



# Forensic Auditing: The Audit of the Future, Today

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# Agenda

- Current events and developments in forensic accounting
- Define the term *forensic auditing*
- What is the audit of the future?
- Forensic audit thinking
- Forensic audit procedures
- Use of technology
- Interviewing tips
- Knowledge checks along the way

# Past Events Relevant to Today

- PCAOB Standing Advisory Group Discussion Paper on Financial Fraud—September 2004
- **Page 21**—Involvement of Forensic Accountants in an Audit of Financial Statements: “The auditor may respond to an identified risk of material misstatement due to fraud by assigning additional persons with specialized skill and knowledge such as forensic ... specialists ... to the engagement.”
- **Page 22**—“a forensic accountant participating in an audit generally performs **investigative services** that make use of a CPAs skills including the application of accounting and auditing knowledge as well as **investigative skills to collect, analyze and evaluate evidential matter and to interpret and communicate findings.**”

# SAG Discussion Paper—9/04

- “To perform adequately the fraud detection procedures that might be performed by a forensic accountant in an audit of financial statements, **the forensic accountant should learn critical background information about the company, its business and its environment.** This background information is, for example, particularly important for effective participation in the brainstorming session.”
- Should a forensic specialist, whether employed by the auditor’s firm or engagement by the auditor, be regarded as a member of the audit team? Would treating a forensic accountant as a SAS 73-type specialist create an artificial distinction between the work necessary to detect fraud and the work necessary to complete an audit?

# SAG Discussion Paper—9/04

- **Question 45**—What professional standards should apply to forensic accountants participating in an audit of financial statements? **Should auditors obtain the necessary skills to detect fraud, including forensic skills?**
- **Page 23**—A registered public accounting firm that, during the course of performing an audit of financial statements, detects indications of fraud affecting those financial statements might be requested by management or the audit committee to expand the scope of the audit and perform an **in-depth investigation** to determine the impact of the alleged fraudulent activities on the client and its financial statements.

# SAG Discussion Paper—9/04

- **Question 47**—Can auditors obtain reasonable assurance required by paragraph .02 of AU sec. 110 ... **without performing investigations** to determine the impact of alleged fraudulent activities on the financial statements?
- **Question 48**—What restrictions on the arrangements for the **in-depth investigation** would be necessary to avoid an impairment of independence?
- **Question 49**—Does a forensic accountant employ an **investigative mindset** that is different from the professional skepticism of an auditor of financial statements?

# Current and Future Events

- How current and future events will impact forensic auditing:
  - PCAOB—At the April 2010 meeting the Standing Advisory Group (**SAG**) discussed the undertaking of a standard-setting initiative to consider improvements to the auditor's standard reporting model, and clarification of the auditor's report of the ***auditor's role in detecting fraud*** under current auditing standards.

# Current and Future Events

- PCAOB—April 2010 meeting:
  - The current auditor's report does not mention fraud
  - Advisory Committee on the Auditing Profession (**ACAP**) recommended "expressly communicating to investors, other financial statement users, and the public the ***role of the auditors in finding and reporting fraud.***"
  - ACAP recommended that the PCAOB "review and update the ***auditing standards governing fraud detection and fraud reporting.***"



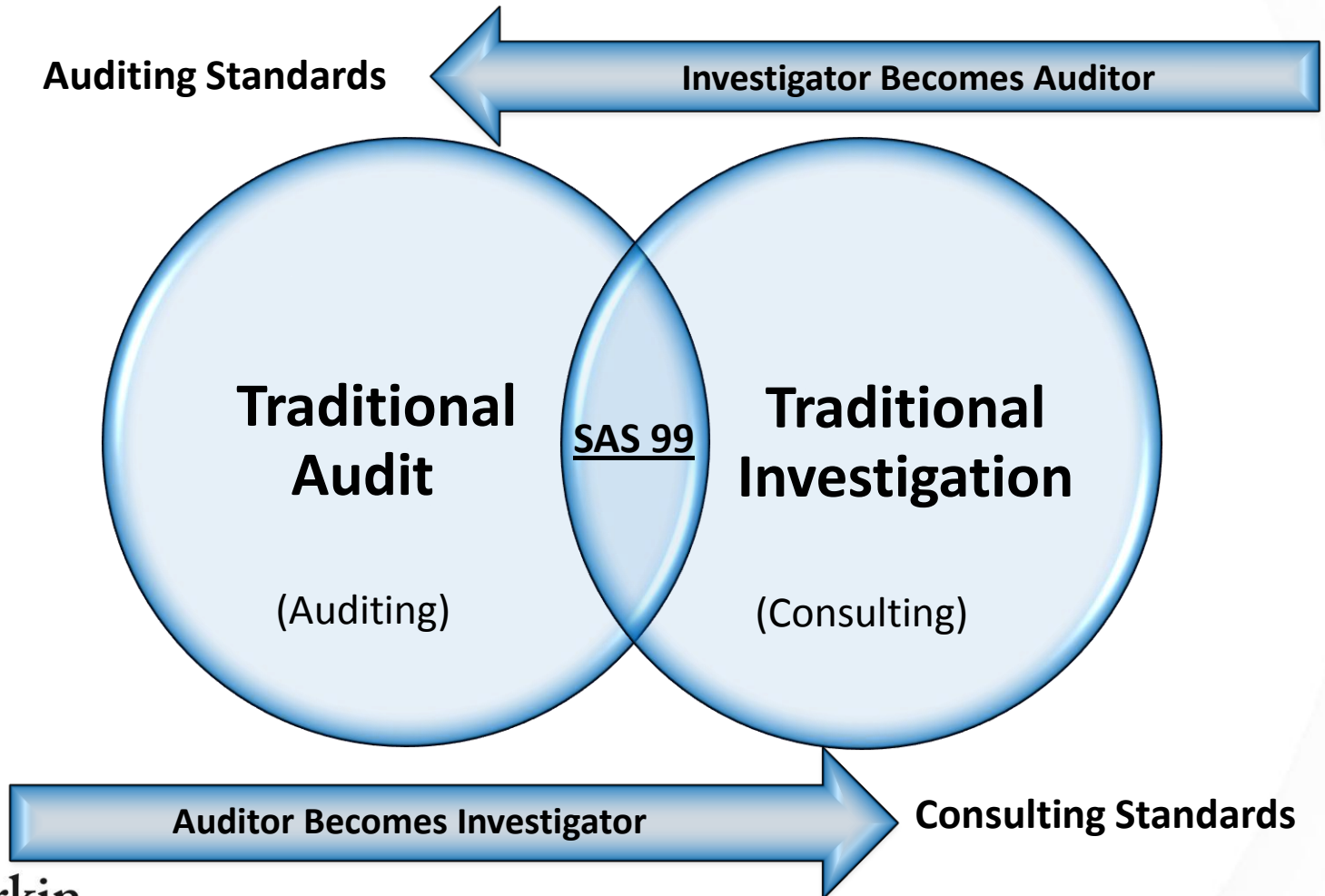
# Current and Future Events

- PCAOB—April 2010 meeting:
  - Some SAG members stated that the current auditor's report model is ***"very routine," "sort of a boiler plate," and the "information content is minimal."***
  - ACAP recommendation suggests that the ***auditor's report should articulate the "auditor's role and limitations in detecting fraud."***

# Current and Future Events

- PCAOB—April 2010 meeting:
  - The Global Public Policy Symposium (Nov. 2006) claiming "there is a significant 'expectations gap'..."
    - Proposed certain ideas of change:
      - A **forensic audit** on a regular basis
      - A **forensic audit** on a random basis
      - Other "choice-based" options
  - PCAOB discussion question—should auditing standards be amended to **require a forensic audit** component to the audit, or another option?

# A Forensic Audit?



# Knowledge Check Discussion Question

Will auditing standards be amended to require a forensic audit?

- A. Yes, a forensic audit will be required
- B. No, a forensic audit will not be required
- C. No, a forensic audit will not be required; however, additional procedures will be incorporated
- D. Other

# What Is a Forensic Audit?

- A. An audit
- B. An investigation
- C. An agreed-upon procedures engagement
- D. A proactive search for fraud
- E. Expansion of SAS 99 procedures

The answer is—it depends.

# The Audit of the Future

- Forensic Auditing is a new concept that comprises three key ingredients:
  - Forensic Audit Thinking
    - in other words “thinking forensically”
  - Forensic Audit Procedures
    - both proactive and reactive
  - Appropriate use of technology and data analysis

# Forensic Audit Thinking (FAT)

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# Forensic Audit Thinking—FAT

- **Forensic Audit Thinking involves the critical assessment throughout the audit of all evidential matter and maintaining a higher degree of professional skepticism that fraud may have occurred, is occurring, or will occur in the future.**



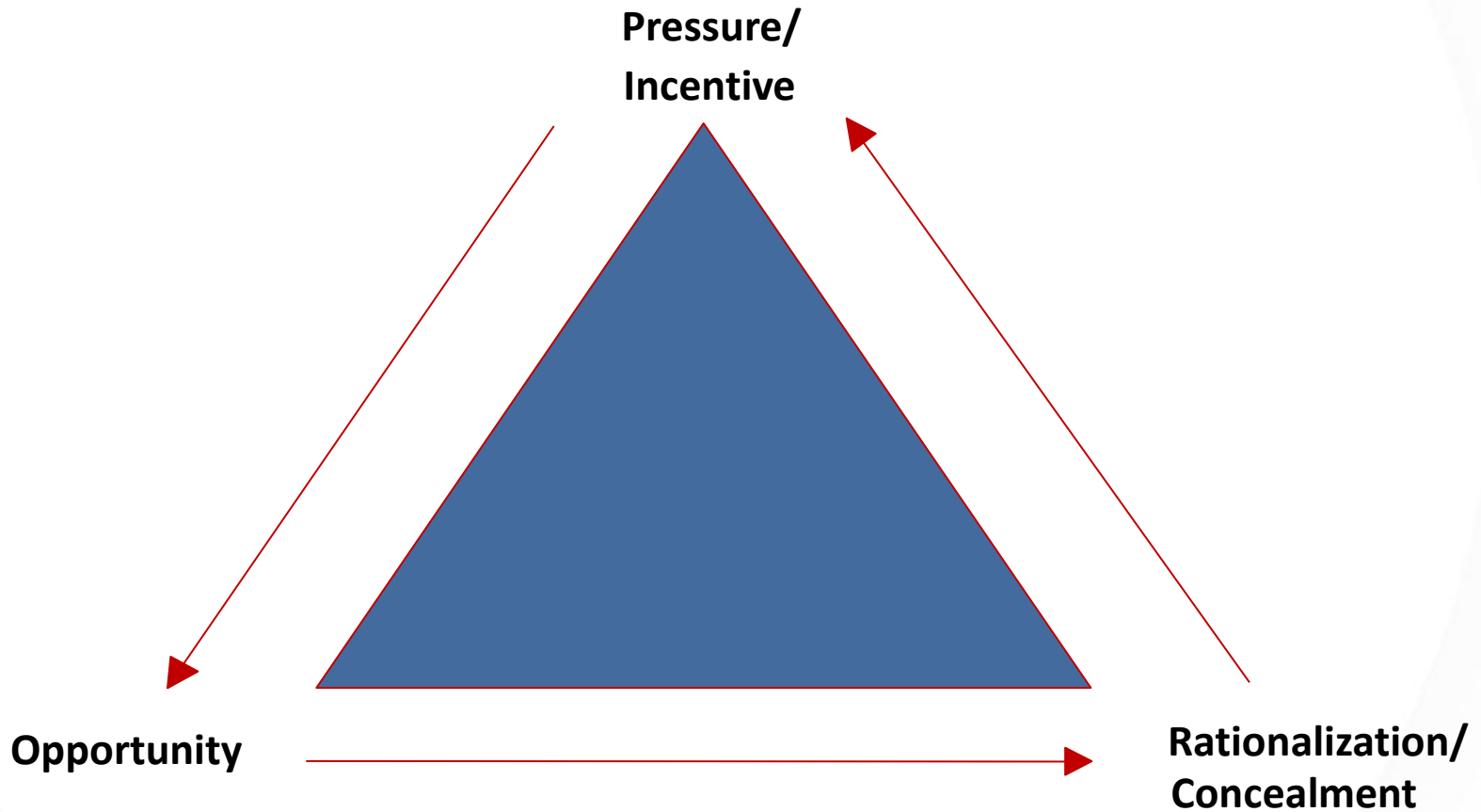
# FAT General Considerations

- Yes, fraud can happen anywhere! Most, if not all companies, will experience fraud at some level.
- Know what you are looking for and be prepared to do something if and when you find it.
- Forensic thinking is a mind shift where the auditor believes that the possibility of fraud may exist and the controls may be overridden to accomplish that possibility.
- Forensic thinking is used throughout the audit.
- Know your client—what is the tone at the top?

# Assess the Tone at the Top

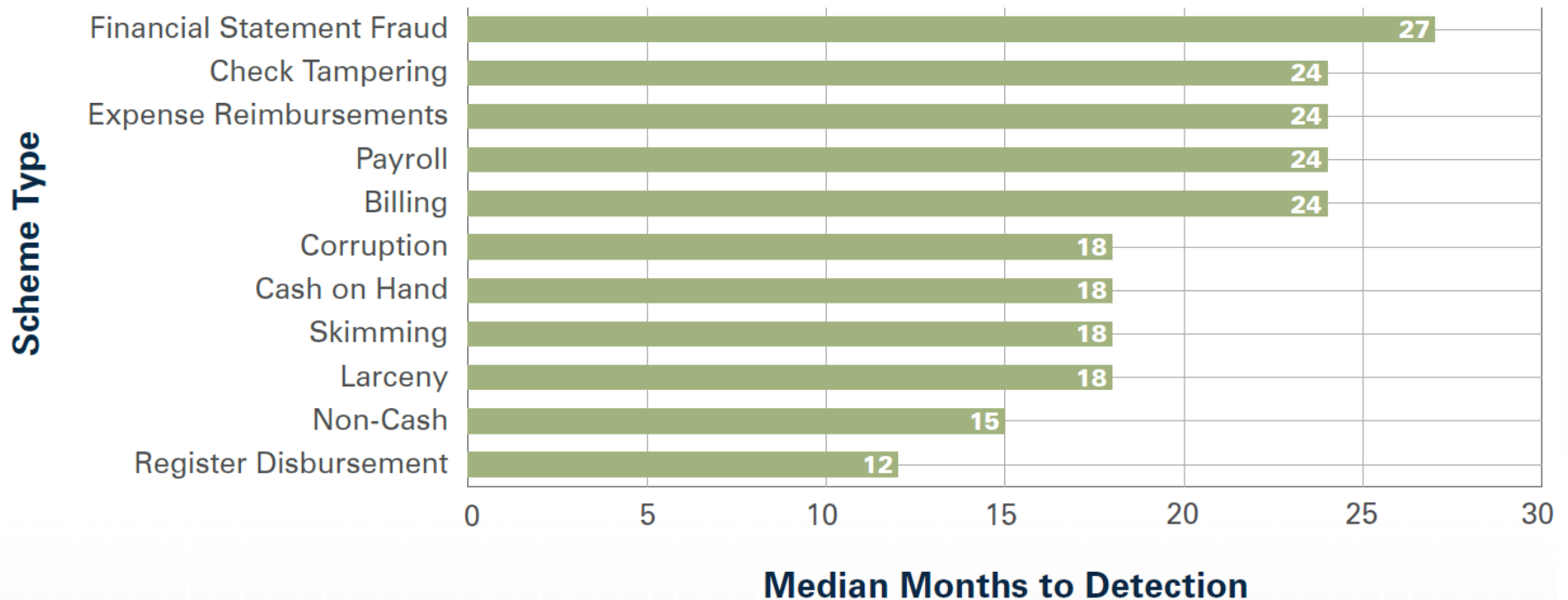
- Does management act with the highest levels of integrity?
- Is management committed to upholding its code of conduct?
- Are oversight mechanisms in place and functioning that will prevent, deter, and detect management override of internal controls?
- Test ethics, conduct, conflict of interest, compliance, and fraud prevention programs.
- Test the operation and adequacy of confidential disclosure processes and management's response to identified risks.
- Test the tone at the top including communication of management's philosophy and operating style.

# The Fraud Triangle



# Gestation Period for Frauds to Be Detected

Median Duration of Fraud Based on Scheme Type



# Planning

- Gathering of background information from client:
  - Prior year knowledge
  - Current company information
  - Preliminary interviews
  - Internal pressures
- Gather external background information:
  - Current company research
  - Industry research
  - Market pressures

# Brainstorming Essentials

- Discuss various broad programs to prevent, detect, and respond to fraud issues (antifraud programs and controls).
- Examine company-level controls such as hotlines, employee handbook, code of conduct, hiring practices, termination of employee protocol, etc.
- Evaluate process-level controls over recording transactions, segregation of duties, approval limits, continuous monitoring, etc.
- Discuss computerized controls and how they will be tested.

# Risk Assessment

- Economic, environmental, and industry factors
- Pressures and incentives that could drive behavior
- Assess areas where internal controls could be overridden
- Internal pressures (budget constraints, approval levels, etc.)

# Risk Assessment (Cont'd)

- Review prior year's audit work papers
- Review current information gathered
- Comparison to competitor's analysis
- Stock price, analyst estimates, market pressure analysis
- Insider-trading analysis
- What is the "fraud du jour"?



# Case Example

- While conducting a brainstorming session, we determined that the client was doing much better in China than their competition.
- We asked what internal controls and fraud prevention procedures were in place to detect a possible FCPA violation.
- We were told that the company had controls in place.
- The company subsequently had an FCPA issue.
- The controls in place were overridden by the country manager.

# Knowledge Check

Forensic Audit Thinking involves:

- A. An increased level of professional skepticism
- B. Following prescribed checklists
- C. A critical evaluation of evidence obtained
- D. All of the above
- E. Both A and C above

# What Professional Standards Are Auditors Following If They Conduct an Investigation?

- A. Auditing Standards
- B. ACFE Code of Professional Standards
- C. Private Investigation Standards
- D. Statement on Standards for Consulting Services No. 1

# Forensic Audit Procedures (FAP)

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# Forensic Audit Procedures—FAP

- Forensic audit procedures are more specific and geared toward detecting the possible material misstatements in financial statements resulting from fraudulent activities or error.
- Audit procedures should align with fraud risks and fraud risk assessments.
- If fraud was occurring at your audit client, what procedures would detect it?

# Key Characteristics for Effectively Implementing Forensic Procedures

Those performing forensic procedures (either the auditor or the forensic specialists) may consider having:

- An investigative mindset—more than skeptical
- An understanding of fraud schemes and indicia of fraud
- Experience in dealing with fraud issues
- Knowledge of certain investigative, analytical, and technology-based techniques
- Knowledge of legal process (pitfalls, ramifications, etc.)

# FAP—The Seven Investigative Techniques\*

1. Public document reviews and background investigations
2. Interviews of knowledgeable persons
3. Confidential sources and informants
4. Laboratory analysis of physical and electronic evidence
5. Electronic and physical surveillance
6. Undercover operations
7. Analytical procedures

\* Source: Based on “The 7<sup>th</sup> Investigative Technique” by Richard Nossen (modified from the original text).

# Case Example

- Prior to going into the field with the audit team (forensic in the audit) we did a public records search looking for insider-trading activities—best practice!!
- We saw that a number of insiders had significant trading activities.
- We reported this to the audit partner.
- Six months later, a class action lawsuit was filed against the officers and directors for “alleged” insider trading.



# Interviewing Basics

- Be objective and not biased.
- Be well prepared.
- Understand that listening is essential—two ears one mouth.
- Don't prepare a list of questions in advance.
- Be professional at all times.
- Maintain eye contact.
- Prepare a memo or written report of your interview (this should be in a previously approved format for consistent results).
- Don't express opinions (yours not theirs).

# Prior to the Interview

- Don't call it an interview when setting it up—use terms such as “I'd like to come by to visit with you” or “I'd like to have a few minutes of your time to discuss ....” The terms *interview* and *inquiry* sound threatening.
- Review documents and know the span of authority of the person be interviewed.
- Have evidence or documents copied and ready for review by interviewee.
- Have a partner as a note taker—discuss roles.

# Note Taking

- Ask for permission to take notes—Is it okay if I jot down a few notes?
- Don't record more than one interview on a piece of paper.
- Be sure to list only the pertinent facts.
- Use quotes sparingly, but when a statement is relevant do it.
- Prepare an interview memo timely.
- Consider reviewing it with interviewee.

# Knowledge Check

The forensic auditor should be fully prepared for the interview with a script to follow:

- A. True
- B. False

# Knowledge Check

The purpose of an interview is to obtain an admission of wrongdoing.

- A. True
- B. False

# Knowledge Check

Which of the following is NOT an investigative technique?

- A. Interviews
- B. Background checks
- C. Confirmation with third parties
- D. Handwriting analysis
- E. Using confidential sources (informants)

# Appropriate Use of Technology

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## Using Forensic Data Analysis to Find Fraud

# Forensic Data Analysis

- **Forensic Data Analysis** is the process of gathering, summarizing, comparing, and aggregating existing disparate sets of data that organizations routinely collect in the normal course of business with the goal of detecting anomalies that are traditionally indicative of fraud or other misconduct.
- Can be used in the **Prevention, Detection, or Response** of fraud or other misconduct.
- Provides additional comfort to C-Level Executives, Audit Committees, Internal Audit Departments, and Management.



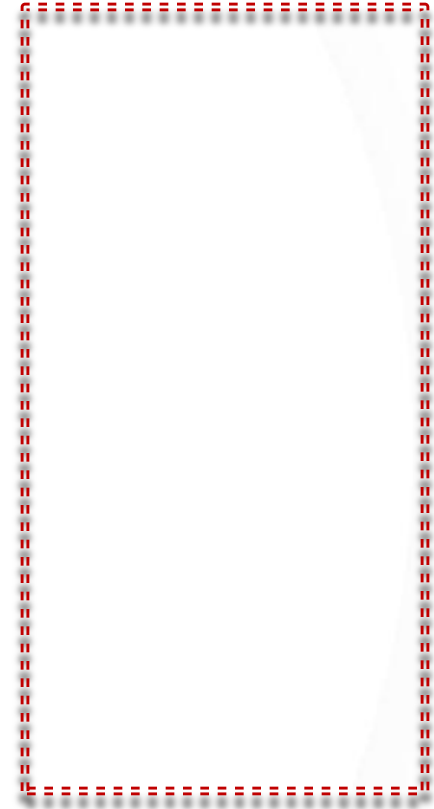
# Benefits of Forensic Data Analysis

- Analyzes 100% of data sets rather than using statistical sampling—Risk Based Sampling.
- Can help identify potential control environment weaknesses.
- Can assist with the assessment of the effectiveness of existing anti-fraud and fraud risk management programs and practices.
- Can help to Identify potential policy and process violations—vendor acceptance/approval process, T&E, etc.
- Can assist with interviews in investigations.

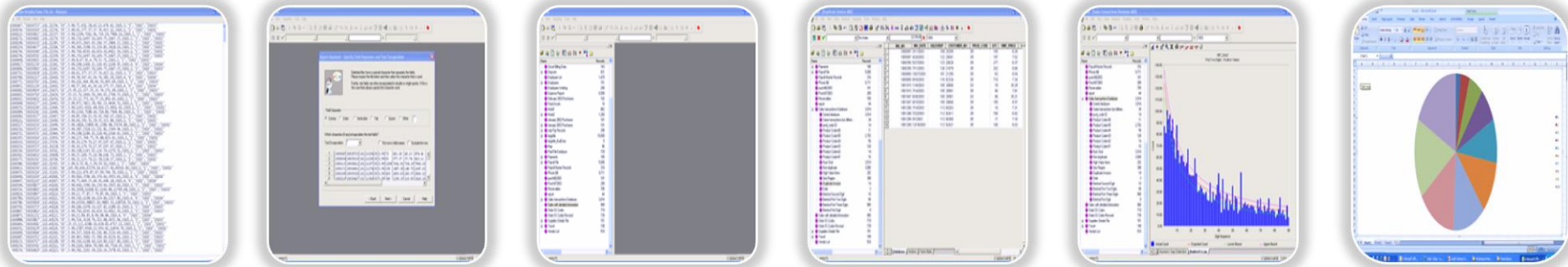
# Forensic Data Analysis



## Data Analysis Tool



# Forensic Data Analysis Process



1. Acquire Data and Normalize

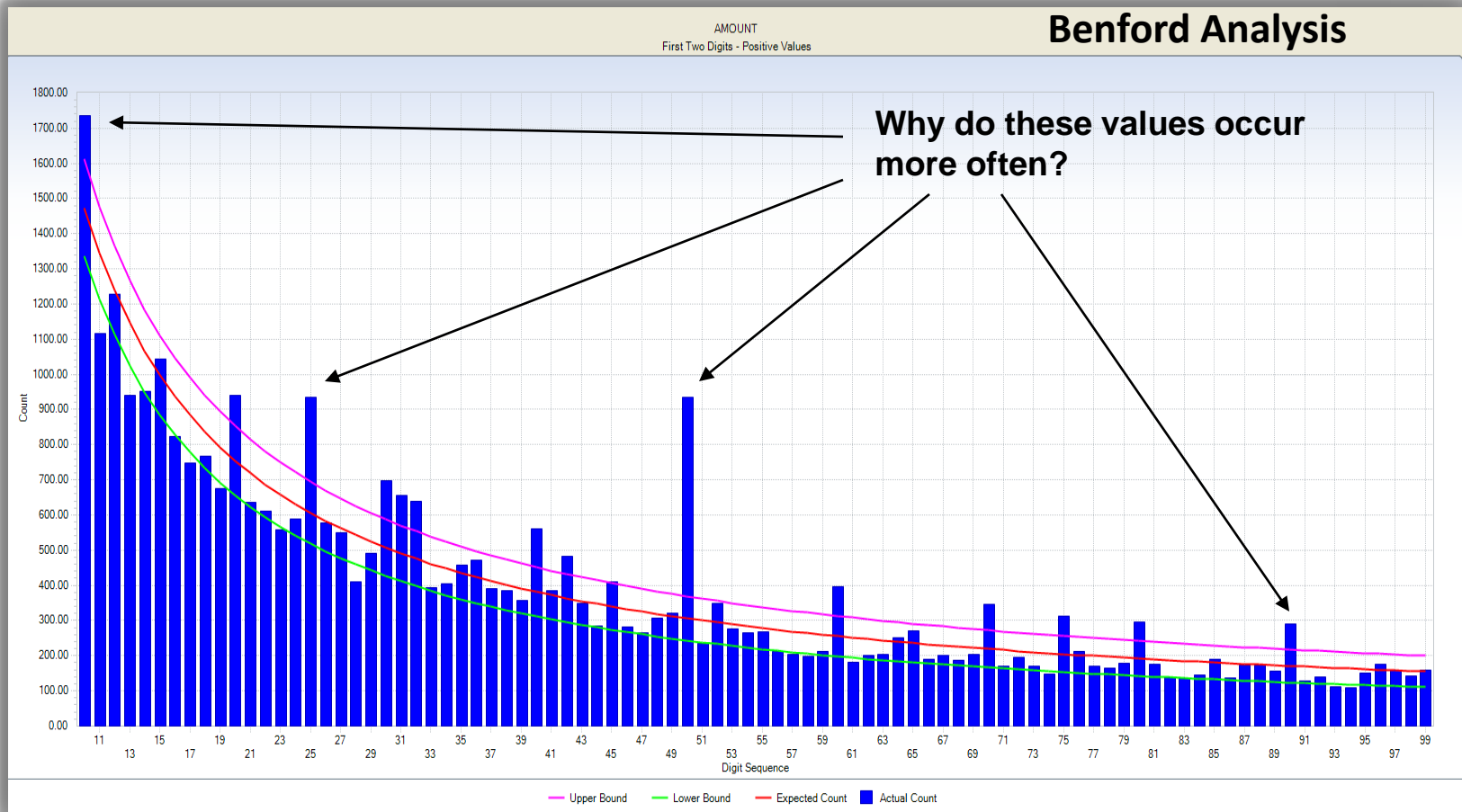


2. Brainstorming and Real-Time Data Analysis



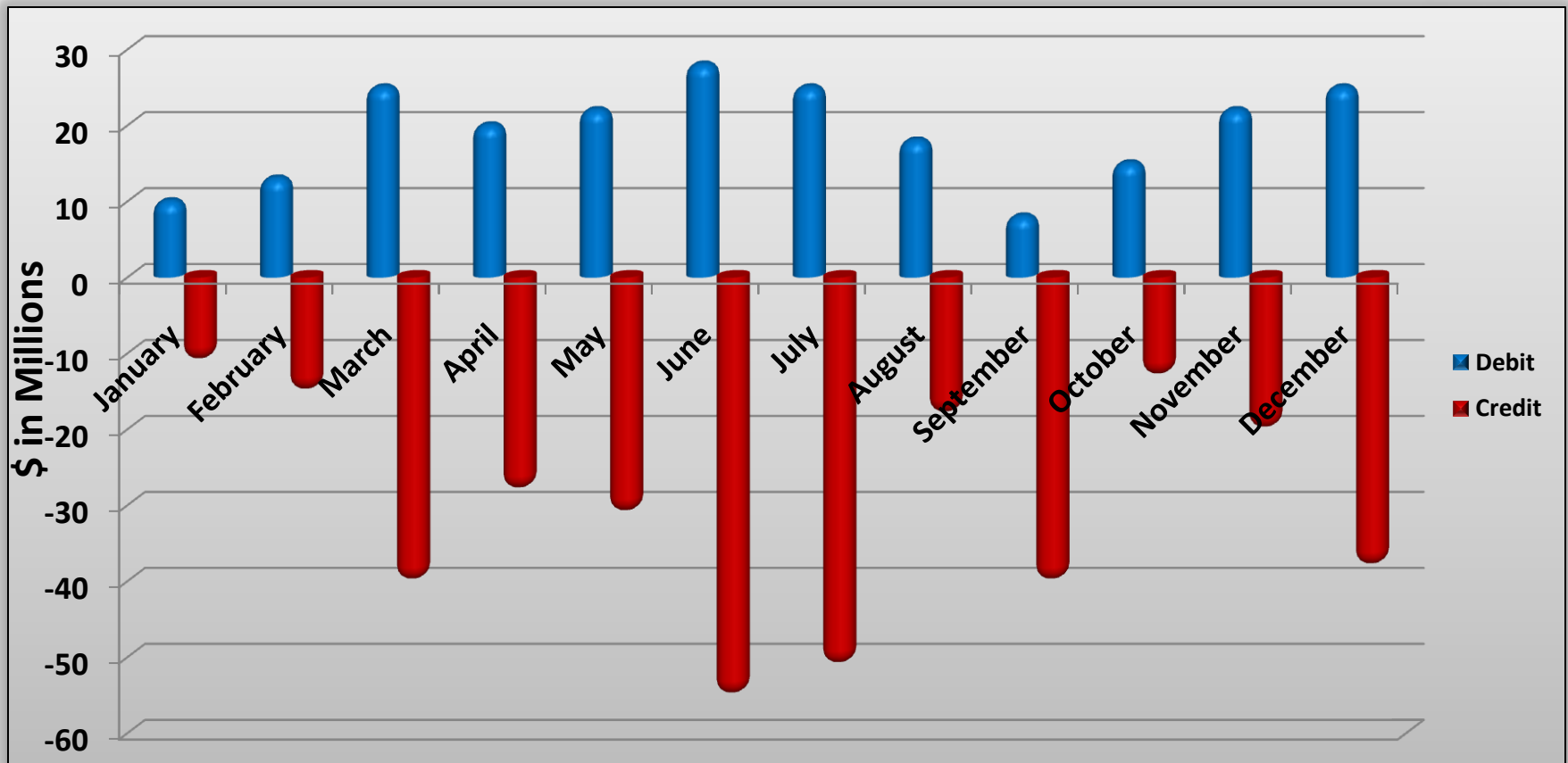
3. Output Trends and Anomalies

# Digital/Frequency Testing

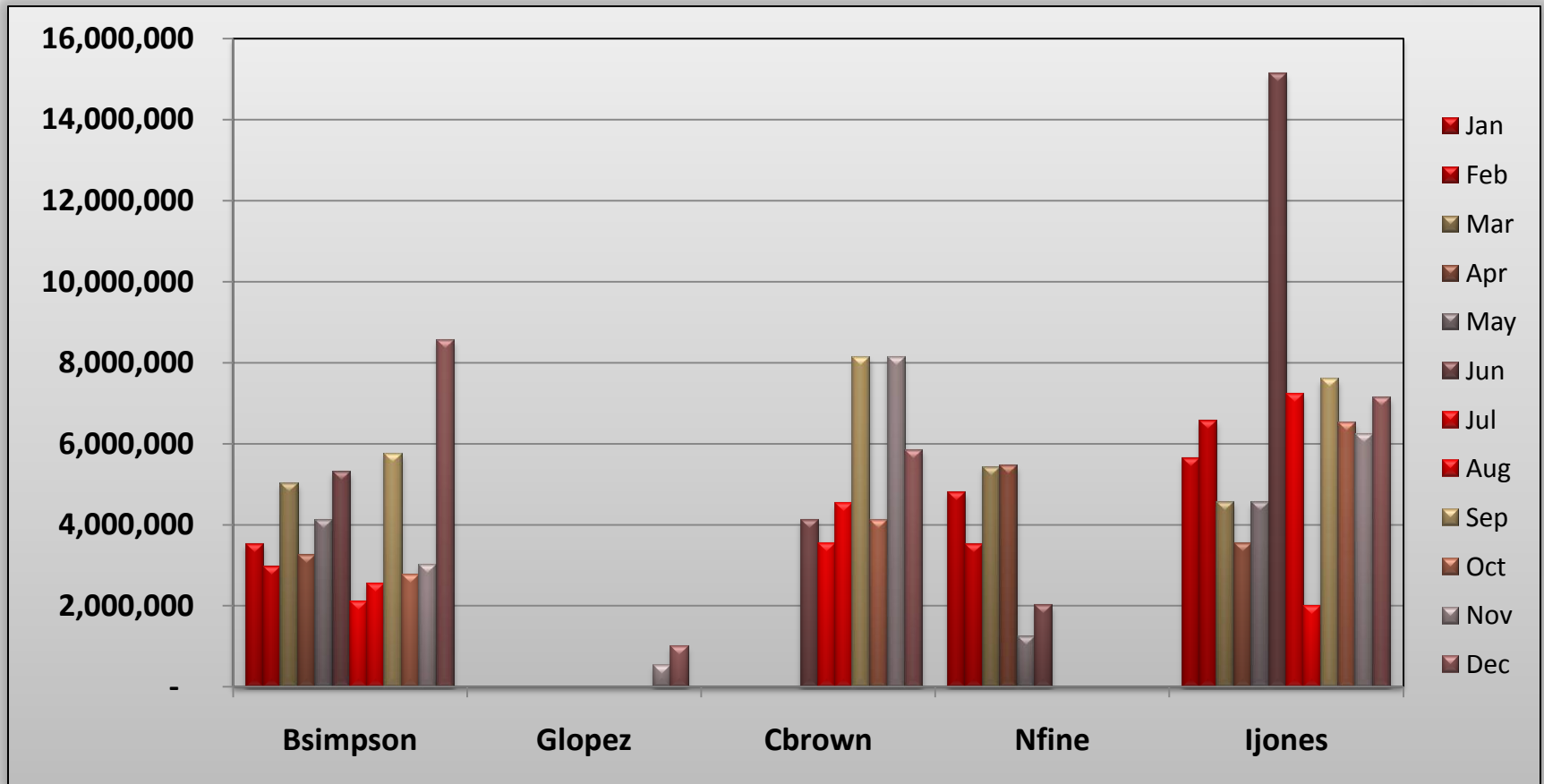


# Analytical Testing—Income Statement Items

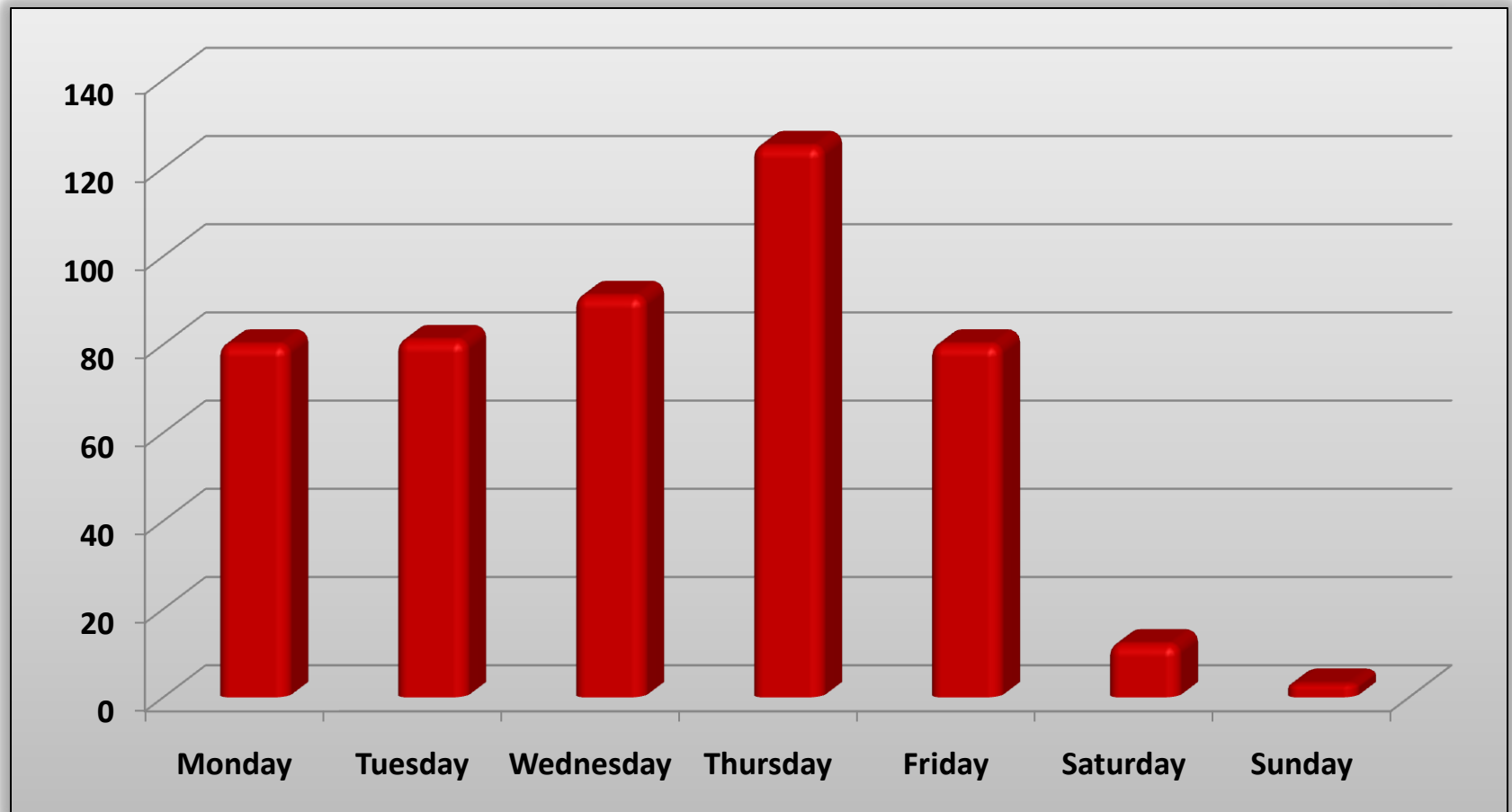
Revenue Trending



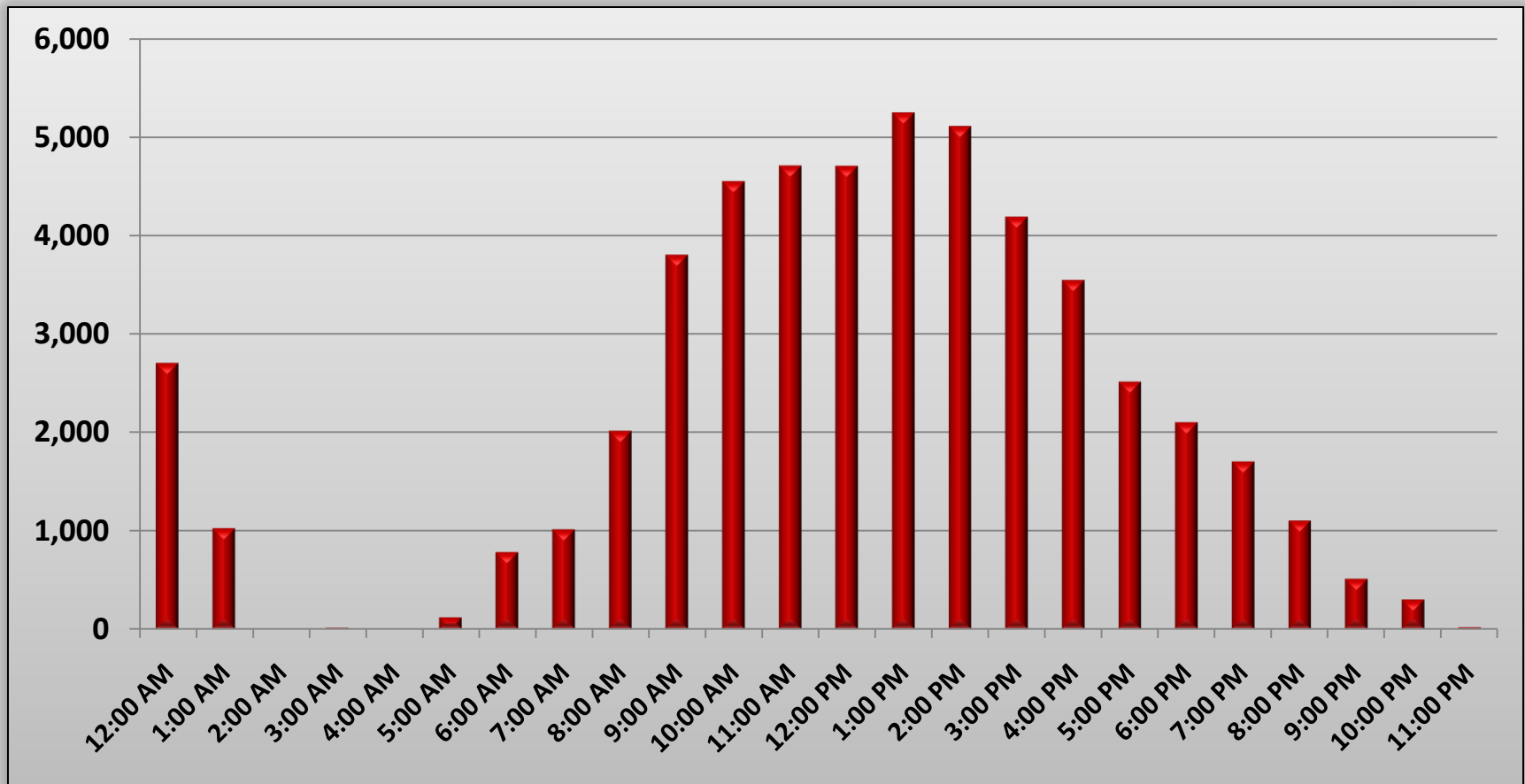
# Analytical Testing—User Activity by Month



# Analytical Testing—Day of the Week



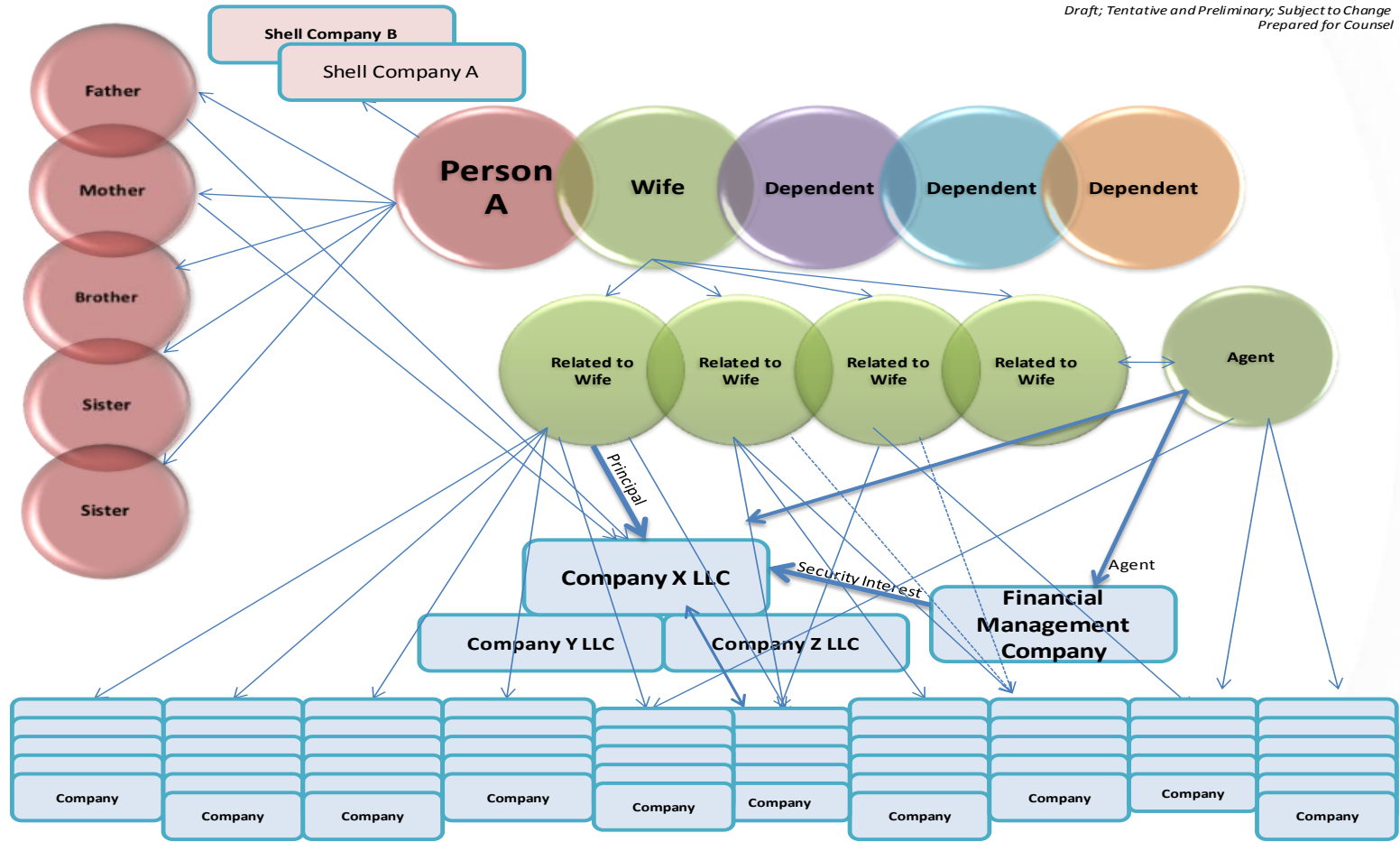
# Analytical Testing—Time of Day



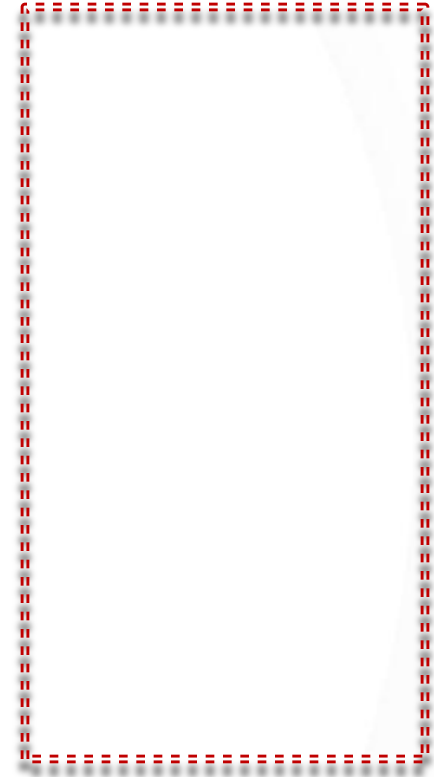


# Related-Party Analysis

*Draft; Tentative and Preliminary; Subject to Change  
Prepared for Counsel*



# Computer Forensics and E-Discovery



# Knowledge Check

Forensic Technology Tools can help to find the indicia of:

- A. Misappropriation of assets schemes
- B. Corruption schemes
- C. Financial reporting schemes
- D. All of the above

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# Questions?

# Contact Info

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**The End**