



The Institute of Chartered Accountants of India

National Conference on Company Law

Topic: Red flags in audits of companies



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CA Shashank Bhaskar Karnad

Date: 21 April 2023, 11:30 am to 1:00 pm

Private and Confidential

❑ Summary – What we will Cover Today (~90 minutes)

- ❑ Understanding Fraud and its meaning (5 mins)
- ❑ Fraud Triangle – Dr Donald Cressey’s theory on what causes fraud (5 mins)
- ❑ Corruption Perceptions – India’s rank according to Transparency International (5 mins)
- ❑ Importance of observation and diligence (5 mins)
- ❑ Profile of a fraudster – who is a fraudster...and the science behind it (5 mins)
- ❑ Ethical dilemmas – what are they and how do we deal with them (30 mins)
- ❑ Role plays (30 mins)
- ❑ How to mitigate fraud risks – quick wins (5 mins)
- ❑ Q&As and interactions – throughout the session!



➤ Understanding Fraud

Companies Act 2013, defines fraud in relation to affairs of a company or a body corporate, includes:

Any act, any omission, concealment of any fact, or abuse of position committed by a person or any other person with the connivance in any manner –

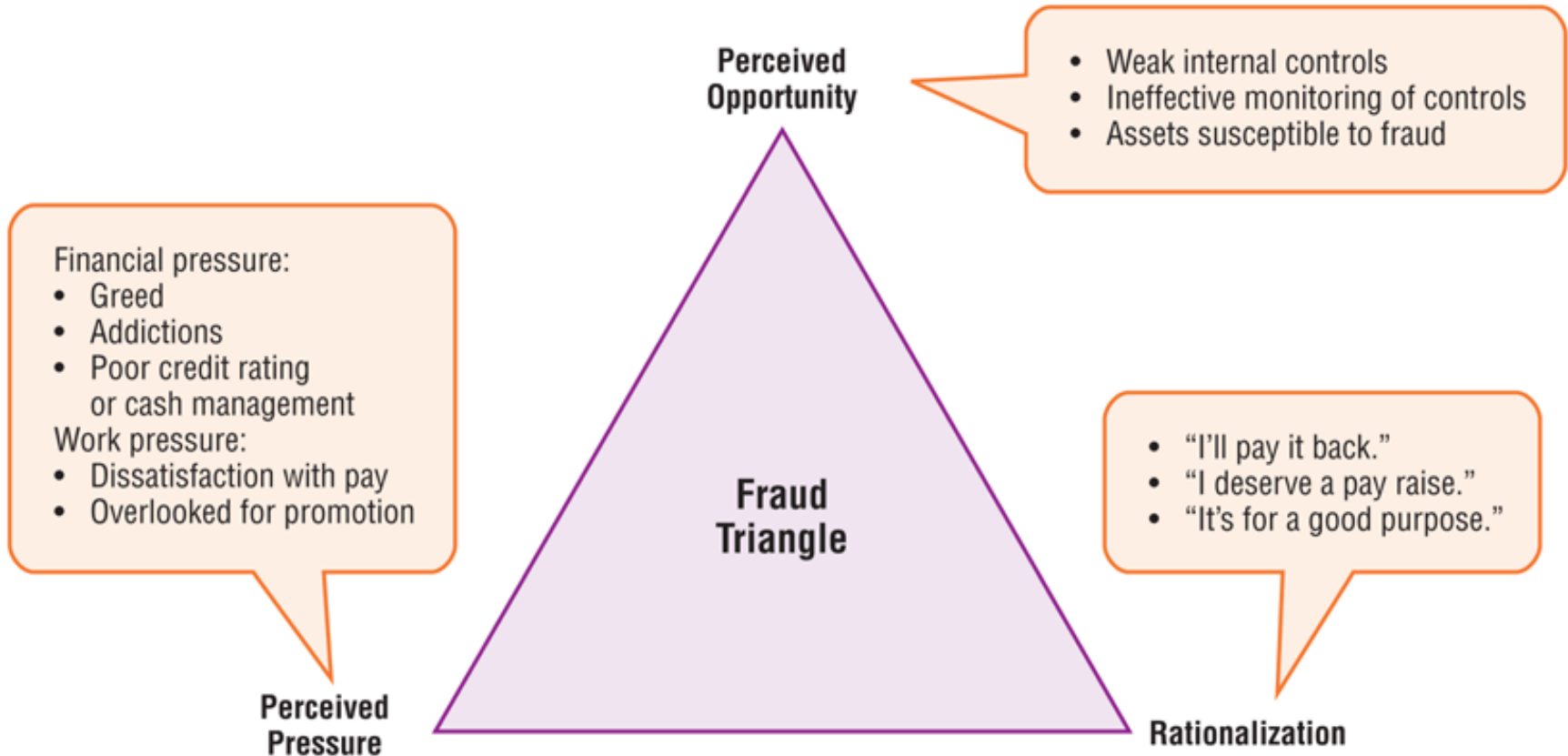
- with intent to deceive,
 - to gain undue advantage from, or
 - to injure the interests of;
-
- the company, or,
 - its shareholders, or,
 - its creditors, or,
 - any other person

Whether or not there is any wrongful gain, or any wrong loss, where:-

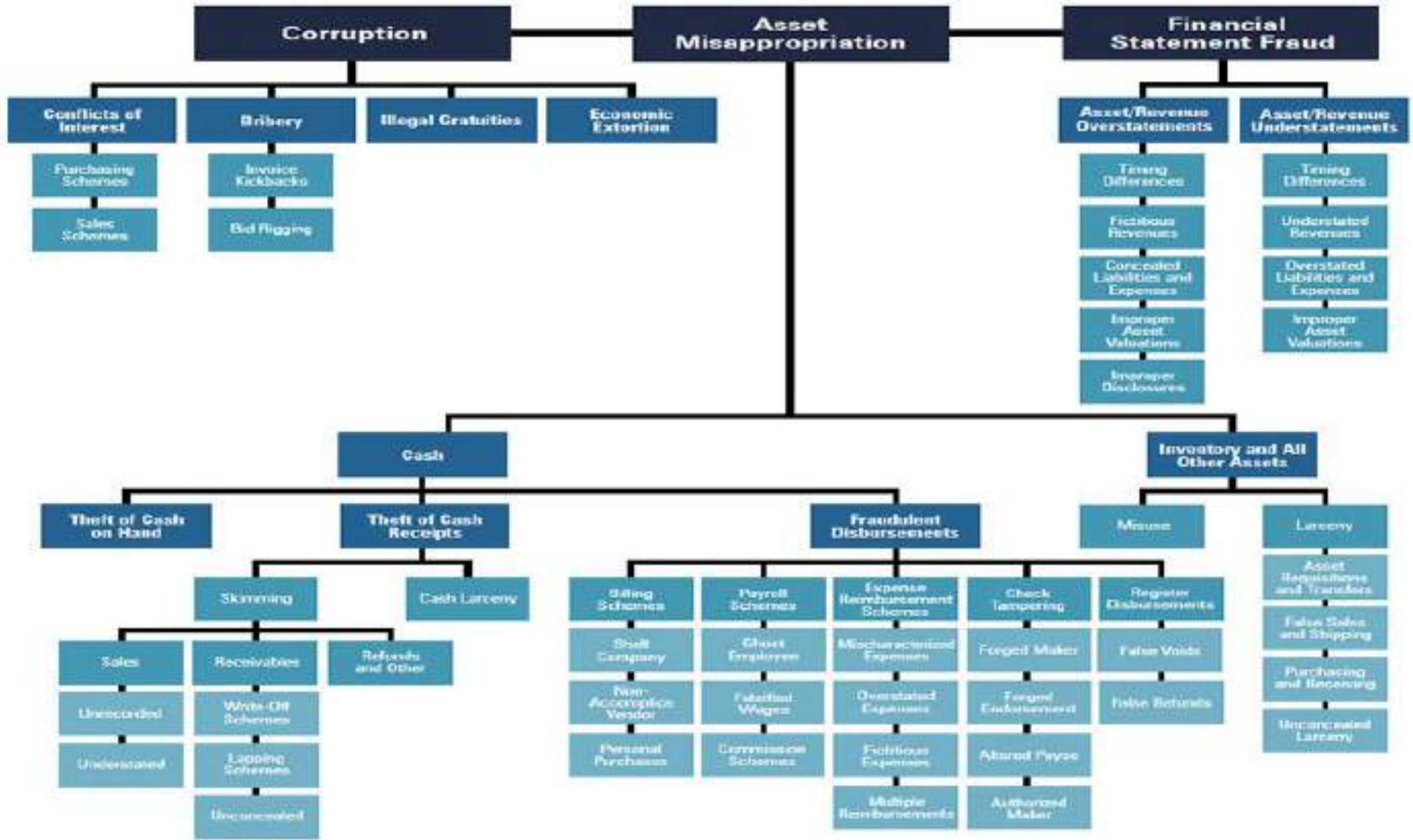
Wrongful Gain means the gain by unlawful means of property to which the person gaining is not legally entitled

Wrongful Loss means the loss by unlawful means of property to which the person losing is legally entitled.

➤ Fraud Triangle: Dr Donald Cressey



➤ ACFE Fraud Tree



Transparency International – India's rank vs the World



CORRUPTION PERCEPTIONS INDEX 2020

The perceived levels of public sector corruption in 180 countries/territories around the world.



SCORE	COUNTRY/TERRITORY	RANK	SCORE	COUNTRY/TERRITORY	RANK	SCORE	COUNTRY/TERRITORY	RANK	SCORE	COUNTRY/TERRITORY	RANK	SCORE	COUNTRY/TERRITORY	RANK	
88	Denmark	1	88	United States of America	25	44	Rwanda	49	44	Argentina	79	30	Malawi	129	
88	New Zealand	1	88	Seychelles	27	42	Grenada	52	42	Bahrain	79	30	Mali	129	
85	Finland	3	85	Taiwan	28	42	Italy	52	42	China	79	30	Russia	129	
85	Singapore	3	85	Barbados	29	42	Malta	52	42	Cote d'Ivoire	80	29	28	Lebanon	134
85	Sweden	3	85	Bahamas	30	41	Mauritius	52	41	El Salvador	80	29	28	Laos	134
85	Switzerland	3	85	Qatar	31	41	Saudi Arabia	52	41	Kosovo	80	29	28	Mauritania	134
84	Norway	7	84	Spain	32	41	Malaysia	57	41	Thailand	80	29	28	Togo	134
82	Netherlands	8	82	Korea, South	33	40	Namibia	57	41	Vietnam	80	29	28	Dominican Republic	137
80	Germany	9	80	Portugal	33	40	Greece	59	40	Bolivia and Nevegozina	111	28	28	Guinea	137
80	Luxembourg	9	80	Rotswana	35	40	Armenia	60	40	Mongolia	111	28	28	Liberia	137
79	Australia	11	79	Brunei Darussalam	35	40	Jordan	60	40	North Macedonia	111	28	28	Myanmar	137
79	Canada	11	79	Israel	35	40	Slovakia	60	40	Panama	111	28	28	Paraguay	137
79	Hong Kong	11	79	Lithuania	35	40	Belarus	65	40	Moldova	111	28	28	Angola	142
79	United Kingdom	11	79	Slovenia	35	40	Croatia	65	40	Philippines	111	28	28	Djibouti	142
75	Austria	15	75	Saint Vincent and the Grenadines	40	37	Cuba	65	40	Egypt	111	28	28	Papua New Guinea	142
75	Belgium	15	75	Cabo Verde	41	37	Sao Tome and Principe	68	39	Kuwait	111	28	28	Uganda	142
75	Estonia	17	75	Costa Rica	42	36	Montenegro	67	39	Nepal	111	28	28	Bangladesh	148
75	Iceland	17	75	Cyprus	42	36	Senegal	67	39	Sierra Leone	111	28	28	Central African Republic	148
75	Japan	18	75	Latvia	42	36	Bulgaria	68	39	Ukraine	111	28	28	Korea, North	150
75	Ireland	20	75	Georgia	45	34	Hungary	69	38	Zambia	111	28	28	Libya	154
75	United Arab Emirates	21	75	Poland	45	34	Jamaica	69	38	Niger	123	25	25	Equatorial Guinea	154
75	Uruguay	21	75	Saint Lucia	45	34	Romania	69	38	Bolivia	124	25	25	Sudan	154
75	France	23	75	Dominica	48	34	South Africa	69	38	Kenya	124	25	25	Venezuela	154
75	Bhutan	24	75	Czechia	48	34	Tanzania	69	38	Kyrgyzstan	124	25	25	Yemen	154
75	Chile	25	75	Oman	48	34	Gambia	75	37	Mexico	124	25	25	Syria	154
				Qatar	48	34	Maldives	75	37	Pakistan	124	25	25	Somalia	154
							Vanuatu	76		Azerbaijan	129	25	25	South Sudan	154
										Gabon	129	25	25		



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CORRUPTION PERCEPTIONS INDEX 2020

ASIA PACIFIC

45/100

AVERAGE SCORE



SCORE	COUNTRY/TERRITORY	RANK	SCORE	COUNTRY/TERRITORY	RANK
88	New Zealand	1	40	Timor-Leste	86
85	Singapore	3	38	Sri Lanka	94
77	Australia	11	37	Indonesia	102
77	Hong Kong	11	36	Thailand	104
74	Japan	19	36	Vietnam	104
68	Bhutan	24	35	Mongolia	111
65	Taiwan	28	34	Philippines	115
61	Korea, South	33	33	Nepal	117
60	Brunei Darussalam	35	29	Pakistan	124
51	Malaysia	57	28	Laos	134
43	Maldives	75	27	Myanmar	137
43	Vanuatu	75	27	Papua New Guinea	142
42	China	78	26	Bangladesh	146
42	Solomon Islands	78	21	Cambodia	160
40	India	86	19	Afghanistan	165
			18	Korea, North	170

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➤ Profile of a Fraudster – Key Facts Based on Research – why? Let's discuss...

- ❑ between the ages of 36 and 55 (69% of fraudsters investigated) – why?
- ❑ predominantly male (79 percent) – why?
- ❑ a threat from within (65 percent are employed by the company) – why?
- ❑ holds an executive or director level position (35 percent) – why?
- ❑ employed in the organization for at least six years (38 percent) – why?



➤ Profile of a Fraudster – Key Facts Based on Research – why?

- ❑ described as **autocratic** (18%) and are **three times** as likely to be **friendly** – why?
- ❑ **esteemed**, describing themselves as **well-respected** in their organization – why?
- ❑ likely to have **colluded** with others not a “**lone-wolf**” (62%) – why?
- ❑ motivated by **personal gain** (60%), **greed** (36%) – why?
- ❑ significant cases discovered based on **whistleblower complaints** (69%) not conventional “**controls**” – why?

Cardinal rule: *Every **fraudster** is a **high performer**, has an **aura of greatness**.
He/she is everybody's **blue eyed boy/girl**, which makes it **difficult** to
interpret and translate even **obvious red-flags as FRAUD***

Ethical dilemmas – fraud risk (Independence/Conflict of interest) (1/4)

➤ *You have just joined as the procurement head of a large company. You have moved to a new city with your family. Your 10-year old child has not got admission in the most coveted school in the city though you have tried hard to get him admitted into that school. Besides the career opportunity, that was your primary reason to agree move to this city. You casually mention this to a supplier when he asks you how you are settling down in the new city. Without your request for help, he offers to speak with his uncle, who he says, is the managing trustee of that school.*

	What would you do?	What would others do?
▪ Accept the offer from the supplier, since it is a matter of your young child's future	<input type="checkbox"/>	<input checked="" type="checkbox"/>
▪ Decline the offer and blacklist the supplier for trying to indirectly influence you	<input type="checkbox"/>	<input type="checkbox"/>
▪ Discuss with your spouse and accept the offer if he/she agrees	<input type="checkbox"/>	<input checked="" type="checkbox"/>
▪ Politely decline the offer since according to you it is an inducement	<input checked="" type="checkbox"/>	<input type="checkbox"/>

Ethical dilemmas – fraud risk (Procurement) (2/4)

- *You have been transferred to a location in South India, far away from a big city, as a Manager in the procurement function. Your parents, who have worked very hard to bring you up through immense poverty, are very old. They stay with you in your company provided accommodation. One stormy night, your father, who is almost 70-years old, has a heart attack. You take him to the local hospital, where the Doctor advises you to shift him to a bigger hospital in the city and to get a bypass surgery done urgently, else his very survival is at risk. The bypass surgery costs INR 8 lakhs. Your medical insurance covers up to INR 2 lakhs but you do not have the balance money. You call up a few colleagues to discuss this situation, but they are unable to help you financially. Soon thereafter, a large supplier drops in to the hospital with money for the surgery, and offers to move your father to the city, in his car.*

	What would you do?	What would others do?
▪ Accept the offer from the vendor as a godsend, since it is a matter of life and death of your beloved father	<input type="checkbox"/>	<input checked="" type="checkbox"/>
▪ Decline the offer as it is a violation of your code of conduct and blacklist the supplier for trying to blatantly bribe you	<input type="checkbox"/>	<input type="checkbox"/>
▪ Discuss with your boss, who is the Procurement head, and if he agrees, accept the vendor's offer	<input type="checkbox"/>	<input type="checkbox"/>
▪ Politely decline the offer since according to you it is a bribe but do nothing further	<input checked="" type="checkbox"/>	<input type="checkbox"/>

Ethical dilemmas – fraud risk (Projects/CAPEX) (3/4)

➤ *Your company is in the process of sub-contracting civil work for a new factory being developed in Maharashtra, at a budget of INR 500 crores. You are the AVP – Projects for the Western region. Late last year, your brother-in-law, a civil engineer and who had completed his interior design course from a good institute and had worked with a competitor in the projects function for a few years, set up his own civil work business named Shreeji Enterprises. He has been struggling a bit since the COVID-19 pandemic and his business has not fully recovered, since there have been fewer projects coming his way. He comes and meets you as he considers you his role model and asks you if you can help him get some work with your company since he knows that you are the regional project manager. Your brother-in-law also tells you in confidence that financial troubles are causing a lot of fights at home with his wife (your sister) and she has threatened to go and stay with her parents till his financial situation improves.*

	What would you do?	What would others do?
▪ Allocate a few projects to him to help him stabilise his business, at the standard price which you pay to other vendors who provide similar services	<input type="checkbox"/>	<input checked="" type="checkbox"/>
▪ Inform him that your company has a clear policy on conflict of interest and that you cannot help him	<input checked="" type="checkbox"/>	<input type="checkbox"/>
▪ Inform your boss about your brother-in-law's difficult situation, and if he agrees, allocate some civil work business to your brother-in-law's firm	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
▪ Tell your brother-in-law that your wife, who is a housewife, should be a minority partner in Shreeji Enterprises so that she is also able to earn some income	<input type="checkbox"/>	<input checked="" type="checkbox"/>

Ethical dilemmas – fraud risk (sales/bribery and corruption) (4/4)

➤ *As the VP Sales of Alpha Corporation Limited, you are due to succeed the President Sales of the company when he retires in December 2023. You have really worked your way to the role of VP Sales of Alpha. You are hoping to hear the good news of your promotion to President Sales soon. Just then your phone rings and you receive a call from one of your largest customers, a Government company in UAE, for their World Bank funded project in Central Africa, saying that your USD 200 million order for supply of material, is going to be cancelled, due to performance issues related to both delivery and quality. You take the next flight to Dubai to meet the customer. You try your best to convince the customer, but that does not help, as there are serious performance issues over an extended period of time, that have made the project unviable for the customer, according to him. Just as you are about to give up and walk away, the customer's assistant suggests a solution, should you be interested. He recommends that you hire a specific project management company to oversee the equipment supply and project implementation and that the company charges a 5% fee for their services. He suggests the name of Pegasus Enterprises, who he says is a "highly reputed" vendor. When you make a few enquiries, you learn that Pegasus is owned by the customer's son-in-law, who has helped suppliers in similar situations before*

What would you do?

What would others do?

- **Accept the suggestion as you have a lot at stake, since losing a USD 200 million order could be troublesome for your career**
- **Let your customer know that you will hire the right project management consultant after following due process, which could take time, at the risk of the customer cancelling your order in the meantime**
- **Tell the customer that you will not be able to hire the project management company suggested by him but that you have an empanelled project management company that your company works with in the region. The customer is not happy with your answer**



Role play - need six volunteers, so please read carefully!!!

(5 Mins to read and 10-15 mins for the discussion)

Dragon Oil is a successful Indian company that has grown 10X in ten years. Their blockbuster IPO was the most successful in 2022. A lot of anchor investors participated. Post the IPO, their stock price tripled within a year. Their Managing Director, Rajesh George, an aggressive, dynamic, suave and accomplished MIT graduate and Harvard MBA, with an astute sense of timing deals. He has also been profiled in Forbes, in and has been recognized in the Global 40-under-40 list by Forbes. Dragon Oil has won corporate governance awards from global organizations including the Economist and News Week. The company is looking at rapid expansion and has global aspirations. Of course, this rapid growth has not gone down well with several competitors, and there are Global forces trying to bring down the company and discredit the MD.

Recently, one of Dragon Oil's associates named Adam Stevens, who leads a large EPC vendor, based in the Middle East, informed Rajesh that a large state-owned oil and gas company in Azerbaijan, Azeroil, is up for sale. He also offers to set up a meeting with the powerful Minister in Baku, Azerbaijan if Dragon Oil wants to buy Azeroil. The Minister is expected to be the next President of Azerbaijan. Adam cautions Rajesh that the minister has already had roadshows in China and the Saudi's are also eyeing Azeroil. Azeroil is 20X the size of Dragon and Dragon's own cash will not suffice. Dragon is already leveraged with a debt/equity ratio of 2:1 and taking on more debt could impact the risk profile and financial health. However, buying Azeroil will help Dragon gain size and scale, and help with a US listing on the NYSE in just a few months after completing the acquisition. This will put Dragon in the league of Global oil and gas majors, like Exxon etc.

True to his character, Rajesh promptly visits Baku to meet the Azeri O&G Minister. The meeting goes off better than expected. The Azeri Minister talks about being a fan of Bollywood movies, his love for butter chicken and "naan-bread", Indian music, Shahrukh Khan, Amitabh, Raj Kapoor. Overall, he is quite friendly and warm, which pleasantly surprises Rajesh. Down to business, the Minister talks about being quite keen to let Dragon acquire Azeroil. He asks Rajesh, if as part of the deal, he would be open to earmark and transfer sweat equity amounting to USD 200 million from the ADR issue, in Dragon, to an employee welfare trust set up in the Cayman Islands. He justifies that many staff in Azeroil would lose their stock options due to the sale, as they cannot guarantee that their jobs will be safe. He confides in Rajesh that he cannot officially make such a request as part of the deal terms due to Azerbaijan's old-fashioned laws that are difficult to modernize. He also informs Rajesh, that under Azeri investment laws, it is necessary to have a local investment bank represent Dragon in the deal. The Minister recommends a large and well-known investment bank, which he says has won several deal-related awards in 2021 and 2022 and has helped in the sale of other state-owned enterprises. He mentions that the investment bank is being considered for a buy by Goldman Sachs and JP Morgan. He asks Rajesh to not discuss the highly confidential terms of their deal with anybody, since this is a highly coveted asset and competition is intense. He reassures Rajesh that given his love for India and Indians, he will support Dragon.

Rajesh makes discreet enquiries with Adam and learns that the O&G Minister's eldest daughter is a Partner with the investment bank and that only the top management team at Azeroil has stock-options and they may not be very significant in value. Rajesh returns to Mumbai and promptly calls for a Board meeting to discuss this deal. Participants are: (a) One independent director (b) Executive Director Finance (c) Nominee Director from a PE fund investor in Dragon (d) Executive Director Production (e) Executive Director for Audit and Risk Management. Rajesh presents his pitch to the Board members and his case in favour of going ahead with the deal. He talks very eloquently of significant benefits to shareholders and about the additional stock options to the executive directors and how their collective wealth would grow.

(5 Mins to read and 10-15 mins for the role play)

Private and Confidential

Debrief – Everybody participates

Questions to consider (indicative only): 10-15 mins

1. What was going on – controlled discussion or chaos?
2. Who was influential and why – the MD, the Executive Directors, the whole Board? Was there unity and clarity of purpose and were actions properly evaluated?
3. How would you characterize the corporate Governance in this company?
4. Who was subdued, not contributing as much as they should have and why?
5. Were ALL key points covered? If not, what, if anything, was missed?
6. How was the discussion: wholesome and healthy in general and did it run like a Board meeting should run for a company of Dragon's profile?
7. How was the conclusion reached and what is your view about the conclusion?
8. What, if anything, could go wrong going forward and what, if any, opportunities were lost by Dragon?
9. Any other questions...

Case studies – extra audit steps to undertake? (CFA, warranty, JV)

- *You are an internal audit team member who has travelled to a location in central India for a quarterly audit, to a CFA location. When you review warranty claims, you notice a significant number of claims relating to your product as a percentage of total sales compared to the previous quarter. You also notice that some of the products are recently sold and do not have a reason to necessitate a warranty claim so soon. When you make enquiries, you notice that the Manager seems nervous at your line of questioning and gives you evasive answers. Another issue you notice are Journal Voucher (JV) entries in dealer accounts. When you make enquiries, you are informed that these relate to transfers made to a common pool before making payments to the dealers. When you ask for documentary proof, you are shown a few letters and e-mails written by dealers asking their balances to be paid. You are not entirely satisfied and would like to make further enquiries.*

- *How will you go about this? A few options are listed below to consider within the ambit of IA...*
 - Report your observations as per your audit findings, do not deep dive given that you do not have the relevant experience, and move to the next location as per your IA schedule
 - Dig deeper on some of these areas and identify if there is a likely fraud risk or instances of fraud – if this is your plan, what would you do?
 - Speak with your internal audit head and ask him/her for advice based on your assessment of facts, but you know him/her to be a reticent person who is close to retirement and that he/she generally does not like to “rock the boat”
 - You compare this with the previous internal audit observations of this location and discuss with the team member who did that work so you get a second opinion on this case to build a stronger case for a deep dive...and then carry out a deep dive. What will you do in that deep dive review and how?
(Discussion: 5 to 10 mins)

Case studies – extra audit steps to undertake? (BTL, sales promotion)

- *You are carrying out a review of sales promotion and BTL expenses for the Western region as part of your quarterly review.*
- *When you review a few items of expense incurred, you find costs related to dealer meets, where you find the invoice of an event management company, for INR 25 lakhs. There are no further details provided in the bill such as cost break downs or supporting proof for why the INR 25 lakhs were paid.*
- *When you make enquiries with the auditee, you discover that the arrangement with the event management company did not require provision of details in the invoice, which is contractually provided for, he tells you.*
- *When you make further enquiries with the team, for the procurement process that was followed, you are informed that this event management company is owned by an ex-employee of the group, who is known, and therefore a detailed procurement process was not followed.*
- *However, you are shown a few quotations received from other event management companies, some costlier and some cheaper than the ex-employee's company.*
- *You are reasonably fine with the answer/evidence provided. Will you do anything further within the ambit of the internal audit? Yes/No...?*
- *If so, how will you get buy-in and how will you go about this review? – (Discussion: 5 to 10 mins)*

Case studies – extra audit steps to undertake? (CAPEX, Opex)

- *As part of your review of the security solutions business of the group, you find a recent purchase of 100 laptops with specialized high-end software, for a new project team that travelled to Budapest, Hungary and has been stationed there for the last one year, for one of your large European client's project, in the telecom sector*
- *When you check the procurement process followed for the purchase of laptops and software, you find a different construct. You find that the purchase of the hardware and software respectively, has not been made directly from either the OEM (for the hardware) or from the software publisher (for the high-end software), but from a dealer that provides both the hardware and high-end software. When you make enquiries, you are informed that the purchase of equipment with the high-end software is possible only through that dealer appointed by the software publisher, who does not have a team in India*
- *You make enquiries about whether suppliers for any other laptops were considered, given that this is not the best or most popular brand in the market. You are informed by the team that the specifications for the hardware and software had been provided by the telecom client from Budapest and that here was only one dealer that the hardware company had in the India region.*
- *When you review the expense reports of the team that traveled to Budapest, given that they are considerably material, you note that they are in line with the staff entitlements as per client's policy, but that there are some expense reports that appear to have similar looking restaurant bills filed as claims by team members based in two different offices of the client in Budapest.*
- *You do not think too much about all this. You are reasonably fine with the answers/evidence provided to you.*
- *Will you do anything further? If so, what will you do, how will you get buy-in for this, and how will you go about this review within the ambit of your internal audit plan? – (Discussion: 5 to 10 mins)*

Case studies – ideal investigation approach?

- *You are the internal audit and investigation lead for the company. Your CFO calls you up to tell you that they have had what he suspects to be phishing attack against the company. He tells you that an international supplier, who your company owed about USD 50 million to, for supply of a large order before Christmas, never got paid his dues, though your company has proof that the money was transferred to the vendor. Upon making initial enquiries, you discover that the team member in the accounts team, an accounts executive, who processes payments, got an e-mail from the supplier based in Singapore, asking for a change in his bank account from Citibank to DBS. In good faith, the accounts executive went ahead to process the payment on the basis of an e-mail sent by the vendor. Your company has robust process for change in vendor bank accounts in SAP. When you see the e-mail sent by the vendor, you notice that the e-mail was sent from a Gmail address instead of the vendor's official corporate email address. How will you go about the investigation plan?*

What would you do?

- Interview everybody and determine the consequences to each individual based on their role in it, but generally this seems like an external attack against your company
- Carefully review the modus operandi and do not rule out a collusive attack involving an outsider and an insider
- In your assessment, it is an open and shut case of negligence by the accounts executive because the individual did not check for the Gmail address instead of the corporate email address of the vendor
- You inform the CFO to file a cyber crime complaint and let the cyber crime cops investigate the matter

Case studies – ideal investigation approach?

- *You are the IA head of your business. You get an anonymous whistleblower complaint, forwarded to you by your Executive Director, claiming to be from one of your factory employees, that large scale thefts have been taking place from your largest factory in Northern India. The letter alleges that the original parts used in your equipment are being pilfered from the factory and are being replaced by cheaper/low quality parts manufactured by a local company owned by a few senior level employees, to make good the inventory shortage. The letter alleges that the spare parts so stolen are supplied in the after-market, at prices lower than at which the company sells them to its channel partners, thereby impacting the company on several fronts. The letter makes damaging allegations against several people in the organization, citing their involvement in this pilferage scheme. Since you are keen to do something to stop the practice promptly and nip it in the bud, you go about planning your next steps.*

What would you do?

- Element of surprise: visit the factory and survey the process, talk to factory and stores staff, take random samples for authenticity testing, and take a surprise stock count to determine the accuracy of the complaint
- Carefully plan your actions, discuss with your plant head on next steps and do as he advises
- Assess this situation and that this could be a case of organised crime, with collusion, so tread carefully to build informants, carry out covert checks and let the theft continue for some more time before swooping down on the perpetrators
- Ignore the complaint, since due to the pandemic, you and others have been getting anonymous letters from a lot of disgruntled employees, who have been laid off

Key takeaways – quick win fraud risk mitigations

- Code of conduct training and awareness sessions – “Crack the Code” @ CR/CBTs
- Fraud awareness/ethical dilemma sessions – theory vs practical @ CR/CBTs
- Annual compliance confirmations – code of conduct compliance by all @ online
- Fraud risk assessments and anti-fraud controls: what lies beneath?
- Reinforcement of tone at the top – always walk the talk...actions vs words
- Empathizing with real challenges people down the line face – bread vs cake @ MA
- Contractual protection and periodic audits – FCPA/UKBA/PCA risks, Global Tenders!
- Third party DDs to mitigate TP risks – OFAC/PEP lists
- Senior management due diligence – dubious track record and past incidents
- Whistleblower helpline and evangelization thereof – last mile eyes and ears
- Proactive forensic data analytics and transaction testing – the trend is your friend
- Professional skepticism *not* blind “trust” – fraudsters are people, not 0s and 1s
- Hope and pray for the best – only *after* you have done the best you could, not before

**In God we trust,
everything else we audit**

Questions?

