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Fraud Red Flags and the Procedure of Implementation of Forensic Audit

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Abstract: Fraud red flags refer to undesirable situations or conditions that consistently contribute to fraud, waste, and abuse of resources. When an investigator is reviewing the company's stocks or financial statements, certain undesirable characteristics may stand out as fraud red flags or contributors to fraud.It is an obligation of forensic auditor as a fraud-proofing expert to identify certain warning signals, also called "red flags", when identifying a fraud. With a help of methods and techniques carried out in such a type of audit, it is necessary to collect sufficient amount of evidences that will eventually describe the elements of fraud, created damage, and suspected individuals, which will be presented, if necessary, in a court.

Keywords: Fraud, red flags, identifying a fraud, forensic audit, forensic auditors, security, detection of fraud

JEL klasifikácia: C22; C51; Q11; Q13

1. Introduction

Individuals who are engaged in occupational fraud schemes often exhibit certain behavioral traits or warning signs associated with their illegal activity. In the ACFE's 2018 Report to the Nations, survey respondents were presented with a list of 17 common behavioral red flags and asked to identify the red flags that had been displayed by the perpetrator before the fraud was discovered.

These six behavioral red flags have been the most common in every one of our studies dating back to 2008, with a remarkably consistent distribution:

Living beyond one's means
Financial difficulties
Unusually close association with a vendor or customer
Excessive control issues or unwillingness to share duties
Recent divorce or family problems
A general "wheeler-dealer" attitude involving shrewd or unscrupulous behavior

While the presence of these red flags doesn't imply that fraud is being committed, understanding and recognizing the behavioral red flags displayed by fraud perpetrators can help organizations detect fraud and mitigate losses.[1]

2. Identifying of the "Red Flags" and Detection of a Fraud

Red flags can be described as fingerprints in fraud.[2] When fraud occurs, traces of a fraud remain untouched just as fingerprints at the crime scene. Red flags are types of warning signs that can be shown in different forms and can be identified as accounting anomalies, weaknesses in the system of internal controling, analytical anomalies, notices and acquisitions, extravagant lifestyles, or changes in the behavior of the invidividual who commited the fraud. Forensic auditors study and analyze „red flags" in order to prevent and detect frauds.

2.1 Warning Signs of a Fraud

Warning signs, red flags, can be in form of financial or personal information.[3] Warning signs of personal information include changes in behavior and lifestyle. Certainly these attributes need to be cautiously accessed due to various factors that may affect lifestyle and behavioral changes. If such illogicalities coincide with other evidence of fraud, then it is possible to associate them with other evidence. Changes in lifestyle are recorded as red flags if the changes are significant, clearly visible and are present over a longer period of time.

Warning signs that detect irregularities in financial data can be divided by different types of frauds.[4] Most authors commit fraudulent actions on fraudulent financial reporting, illegal appropriation of property and corruption.

Warning signs pointing to corruption are: the company inputs pay more than the usual market price, specific requirements are referred to only one supplier, the projects are divided into two contracts to avoid higher approval, the limited duration of the tender, one bidder often wins tenders, private co-operation between the client and tenderness who are applying for the tender, weak production quality of the new supplier, conflicts of interest (the family relationship between suppliers and employees of client firm) and the purchasing employee who lives above his/her possibilities.[5]

The illegal appropriation of property consists of various categories of frauds, including skimming, money laundering, fraudulent disbursements, and larceny and misuse of property (non-cash larceny and misuse).[6] "Skimming" can also be defined as "obing" or "evading". Skimming is a type of fraud, which occurs before enrollment into a business book.[7] It is difficult to detect this fraud, because it happens outside of the business book.

[1] GLOBAL STUDY ON OCCUPATIONAL FRAUD AND ABUSE (2018) ACFE - Association of Certified Fraud Examiners, Inc., and are registered and/or used in the U.S. and countries around the world.
[2] Singelton, T., Singelton, J., (2010.) Fraud Auditing and Forensic Accounting. Hooboken, New Jersey, John Wiley & Sons, Inc., p. 95
[3] Coenen, T. L., (2008.) Essentials of Corporate Fraud. Hooboken, New Jersey, John Wiley & Sons,Inc., p. 30.
[4] Singelton, T., Singelton, J., (2010.) Fraud Auditing and Forensic Accounting. Hooboken, New Jersey, John Wiley & Sons, Inc., p. 95.
[5] Coenen, T. L., (2008.) Essentials of Corporate Fraud. Hooboken, New Jersey, John Wiley & Sons,Inc., p.84.
[6] Albrecht, C.,Kranacher, M.J., Albrecht, S., Asset Misappropriation Research White Paper for the Institute for Fraud Prevention, (online) .Institute of fraud prevention, p..2., dostupno na: http://www.theifp.org/research-grants/IFP-Whitepaper-5.pdf
[7] Singelton, T., Singelton, J., (2010.) Fraud Auditing and Forensic Accounting. Hooboken, New Jersey, John Wiley & Sons, Inc., p. 108.

Such type of fraud usually is present in different transactions as sales, receivables or refunds.[8] To detect such a type of fraud it is often required to extensively investigate the case by experts or forensic auditors. "Cash Larceny" usually occurs by taking away cash equivalents before they enter the company's business books of the company, and the money is usually stolen from cash register or cash deposits.[9] Fraudulent disbursements are made up of various types of fraud: the fraud of the account occurs when an employee who collects fake personal accounts, counterfeits are related to the modification or falsification of company's invoices for their own needs and purposes, reimbursements include false claims or fictitious business expenses, fraud involves a deception of the company's pay wages that are not earned and payments in cash registers, which consist of fraudulent transactions.[10] Red flags include: unusual activity on business credit cards, purchase of unusual products, employee/employees constantly constantly over the budget, high number of blank invoices, disappearance of invoices, giving employees permission to use business invoices, changing recipients of invoices, surplus of rejected invoices, questionable addresses of recipients of invoices, duplication of invoice numbers, non-existent employees, falsified wages, false commissions and compensation.[11]

Fraudulent financial reporting is done by high management for the benefit of a company, but ultimately financial fraud does not use the company as it is initially manifested while fraud lasts.[12] Some of the common warning signs for this type of fraud are accounting anomalies, accelerated growth, unusual profits, weaknesses of internal controls, and aggressive access by executive directors, stock market obsession, and micro management by executive directors. These warning signs also consist of potential red flags of management style or the character of key directors. Also one of the warning signs, which indicate the change of character of management are secrecy and holding back of certain financial information.

2.2 Detection of fraud

Asset classification is appropriately followed by the procedure of risk analysis. It helps to create a guiding framework for assessing the significance of vulnerability in the context of asset classification and thus facilitate the decision-making in implementing security measures and prioritizing them.

There are more ways of accessing the assessment of information security risks. Based on the approach to risk analysis, the methods are divided as follows:

- Qualitative risk analyses describe the impact and its likelihood verbally. The disadvantage of this approach is in a considerable degree of subjectivity in chosen means of expression by the evaluator, which may lead to misinterpretation of the resulting report. The disadvantage lies also in the inconsistency of such analysis, as well as in the inability to compare the analysis with those of other organizations. Qualitative risk analyses are used especially where it is not possible to evaluate probabilities or impacts numerically.
- Quantitative risk analyses use numerical values to evaluate the impact. The advantage over the qualitative risk analysis lies to some extent in the elimination of the evaluator's subjectivity. The disadvantage of this type of analysis is in the need for sufficient numerical data to evaluate the

[8] Albrecht, C.,Kranacher, M.J., Albrecht, S., Asset Misappropriation Research White Paper for the Institute for Fraud Prevention, (online) .Institute of fraud prevention,str.3., dostupno na: http://www.theifp.org/research- grants/IFP-Whitepaper-5.pdf.

[9] Albrecht, C.,Kranacher, M.J., Albrecht, S., Asset Misappropriation Research White Paper for the Institute for Fraud Prevention, (online) .Institute of fraud prevention, p.3., dostupno na: http://www.theifp.org/research- grants/IFP-Whitepaper-5.pdf

[10] Singelton, T., Singelton, J., (2010.) Fraud Auditing and Forensic Accounting. Hooboken, New Jersey, John Wiley & Sons, Inc., p. 109.

[11] Coenen, T. L., (2008.) Essentials of Corporate Fraud. Hooboken, New Jersey, John Wiley & Sons,Inc.,p.79.

[12] Singelton, T., Singelton, J., (2010.) Fraud Auditing and Forensic Accounting. Hooboken, New Jersey, John Wiley & Sons, Inc., p. 99.

impacts and their probabilities. It is quite difficult to set the rating scale. Each successive step increases the number of combinations of impact probabilities. There are also specialized software tools for quantitative risk analyses.

- As a result of risk analysis, the risks assessed as being damaging and unacceptable, can have a significant negative impact on the business. Therefore, it is the latter category of risks that should be prioritized in the process of applying security measures in order to reduce them to an acceptable level.

2.3 Risk Assessment of Fraud

Regulators, shareholders and the legal system often point out that it is crucial to assess the risk of fraud and how risk management is essential to building and maintaining an effective anti-fraud program. Enterprises attempt to identify and assess the risk of fraud in the overall risk assessment in the business environment or as a stand-alone project.

The assessment of the risk of fraud should be carried out periodically in order to identify potential fraud or events and mitigate the potential difficulties that the company would have.[13] Auditors should check and test the ways and how efficiently the enterprise carries out the risk assessment of fraud and the importance that management assigns to risk management and its composition in company policies and procedures.

In order to better assess the risk of fraud, it is necessary to study the company's business and the economic and market situation in which the company operates, the presence of other fraud risks and also the effectiveness of internal controls.

Likewise, risk factors can be observed at several levels, as mentioned at the business level, then at the level of people, sectors, geography, products or services, controls, information systems, and accounting and business processes.[14]

The Association of Certified Fraud Investigators has produced fifteen questions that help determine the potential for fraud in the company and create an action plan to mitigate this risk. Questions are placed such as whether one or two key employees appear to be dominating the company, whether one of the employees is closely related to suppliers, educates the company's employees regarding the ethics and education programs and the fraud prevention program, employees who have access to confidential information information and whether a confidentiality agreement has been signed.

SAS 99 provides guidance on how auditors can apply a risk management approach to minimize corporate fraud and provide the most important guidance.15 The first risk management guideline attaches importance to the discussion with the staff involved in the audit process regarding the risks posed by material misconduct arising from fraud. Other guideline requires obtaining the information needed to identify the risk of material irregularities. In order to be able to collect such information, it is necessary to: examine management and others within the enterprise about fraud risks, the investigation covers information on potential fraud, fraud knowledge, view on fraud risk in the company management, and views on risk management programs and internal controls in the enterprise that should reduce the specific identified risk of fraud. Further, it is necessary to include the results of analytical procedures in the audit planning. The following directive covers the identification of risks resulting from material irregularities. Auditors use information collected through compliance with the first two risk management guidelines. Then it comes to assessing the risk identification with the risk management program and the internal control ratings of the audited company. After the presented guidelines there follows the results of the assessment. The final guideline presents the evaluation of audit evidence. During the audit, the auditors must assess the risk and material irregularities due to the

[13] Golden, T., Skalak, S., Clayton, M., (2006.) A guide to forensic accounting investigation, Hoboken, New Jersey., John Wiley & Sons, Inc., p. 43.
[14] Singelton, T., Singelton, J., (2010.) Fraud Auditing and Forensic Accounting. Hooboken, New Jersey, John Wiley & Sons, Inc., p. 114.
[15] Golden, T., Skalak, S., Clayton, M., (2006.) A guide to forensic accounting investigation, Hoboken, New Jersey., John Wiley & Sons, Inc., p. 47.

possibility of fraud, and at the completion of audit, he/she must evaluate if the audit evidence collected affects the risk assessment, furthermore, the auditor must take into account if the identified irregularities can be a fraud detector and assess the impact on the financial statements.

3. Procedure for a forensic audit investigation

A forensic auditor is required to have special training in forensic audit techniques and in the legalities of accounting issues.

A forensic audit has additional steps that need to be performed in addition to regular audit procedures.

Plan the investigation – When the client hires a Forensic auditor, the auditor is required to understand what the focus of the audit is. For example, the client might be suspicious about possible fraud in terms of quality of raw material supplied. The forensic auditor will plan their investigation to achieve objectives such as:

- Identify what fraud, if any, is being carried out
- Determine the time period during which the fraud has occurred
- Discover how the fraud was concealed
- Identify the perpetrators of the fraud
- Quantify the loss suffered due to the fraud
- Gather relevant evidence that is admissible in the court
- Suggest measures that can prevent such frauds in the company in future

Collecting Evidence – By the conclusion of the audit, the forensic auditor is required to understand the possible type of fraud that has been carried out and how it has been committed. The evidence collected should be adequate enough to prove the identity of the fraudster(s) in court, reveal the details of the fraud scheme, and document the amount of financial loss suffered and the parties affected by the fraud.

A logical flow of evidence will help the court in understanding the fraud and the evidence presented. Forensic auditors are required to take precautions to ensure that documents and other evidence collected are not damaged or altered by anyone.

Common techniques used for collecting evidence in a forensic audit include the following:

- Substantive techniques – For example, doing a reconciliation, review of documents, etc
- Analytical procedures – Used to compare trends over a certain time period or to get comparative data from different segments
- Computer-assisted audit techniques – Computer software programs that can be used to identify fraud
- Understanding internal controls and testing them so as to understand the loopholes which allowed the fraud to be perpetrated.
- Interviewing the suspect(s)

Reporting – A report is required so that it can be presented to a client about the fraud. The report should include the findings of the investigation, a summary of evidence, an explanation of how the fraud was perpetrated, and suggestions on how internal controls can be improved to prevent such frauds in future. The report needs to be presented to a client so that they can proceed to file a legal case if they so desire.

Court Proceedings – The forensic auditor needs to be present during court proceedings to explain the evidence collected and how the suspect was identified. They should simplify the complex accounting issues and explain in layman's language so that people who have no understanding of the accounting terms can still understand the fraud that was carried out.

To summarize, a forensic audit is a detailed engagement which requires the expertise of not only accounting and auditing procedures but also expert knowledge regarding the legal framework. A forensic auditor is required to have an understanding of various frauds that can be carried out and of how evidence needs to be collected.

4. Conclusions

Today's financial services industry is challenged with increasingly innovative ways of committing fraud and cyber-crime. While banks, building societies and credit card companies comply with ever-changing regulations and legislation and contend with increasing pressure to release products that enhance the customer experience, first generation fraud management systems are falling short.

Forward-thinking financial institutions evolving their fraud management systems from a level of basic standalone detection to a more enterprise-focused approach that integrates disparate data platforms, predicts risk assessment using adaptive analytics, all with real-time functionality and without compromising on customer satisfaction.

While there are a number of fraud detection software solutions available for individual internet banking, mobile banking and credit card platforms, each has its own case management interface, the majority of which fail to meet the exacting needs of the financial service provider.

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