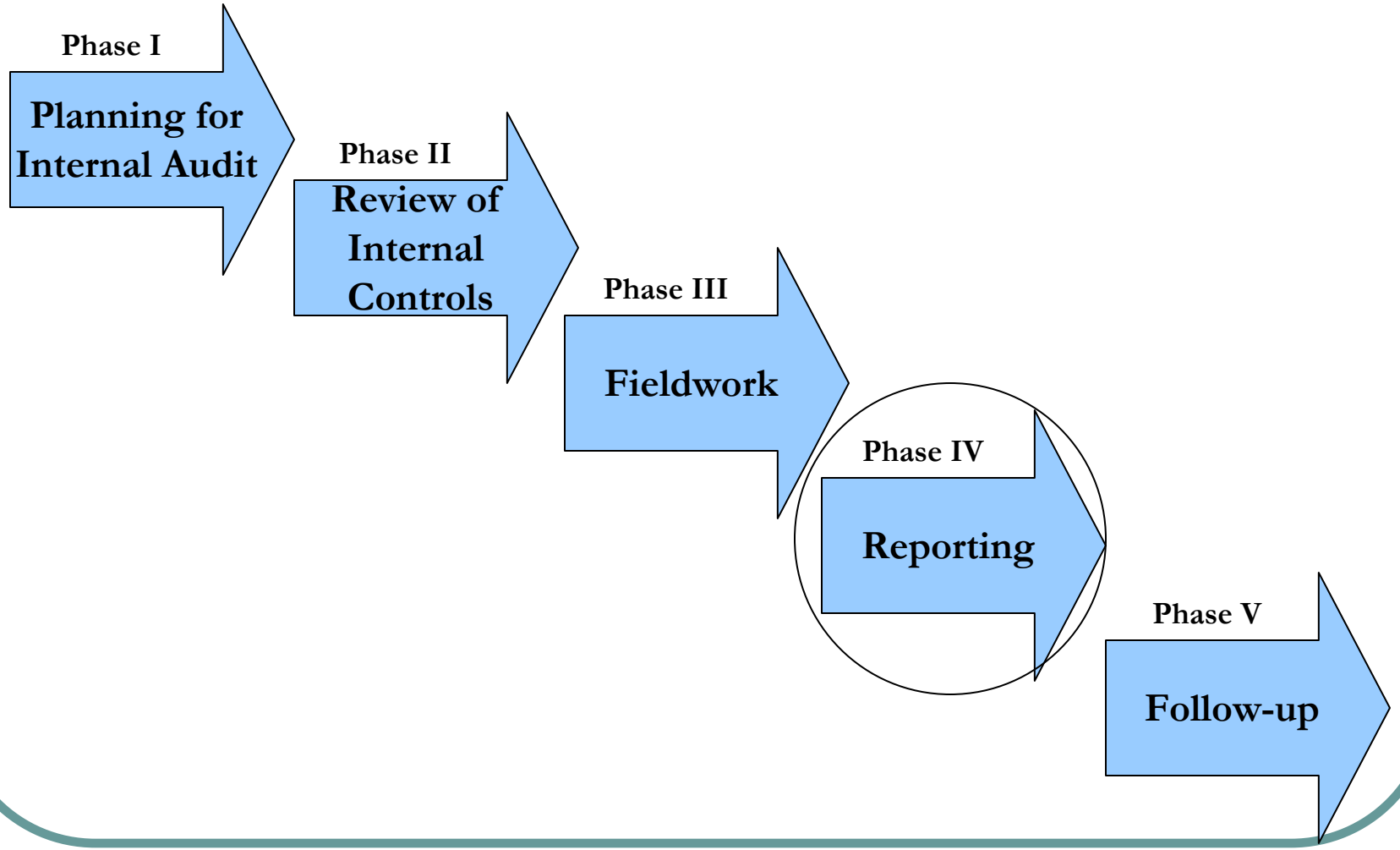
- Compliance Testing
- Substantive Testing
  - Analytical Procedures
  - Review of Documents
  - Re-performance
- Observation
- Testing of Systems
  - Parallel Testing
  - Embedded Audit Modules
  - Review of system logs

Working Papers

- Audit Scope Documents
- Survey Planning Memorandum
- Audit Assignment & Independence Statement
- Engagement Letter & Notification
- Minutes of Initial Meeting / Entrance Conference
- Minutes of Interviews
- Flowcharts
- Internal Control Questionnaires
- Finding Sheets with Evidence
- Analytical Procedures
- Other Documents

Phase IV: Reporting

Internal Audit Process



Internal Audit Reports

- Introduction
  - Audit report users
  - Audit background, purpose & scope
  - Frameworks / standards used
  - Audit Methodology
- Key Findings
  - Observation
  - Impact and risk rating / significance
  - Recommendations
  - Management Comments and agreed action
- Conclusion
- Appendixes (if required)

Versions of Internal Audit Reports

- Draft Report
- Exit Conference & Discussion on Draft
- Management Response
- Agreed Management Action
- Target Implementation Dates
- Final Report

Sample Audit Report

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Sample Audit Report

2.6 OTHER FINDINGS

At the request of the Quality, Information and Technology Branch, the management fees charged to the program were also examined without, however, auditing the validity of the amounts claimed. The review revealed that the maximum amount eligible under the Agreement, that is $3,508,000, had not been reached yet on March 31, 2004.

In addition, a reconciliation between the Program's cumulative expenditures recorded in the 2003–2004 Performance Measurement Report and the data available in SIMSI, on the basis of which the audit sample was established, revealed that both sources yielded equivalent totals.

3.0 CONCLUSION

Based on the compliance procedures carried out, it is our opinion that key controls are being applied correctly by CED's Infrastructure Branch. The tests performed on a representative sample of 50 files showed that the deviations from key project approval controls represented a rate of non-compliance of only 4% among all the files examined. As for payment approval, it seems that key controls are applied effectively because our audit did not reveal any cases of non-compliance among the 42 payments reviewed.

In general, the other items observed appeared to have little material impact on the risk level.

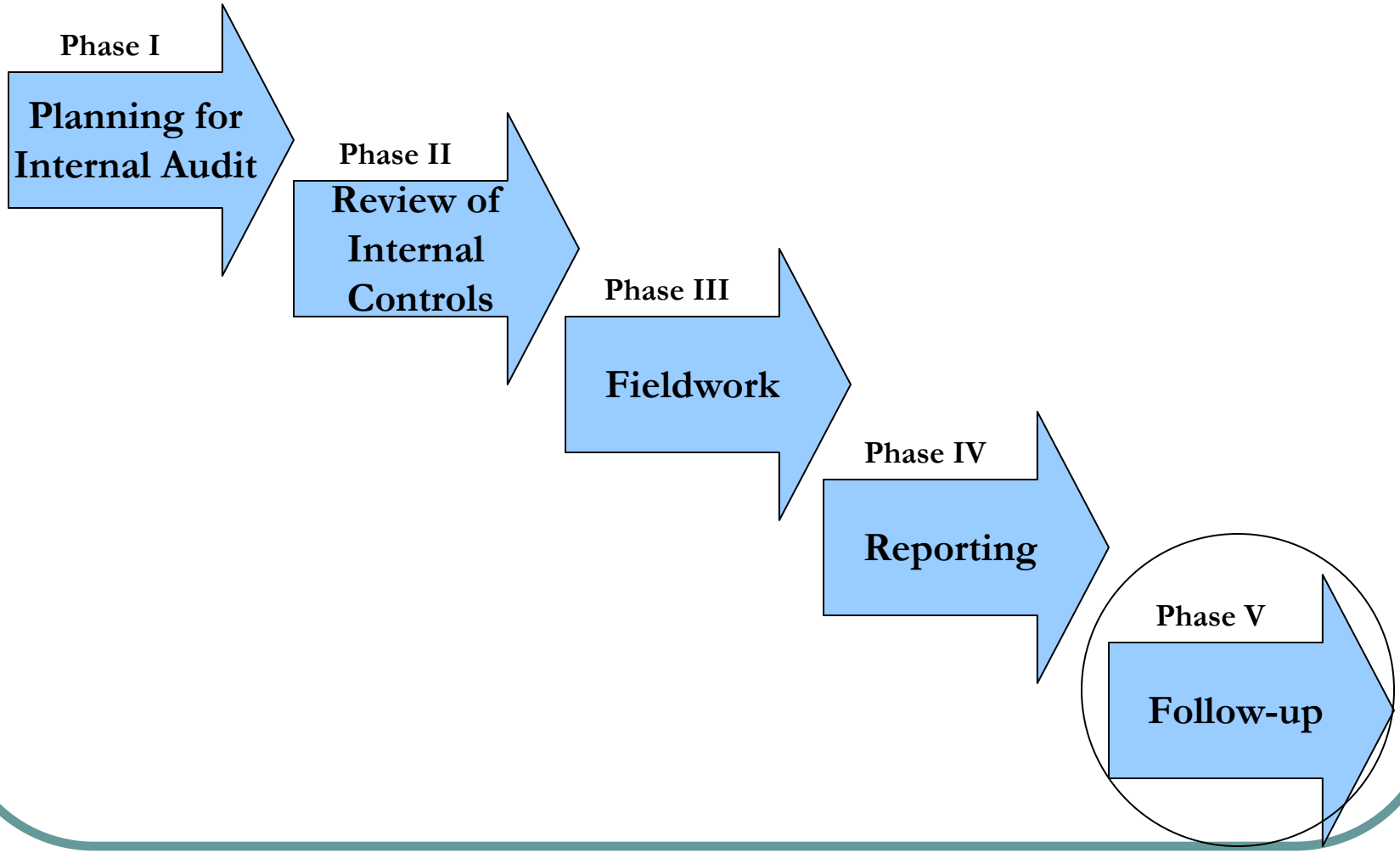
4.0 MANAGEMENT'S RESPONSE

We are satisfied with the results of the compliance tests that were carried out. Despite the few minor deviations observed, the quality and usefulness of the key controls show that they are, on the whole, effective. With respect to the fact that the submission of claims and, more particularly, that, in general, the information given to CED is insufficient, the Agreement's Co-chairs agreed last year that the claim submission and review procedures and the terms governing the payment of financial assistance could be reviewed when the terms and conditions of a new infrastructure program are drafted.

Further to this report, we have, however, added a prerequisite control for the payment of claims submitted by MAMSL. For 1 project in 10, the project sheet calculations submitted in support of claims are checked; our calculations are subsequently included in the claim and project files.
If a significant difference is detected between the amount claimed by MAMSL and the amount calculated, the appropriate parties are informed and asked to provide an explanation.

Phase V: Follow-up

Internal Audit Process



Follow-up

- Review the Audit Report
- Interview the head of auditee organization to establish the latest developments.
- Update Action Plan if there is any change in agreed action plan
- Perform testing and gather evidence whether the action plan has been implemented.
- Issue follow-up Report

Thank you