

How to Use This Manual

OVERVIEW

Fraud is a growing problem for financial institutions. The increase in fraud is difficult to track, since there is no central reporting of fraud statistics specifically for financial institutions. However, based on anecdotal evidence, there has been a significant rise in criminal activity related to identity theft as the value of identities has risen on the black markets. There is also the rise in mortgage fraud coincident with the largest rise in real estate values in the U.S.'s recent past. Workplace fraud has always been a concern, but fraud schemes have grown from simple teller cash drawer thefts to management level frauds that in some cases have driven institutions out of business.

Auditing for fraud is not a new concept, but the professional responsibility to do so is new. Prior to the Sarbanes-Oxley Act of 2002, independent auditors of public companies were not required to focus on detecting fraud. There was no professional standard for these external auditors to search for fraud. Consequently, when they looked to the internal audit function for control reviews, there was no need to discuss fraud prevention and detection controls.

The responsibility for fraud detection changed abruptly after Sarbanes-Oxley when the AICPA issued AU Section 316, Consideration of Fraud in a Financial Statement Audit. This AICPA document is called *Statement on Auditing Standards No. 99* and this statement, together with SAS No. 54 (Illegal Acts by Clients) and the *Report by Committee of Sponsoring Organizations of the Treadway Commission* (COSO Report), form the basis for an external auditor's responsibilities for detecting fraud.

The combination of a new level of professional responsibility for fraud detection and prevention, combined with the rising tide of fraud schemes, has led to a new internal audit specialty called "fraud auditing." A fraud auditor is a professional internal auditor that specializes in testing antifraud controls and in detecting and preventing fraud schemes. Just as in any other internal audit position, the fraud auditor reviews, tests, and recommends corrective actions. However, they do not implement what they recommend and they do not become involved with daily operations. All internal auditors must remain removed from an institution's daily operations so that they can remain objective when they audit the function. This holds true for fraud auditors as

well. Independence and objectivity are critical to a fraud auditor's ability to carry out their job. This means that the fraud auditor should be able to report to the institution's audit committee on antifraud control issues as well as on fraud schemes that have been detected or prevented.

ORGANIZATION OF THE MANUAL

To assist fraud auditors in carrying out their professional responsibilities, this manual provides guidance on the areas that are needed to establish an effective fraud audit function.

In Chapter 1, The Need for Fraud Audits, the need for fraud audits is addressed through a discussion of fraud challenges, the components of fraud, and fraud audit strategies.

In Chapter 2, Fraud Detection Responsibilities and Professional Standards, there is a discussion of the new and expanded professional responsibilities for detecting material misstatements in financial reports and how these guidelines carry over to the internal audit function. Senior management and directors should be made aware of these professional responsibilities and how the internal audit function needs to adhere to these responsibilities to better protect the institution from fraud schemes.

Chapter 3, Identifying Fraud Risks, provides insight into actual fraud schemes, a technology risk identification program, and four simple steps for creating a fraud awareness program. Fraud awareness is necessary because one approach to identifying unpredictable fraud risks stands out among others — training and education.

Chapter 4, Conducting a Fraud Risk Assessment, introduces the risk-based approach to fraud detection and discusses methods for detecting and investigating fraud.

Chapter 5, Evaluating and Testing Controls That Detect or Prevent Fraud, discusses the antifraud control testing process from the fraud auditor's viewpoint, but also describes the external auditor's responsibilities in this area. In addition, there is a discussion of what comprises good internal control from the accounting profession's viewpoint, based on materials from the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Chapter 6, Conducting Fraud Audits, discusses methods that can be used to conduct fraud audits and the attributes of certain high risk areas that are often subject to fraud schemes.

Chapter 7, *Analytical Techniques for Detecting Fraud*, describes analytical techniques that fraud auditors can use in their fraud audit programs and, where applicable, how these same techniques are used in external audits. It is important to emphasize that external auditors will evaluate the work that internal auditors perform. If the work is judged of sufficient quality and is considered objective, the external auditors can use the results of internal audit control reviews and tests of controls to support the external audit. This can save institutions significant amounts of time and money.

Chapter 8, *Techniques for Detecting Employee Fraud*, discusses how to detect workplace fraud schemes. Although the focus of this chapter is on methods fraud auditors can use to detect fraud schemes being carried out by employees, the detection process will also help to disclose schemes that are being carried out by someone outside of the institution.

Chapter 9, *Dealing with Fraudulent Acts*, discusses how to develop a detailed fraud investigation plan if a fraud is detected. This chapter also discusses how statements that senior institution officials of public institutions may make could lead to fraud charges, despite laws to protect individuals making these statements.

Chapter 10, *Customer Information Management*, discusses some of the critical fraud prevention methods and procedures for handling requests for customer information, signing up customers for online banking, ACH transactions, and electronic document delivery, and online banking authentication security.

Chapter 11, *Managing Fraud Risks in Outsourced Arrangements*, discusses fraud risk control procedures for third-party relationships. In addition to these procedures, review Exhibit 11.1, *Supervision of Technology Service Providers Examination Planning Workprogram*, for the issues that examiners will consider in reviewing your institution's relationships with technology service providers (TSPs).

Overall, this manual will help financial institutions to implement a fraud detection and prevention program that limits losses and preserves the institution's reputation.