Chapter 16

AUDITING FOR FRAUD

1600. Definition of Fraud

Fraud is " Any illegal acts characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the application of threat of violence or of physical force. Frauds are perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage." (International Standards for the Professional Practice of Internal Auditing – Glossary)

1601. Audit Responsibilities for the Detection of Fraud

IIA Standard 1210.A2 states that "The internal auditor should have sufficient knowledge to identify the indicators of fraud but is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud." To comply with the standards, each auditor on staff is responsible to be alert for known indications of fraud and common forms of fraud.

1602. Common Forms of Fraud

In the Practice of Modern Internal Auditing, by Lawrence B. Sawyer, he identifies common forms of fraud. They are noted below. All staff members are to be familiar with these items and include tests to address these concerns:

COMMON FORMS OF FRAUD

- Pilfering stamps.
- Stealing merchandise, tools, supplies, and equipment.
- Removing small amounts from cash funds and registers.
- Failing to record sales of merchandise, and pocketing the cash.
- Creating overages in cash funds and registers by under-recording.
- Overloading expense accounts or diverting advances to personal use.
- Lapping collections on customer's accounts.
- Pocketing payments on customer's accounts.

- issuing receipts on scraps of paper or in self-designed receipt books.
- Collecting an account, pocketing the money, and charging it off; collecting charged-off accounts and not reporting the collections.
- Charging customer's accounts with cash stolen from the accounts.
- Issuing credit for false customer claims and returns.
- Failing to make bank deposits daily, or depositing only part of the money.
- Altering dates on deposit slips to cover stealing.
- Making round sum deposits -- attempting to catch-up by the end of the month.
- Carrying fictitious extra help on payrolls, or increasing rates or hours.
- Carrying employees on the payroll beyond the actual severance dates.
- Falsifying additions to payrolls; withholding unclaimed wages.
- Destroying, altering or voiding cash sales tickets and pocketing the cash.
- Withholding cash sales amounts by using false charge accounts.
- Recording unwarranted cash discounts.
- Increasing amounts of petty cash vouchers and/or totals in accounting for disbursements.
- Using personal expenditure receipts to support false paid-out-items.
- Using copies of previously used original vouchers, or using a properly approved voucher of a prior period by changing the date.
- Paying false invoices, either self-prepared or obtained through collusion with suppliers.
- Increasing the amounts of suppliers' invoices through collusion.
- Charging personal purchases to the University through the misuse of purchase orders.
- Billing stolen merchandise to fictitious accounts.

- Shipping stolen merchandise to an employee or relative's home.
- Falsifying inventories to cover thefts or delinquencies.
- Seizing checks payable to the company or to suppliers.
- Creating canceled bank checks to agree with fictitious entries.
- Inserting fictitious accounting entries.
- Causing erroneous footings of cash receipts and disbursements books.
- Deliberately confusing postings to both control and detail accounts.
- Selling waste and scrap and pocketing the proceeds.
- Selling door keys or combinations to safes or vaults.
- Creating credit balances on ledgers and converting the differences to cash.
- Falsifying bills of lading and splitting the revenue with the carrier.
- Obtaining unprotected blank checks and forging the signature.
- Permitting special prices or privileges to customers, or granting business to favored suppliers, for "kickbacks".

1603. Red Flags Which Indicate the Potential for Fraud

In addition, to the common forms of fraud, Mr. Sawyer identified the danger signs toward the potential for fraud. All staff members must be alert to these conditions and activities. They are:

- Borrowing small amounts from fellow employees.
- Placing personal checks that are post-dated or undated in petty cash or change funds.
- Requesting individuals to "hold" maker's check.
- Bill collectors or creditors which appear at JMU.
- Telephone conversations which appear to be designed to stall collectors.
- Plugging figures in order to cover-up inefficiencies.

- Being unfairly critical of others in order to divert suspicion from oneself.

- Placing I.O.U.'s in change funds or petty cash funds, or requesting individuals to accept I.O.U.'s when small loans are due.

- Explanations to audit questions which are vague or misleading.

- Excessive wins and losses achieved through gambling.

- Excessive drinking, and associating with individuals of questionable character.

- Purchasing through "business" channels luxury automobiles and extravagant household furnishings.

- A newly acquired standard of living is explained as money left from a relatives estate.

- Regular overtime practices and a refusal to leave custody of record during the day.

- Refusing promotions or delaying vacations.

- The individual or a family member is inflicted with a serious illness, and a reasonable plan for paying the medical bills does not exist.

- Individuals being "wined and dined" by members of a suppliers staff.

- Carrying unusually large bank balances or unusually heavy transactions in financial markets.

- Carrying larger amounts of cash and always paying bills with cash.

- Rewriting records in order to present the information in a more readable fashion.

1604. The Investigation of Fraud

Upon the discovery of circumstances which suggest that a fraudulent transaction has occurred, proper care should be exercised in order to investigate and come to an opinion as to the validity of the situation. In connection with the investigation, Audit and Management Services will abide by the suggested responsibilities noted in Practice Advisory 1210.A2-1. They are:

1. Assess the probable level and extent of complicity of the fraud within the University. This can be critical to ensuring that information concerning the fraud is communicated to the proper individuals.

2. Determine the knowledge, skills and other competencies needed to carry out the investigation effectively.

3. Coordinate all activities with appropriate management personnel, legal counsel, other specialists, and University Police and Security as appropriate.

4. Design procedures to follow in attempting to identify the perpetrators, extent of the fraud, techniques used, and cause of the fraud.

5. "Be cognizant of the rights of alleged perpetrators and personnel within the scope of the investigation and the reputation of the organization itself."

6. Make recommendations to establish or enhance the existing system of internal controls.

1605. Reporting of Fraudulent Transactions

After an investigation, if it is determined that there is a reasonable possibility that a fraudulent transaction has occurred and involves a University employee, the Director of Audit and Management Services will report the fraudulent transaction to the Auditor of Public Accounts and the Department of State Police in accordance with section 30-138 of the Code of Virginia.

Regardless of whether or not the investigation revealed that a fraud has taken place, an audit report will be prepared. The report will include a brief background of the circumstances, the objectives of the review, the conclusion reached, any control weaknesses noted in the system, and recommendations to correct any weaknesses noted in the investigation.