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Joined-up fraud detection – external audit and internal resources

Before anything else, we want to make clear, write **Veronica Morino** and **Martina Marmai** of Hibis, that this is not another article that puts the blame on external auditors for not spotting the warning signs of fraud, corruption or other malpractice. The purpose, rather, is twofold: first, we will offer some thoughts on how management of fraud risk can be improved in response to better, more useful feedback from external auditors; second, we aim to show that information already available internally can (and should) also be used in early detection, and demonstrate its importance both for reviews conducted by external auditors and management decision-making.

Increased business complexity and erosion of traditional controls due to more integrated systems, decentralization and matrix organisation have reduced management oversight. Keeping in mind that the "*primary responsibility for the detection and prevention of fraud rests with both those charged with governance of the entity and management*" (ISA 240), it is imperative that managers are able to extract critical information both to keep the business running efficiently and to understand how to respond dynamically and effectively to fraud and corruption risk. One might object that not being familiar with topics like internal controls around financial reporting and risk assessment and revenue is a sign of bad management in itself, but it need not be: consider how many operational decisions managers have to take every day and it quickly becomes clear how easy it is to miss the bigger picture, especially as managers generally don't receive any practical training on fraud. With resources limited, clear mandates are key and expectations need to be set right from the start; this will save everyone from having to produce (and/or review) too much information and from missing out on relevant knowledge, both of which could lead to blaming others when problems arise.

Positive expectations

So, what should we expect from external auditors? The standards are clear: the external auditor's job is to express an opinion on whether the information presented in a company's financial statements is accurate, or not, to a reasonable degree. In forming this opinion an auditor is expected to "identify and assess the risk of material misstatement, whether due to fraud or error" (ISA 315), and "to design and implement responses to the risks of material misstatement" identified (ISA 330). On top of that, the newly revised ISA 700 requires auditors to form an opinion on the financial statements themselves, in line with a "*need to increase the value of auditor reporting by making the information provided in the auditor's report more relevant to users*" (ISA 700). In spite of audit firms' efforts to reduce "audit risk", the question is whether it is reasonable to assume that an audit team will manage their work without making mistakes, and how management can take for granted a high-quality review when so much is stacked on so few people. As the whistleblower who first discovered the Madoff scheme put it, "*Who does the audits? People in their 20s. Auditors who do 80 to 90 hours in a busy season and can barely stay awake." (Harry Markopolos)*

While witnessing to a number of ongoing efforts to improve audit quality and reduce the audit risk, a PCAOB [1] inspection from 2018 raises some important questions. The inspection of 700 audits of public companies, performed by more than 160 audit firms in the US and in 30 jurisdictions abroad, confirmed the two key areas of audit weakness to be "internal

Example 1: *As the weeks went by, the newly appointed CEO became more and more frustrated with the operational performance of the manufacturing company he had recently been hired to run. Despite going through the audited figures and discussing the situation, he and the CFO could not figure out why the business had continuously been making losses despite operating in an otherwise profitable market segment. Their main concern was why costs were so high. Moving from the financial statements to the trial balances, it was difficult to understand how the costs were classified and recorded so that they could be monitored and controlled. Catch-all accounts, including "administrative expenses" and "other expenses", were some of the largest cost categories.*

How could the management know where to focus and what to cut when their cost structure was mostly based on such generic categories? From experience, unexpectedly high amounts booked under such catch-all accounts may allow dubious expenses and unwanted costs to accumulate without being questioned, which was never the intention. We have observed this practice go unnoticed by external auditors in several cases.

In further examining the specific general ledger accounts, the same issue emerged in respect of accumulated losses: a major part of that figure was attributable to "other losses", but no further explanation of those could be found in the financial statements, nor in the notes to the financial statements. A reading of the trial balance revealed that they were foreign exchange losses and that only a portion was realized. However, most of the business was carried out in the local currency, and there had not been major exchange rate realignments with other strong currencies in several years. Further checking of the annual statements revealed that the "Finished Goods" inventory was accounted for in an approximate way. More importantly, managers were not informed of stock variances or of an additional stock component. By correlating the trial balance with supplier transaction data we were able to identify significant purchases from a certain supplier that were meant to be sold on. Yet there was no trace of these items in the inventory account.

Even if none of the above could be classified as "proven" fraud, the lack of critical information was leaving open the possibility that fraud could be going undetected. The external auditors had reviewed the accounts and noted some of the discrepancies but had failed to ask the relevant questions.

Of course, when taking critical business decisions, management should not rely solely on the information validated by external auditors. However, if the work of the external auditors does not add anything to management decision-making, if they aren't sufficiently sceptical or stop short even when they are on the right track, then one is left to question the use of their reports.

Inner resource

As well as aiming for better, more specific feedback from external audit to management, we need to consider the gain from a critical overview of internal information. Working full-time in the company, employees in charge of internal control, monitoring and finance can be expected to have far deeper insight into its processes and business than external auditors, not to mention more time and reason to pursue issues further. Informative internal assessment and reporting may sound both a reasonable and straightforward expectation, but it demands quite a lot from those responsible: they have to act as the "organisation's critical friend", advising managers at all levels, evaluating and anticipating risks, analysing and confirming information, and on top of everything, coordinating with other assurance providers to guarantee to executive management and the board that risks are being dealt with effectively. And what if we add early detection of fraud to the list? Do those specialists receive practical fraud training and tasking to look actively for fraud or are they expected to do that in their spare time?

In focussing specifically on early detection of corruption and fraud, we have seen the benefits of using programs to analyse transactions and other data from accounting systems. Now, we must keep in mind that fraud is a dynamic risk, with perpetrators continually seeking to circumvent internal controls. Therefore, in order for any program to spot fraud effectively, two conditions must apply: 1) the search criteria have to be designed by those with experience in looking for and detecting fraud, and 2) the results need to be interpreted by experts able to apply their fraud knowledge to a specific business context.

Example 2: *The following is typical analysis work that was conducted internally via a supervised program. We looked into the money flows for suppliers and customers of an engineering company. Our systems guided us in identifying those suppliers and customers that matched a series of potential fraud criteria. For each, we selected a few documents relating to transactions red-flagged for possible malpractice. A deeper look uncovered the following issues:*

- *poor specification on the invoices of services or goods purchased or sold;*
- *poor or insufficient supporting documentation;*
- *cases where only order confirmations had been filed instead of invoices;*
- *insufficient payment information on the invoices;*
- *discrepancies between the supplier/customer name in the system and what was printed on the invoice;*
- *insufficient supplier credit notes in the transaction file;*
- *multiple customer credit notes, often showing the same employee as reference and not specifying the reason for the returns;*
- *misuse of fields in the accounting system which made it more difficult to associate a document with the corresponding customer.*

The next step was to understand and interpret the various discrepancies and inconsistencies and try to conceive possible "fraud scenarios" they could indicate. Insufficient specification on the supplier invoices, for example, might result in not knowing what goods or services we are purchasing, or who we are sourcing from, with the risk of being overcharged or unnecessarily sourcing items from non-value-adding middlemen instead of producers. If a transaction is approved without the documentation substantiating it, then anyone could submit a claim and be paid without a legitimate reason. This could lead to legal and financial consequences, but also severe reputational damage where unsubstantiated transactions hide bribes or facilitation payments, either to private individuals or to organizations, which may well be located in offshore financial centres. Having only one employee acting as point of contact with many customers risks collusion, whereby some are given special treatment at the expense of the company's reputation and bottom line.

The above fraud indicators could be spotted during external audits too, and sometimes they are, even though in-depth analysis is often considered outside the scope. But if given specific training and a mandate, the benefit of their detailed knowledge of the business, together with access to a range of internal information usually unavailable to external auditors, means internal resources are normally better placed to proactively identify irregularities and early warning signs of fraud. Key information can be gathered, analysed, summarised and presented to management, who are then able to decide whether and how to perform deeper investigation or take other follow-up actions to mitigate identified risks. These further insights make it easier for management, or the board, to propose additional points of focus, whether in functional or geographical areas.

Managers, and therefore the business, assuredly benefit both from enhanced use of external auditors and the smarter application of internal resources. At the end of the day, whether we like it or not, audits and reviews are here to stay, but the same need not apply to fraud and corruption.

Note

1. The Public Company Accounting Oversight Board, created by the Sarbanes-Oxley Act of 2002, is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports.

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