

CPIM

CENTER FOR PUBLIC INVESTMENT MANAGEMENT



A PROGRAM BROUGHT TO YOU BY:

JOSH MANDEL

TREASURER OF OHIO

CASH 120

Internal Controls / Fraud Prevention

Introduction

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Agenda

- Fraud
 - The Basics, Statistics and Examples
 - Red Flags
 - Prevention Techniques
- The Fraud Risk Assessment
- Internal Controls
 - The Basics and Types of Internal Control
- Case Studies

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Fraud – The Basics

Fraud CAN and DOES happen

Fraud – The Basics

A fancy term for:

Lying

Cheating and

Stealing

Fraud – The Basics

It's never “black and white”

Fraud – The Basics

Occupational Fraud

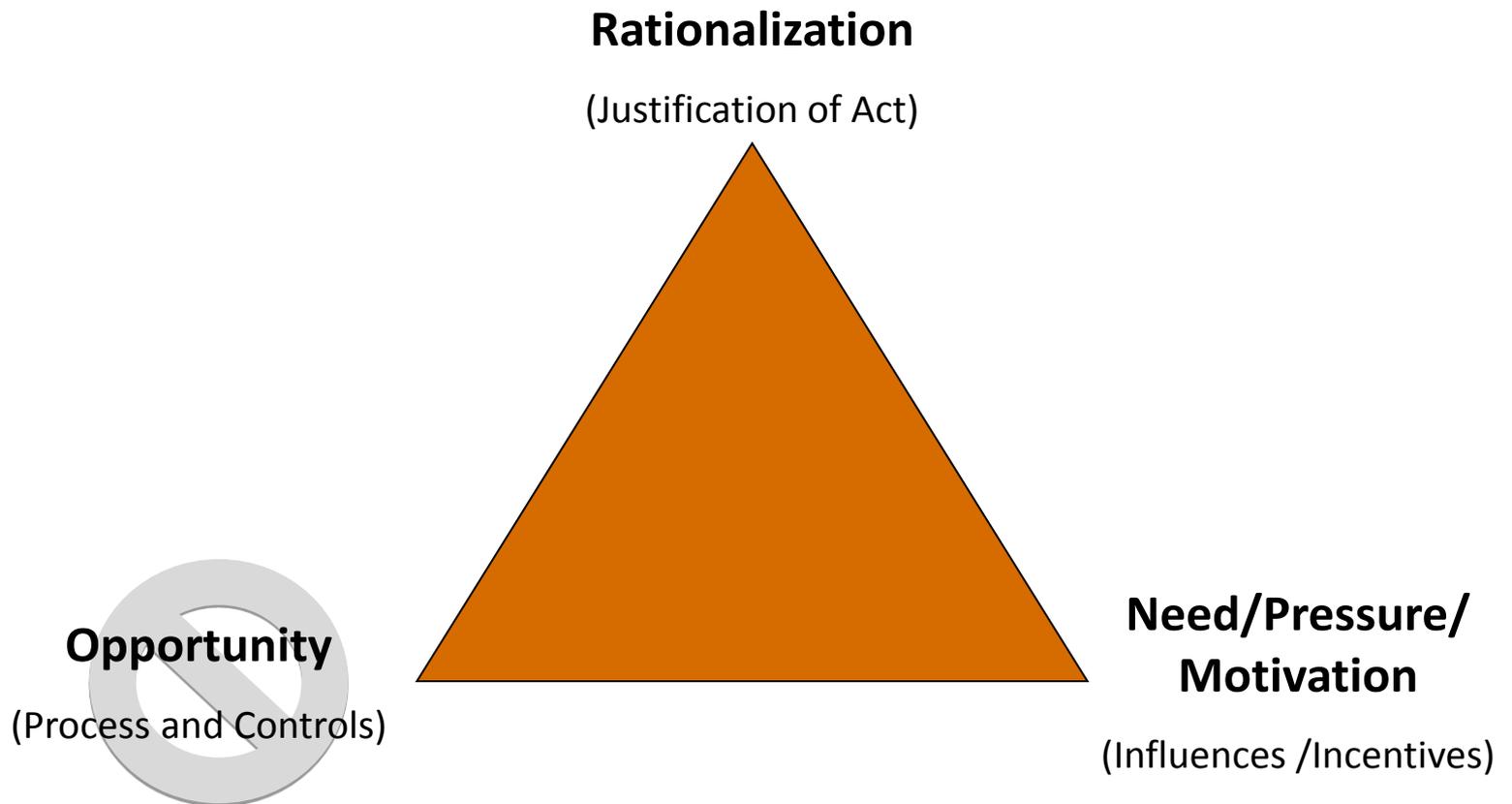
“The use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.”

Fraud – The Basics

- Consider this
 - Fraudsters can be creative
 - Fraudsters can appear trustworthy
 - Fraudsters can be long-standing, reliable employees
 - Fraudsters can be active members of the community
 - Fraudsters are sitting in the cubicle next to you
 - Fraudster are becoming more tech-savvy

Fraud – The Basics

The Fraud Triangle



Fraud – The Basics

- An organization CANNOT control a fraudster's rationalization for his/her actions
- An organization CAN control the opportunities for the fraudster to commit the crime
- Consider the *capability* for the fraudster to commit the crime (the competence to execute)

Fraud – The Basics

- Consequences

- Job loss
- Reduction in future funding
- Civil law suits
- Criminal prosecution
- Destroyed reputation (of the entity AND the individual)



Fraud – The Basics

Government fraud refers to illegal acts that intentionally divest the government of funds through deception or scams. When the government gets swindled, **taxpayers pay the price.**

Fraud – The Basics

“There is no kind of dishonesty into which otherwise good people more easily and more frequently fall than that of defrauding the government.”

- **Benjamin Franklin**

Fraud – The Statistics

- Typical organization loses 5% of revenues each year to fraud
- More than 42% of frauds are detected by tips
- In 58% of cases reported in 2014, the victim organizations have seen no losses recovered
- 85% of cases are due to asset misappropriation, but with the smallest loss
- 9% of cases are due to financial statement fraud, but with the largest loss

Source: ACFE Report to the Nations on Occupational Fraud and Abuse (2014)

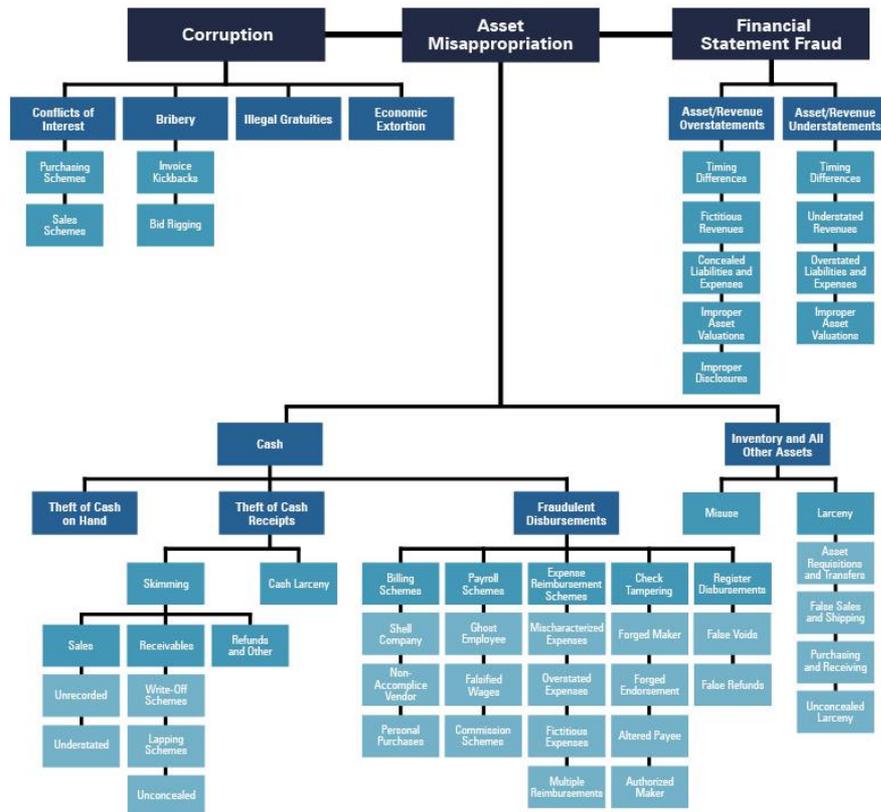
Fraud – The Statistics

- 82% of fraudsters had never previously been punished or terminated by an employer for fraud-related conduct
 - That means that 18% HAD been previous punished or terminated

Source: ACFE Report to the Nations on Occupational Fraud and Abuse (2014)

Fraud – The Fraud Tree

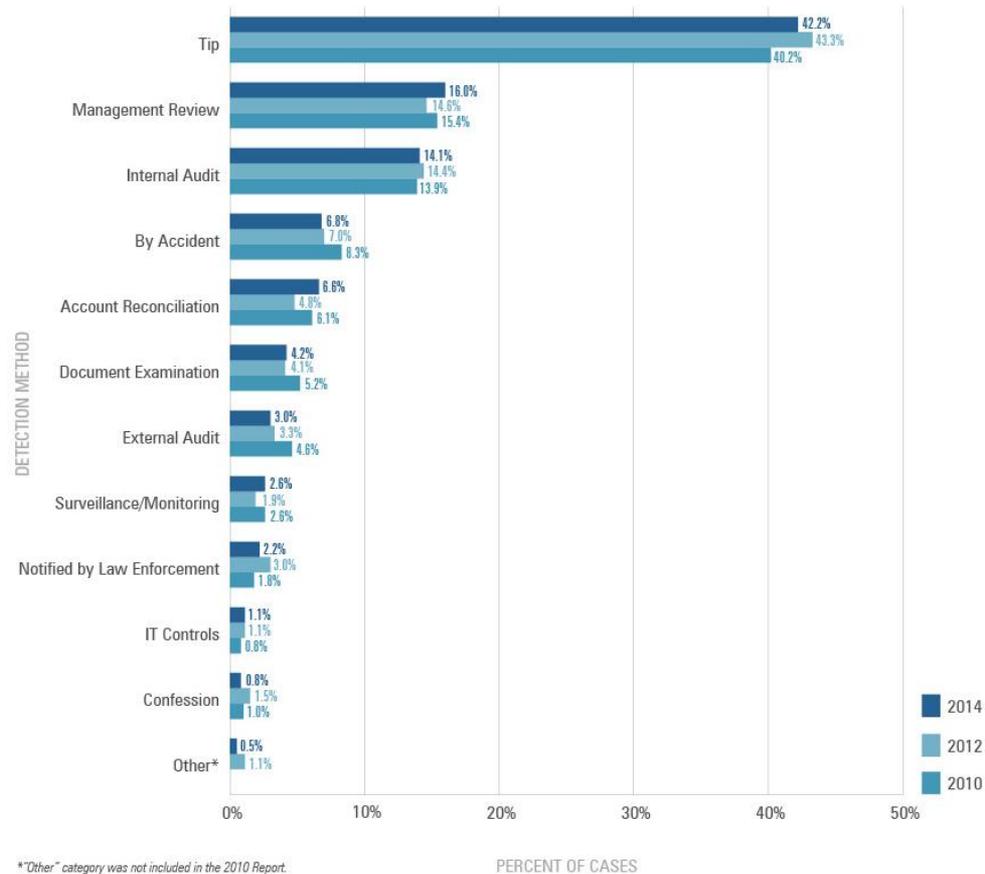
Figure 3: Occupational Fraud and Abuse Classification System (Fraud Tree)



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Fraud – Sources of Detection

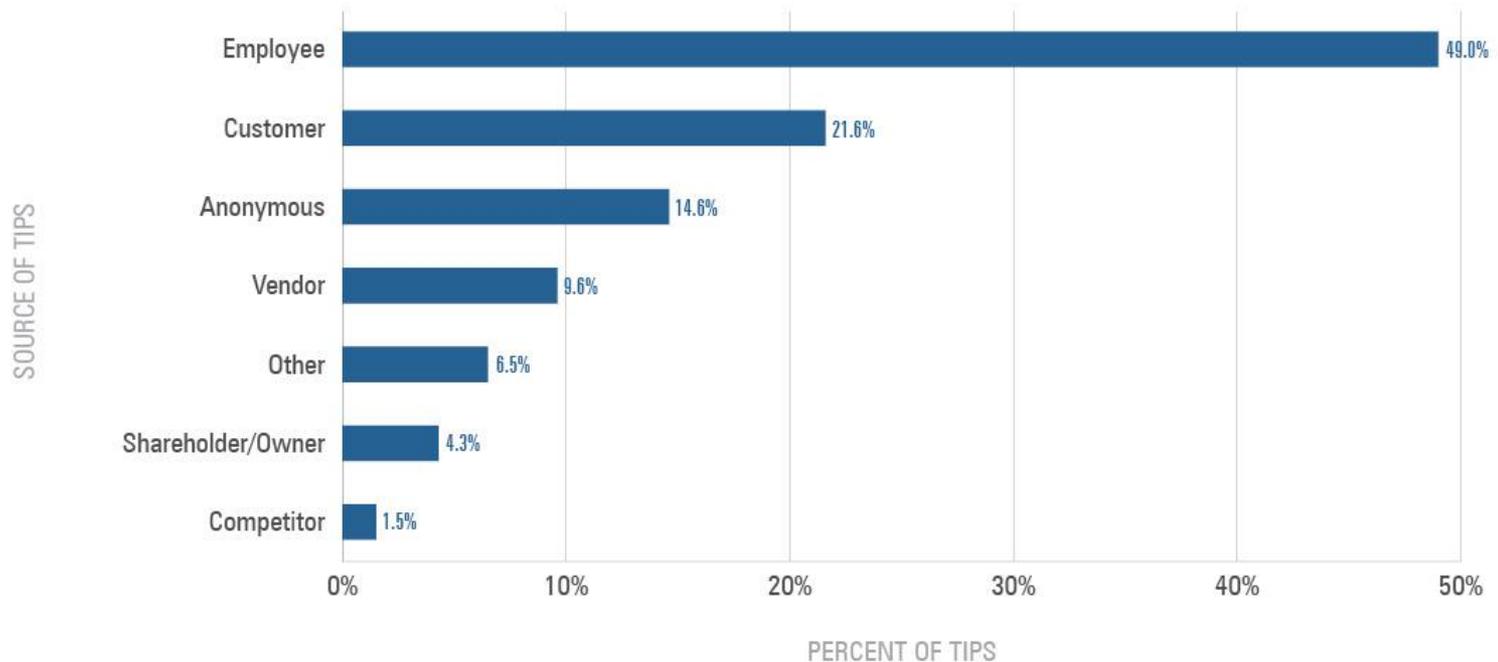
Figure 11: Initial Detection of Occupational Frauds



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Fraud – Sources of Tips

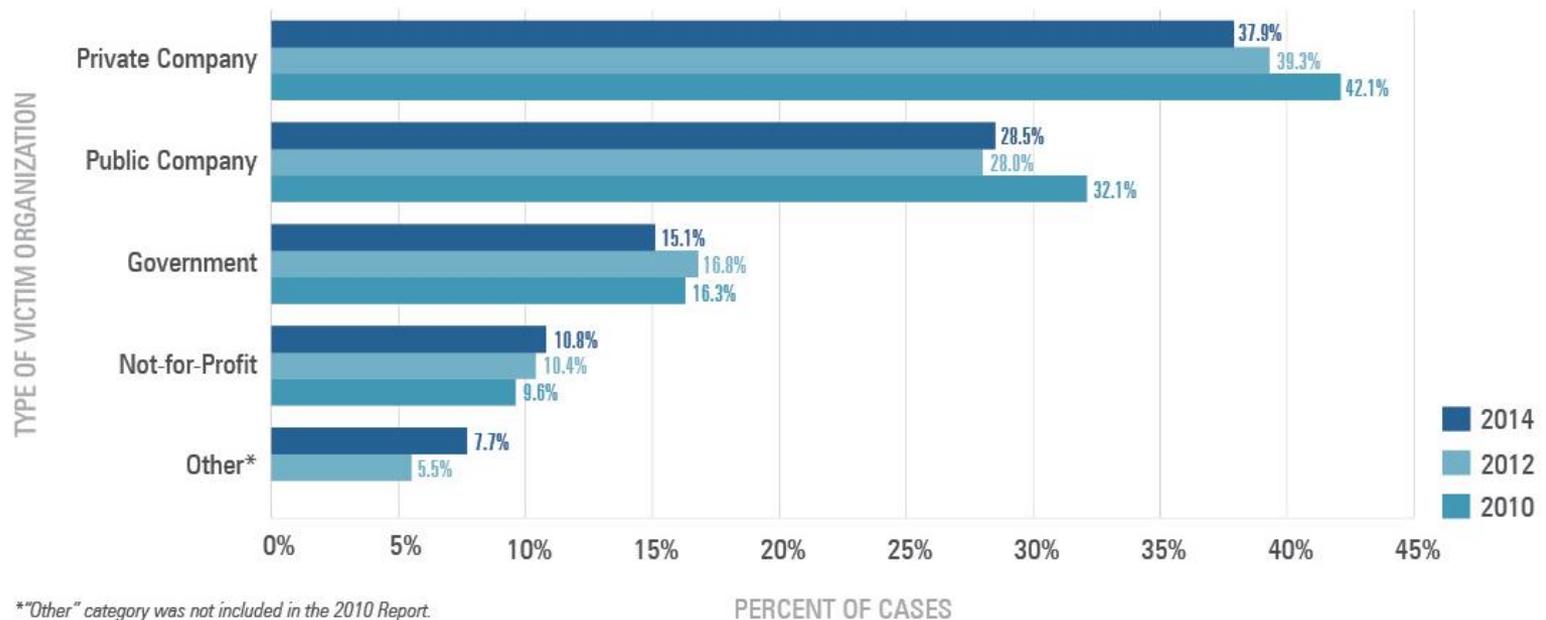
Figure 13: Source of Tips



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Fraud – Type of Victim Organization

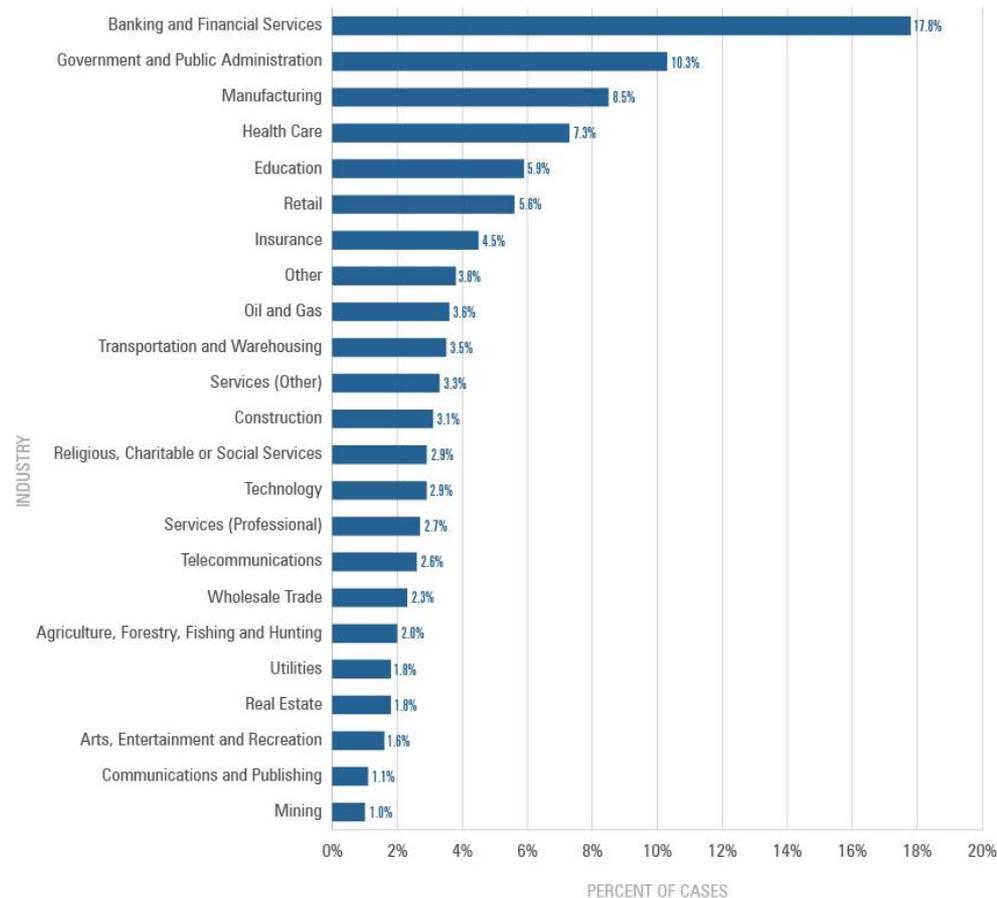
Figure 17: Type of Victim Organization — Frequency



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Fraud – Industry of Victim Organization

Figure 22: Industry of Victim Organizations



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Fraud - Examples

- Treasurer writes unauthorized checks to a business that he/she owns
- Clerk steals cash from the safe and creates fake deposit slips
- Treasurer diverts money received into personal accounts
- Use of government facilities for personal business
- Receiving kick-backs from vendors

Fraud – Red Flags

- Employees
 - Lifestyle or behavior changes
 - Personal debt or credit problems
 - Refusal to take vacation or sick leave
 - Excessive overtime
 - Lack of segregation of duties
 - Does not produce information voluntarily
 - Volatile, arrogant, confrontational or aggressive when challenged
 - Lack of a back-up for the role

Fraud – Red Flags

- Management
 - Reluctance to provide information
 - One individual is dominating decisions
 - Override of internal controls
 - High employee turnover
 - Unusual transactions made outside of the system
 - Financial distress/exhibits stress

Fraud – Red Flags

- Operations Indicators
 - Large number of write-offs
 - Discrepancies between bank deposits and postings
 - Excessive/unjustified cash and/or adjusting entries
 - Incomplete/untimely bank reconciliations
 - Lack of support or tracking of transactions

Fraud – Red Flags

- Cash Receipts and Disbursements
 - Lack of segregation of key duties
 - Missing deposits
 - Absence of a cash receipt log
 - Lack of controls over management signature
 - Uncontrolled access to blank checks

Fraud – Red Flags

- Purchasing
 - Lack of segregation of key duties
 - Excessive/unusual exceptions to purchasing policies
 - Uncontrolled access to the vendor master file
 - Vendors with employee names/addresses
 - Duplicate purchase orders
 - Copies of invoices used to pay vendors
 - Less than arms-length transactions and conflicts of interest
 - Undue influence

Fraud – Red Flags

- Fixed Assets
 - Lack of segregation of key duties
 - Lack of periodic inventories
 - Lack of asset tags/tracking
 - Lack of physical security

Fraud – Basic Prevention Techniques

- Tone at the top
- Open door policy
- Culture of compliance and ethics
- On-going and required anti-fraud training
- Fraud reporting tool (hotline)
- Fraud risk assessments
- **Strong internal controls**

Fraud – Basic Prevention Techniques

- **Strong internal controls**
- Adequate resources
- Robust hiring practices
- Periodic audits/reviews
- Identification of conflicts of interest
- Insist on adequate documentation

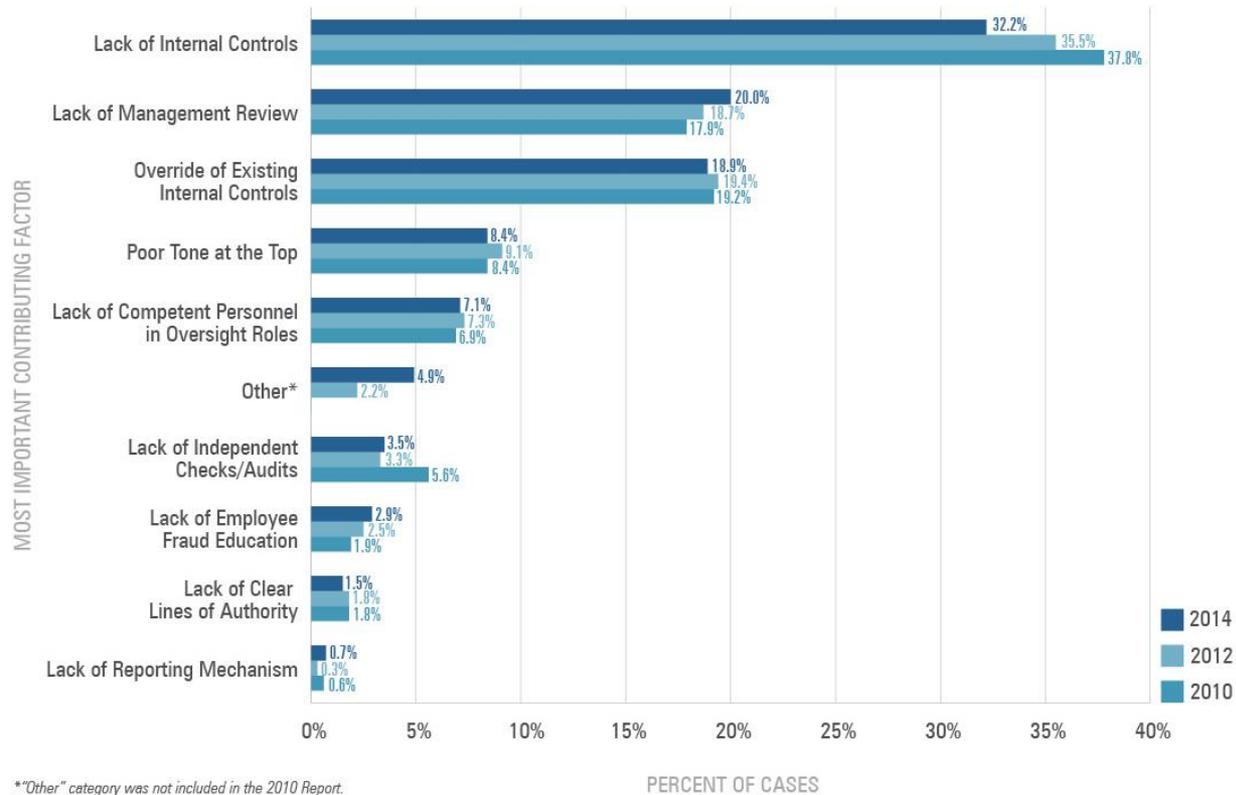
Fraud – Basic Prevention Techniques

- **And one more ...**

Strong internal controls!!

Fraud – Contributors to Fraud

Figure 39: Primary Internal Control Weakness Observed by CFE



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The Fraud Risk Assessment

Step 1: Identify inherent fraud risk — Gather information to obtain the population of fraud risks that could apply to the organization.

Step 2: Assess likelihood and significance of inherent fraud risk — Assess the relative likelihood and potential significance of identified fraud risks based on historical information, known fraud schemes and interviews with staff.

Step 3: Respond to reasonably likely and significant inherent and residual fraud risks.

Step 4: Perform a cost-benefit analysis to decide what the response should be to address the identified risks and design controls.

The Fraud Risk Assessment

- ◉ **Identify Opportunities to Commit Fraud**
 - Create a profile that includes a list of the different areas in which fraud may occur and the types of fraud that are possible in each area (brainstorming, analysis of prior frauds, public information/Google alerts)
 - Consider the various types of schemes and scenarios that could occur within an organization
 - Don't overlook information technology impact (enabler or deterrent)

The Fraud Risk Assessment

- Measuring Fraud Risk Tolerance

Probability/Likelihood

Prior instances, prevalence, and other factors, including volume of transactions and complexity, and number of people involved in the process should be considered

- Remote
- Reasonably possible
- Probable

The Fraud Risk Assessment

- Factors of Measuring Probability
 - Companies are downsizing
 - Budgets are decreasing
 - Companies are doing more with less
 - Increased government regulation
 - Stressed and disaffected employees
 - Stock pressure

The Fraud Risk Assessment

- Measuring Fraud Risk Tolerance

Severity/Impact

Should include financial, monetary, operational, reputational as well as criminal, civil and regulatory liability considerations

- High
- Moderate
- Low

The Fraud Risk Assessment

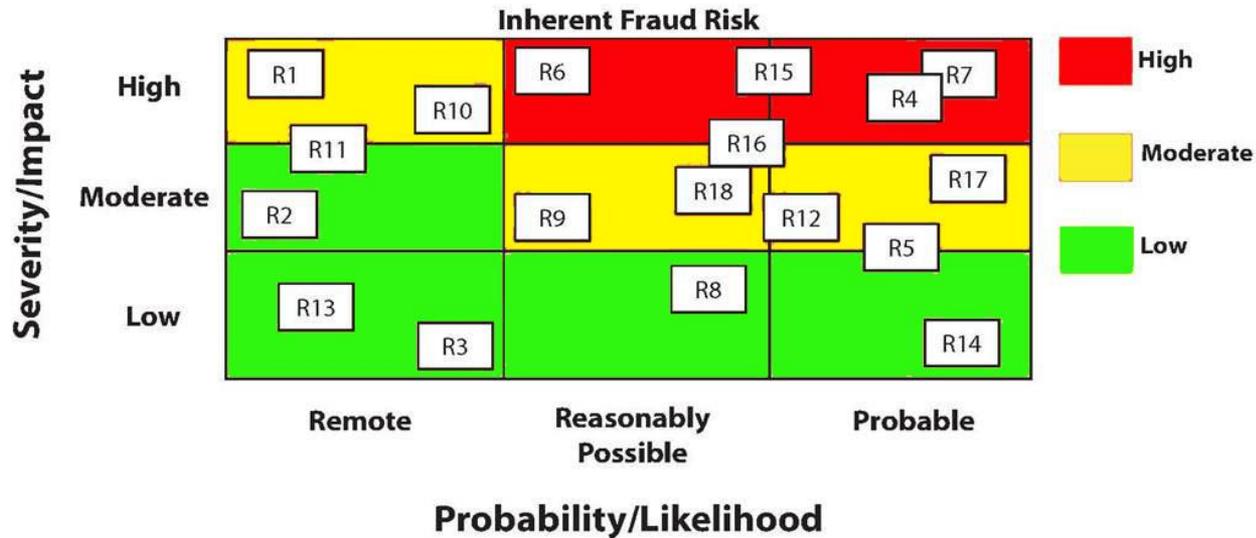
Activity Name	Fraud Risk Assessment
Preparer	XXXX
Preparation Date	X/X/20XX
Updated by	XXXX
Last Revision Date	X/X/20XX

Potential Fraud Risk	Examples	Susceptible Process	Fraud Type	Potential Impact/Severity (H,M,L)	Probability of Fraud Occurrence (H,M,L)	Inherent Fraud Risk (H,M,L)	Controls to Mitigate Inherent Risk	WP REF	Residual Fraud Risk (H,M,L)	Comment / Control Gap
Improper application of GAAP	Secure credit based upon improper accounting (falsify meeting the debt	Financial Reporting	Fraudulent Financial Reporting	H	M	H	Insert Control 1 Insert Control 2		H	
Inappropriate top-sided journal entries	Manipulation of financial performance	Financial Reporting	Fraudulent Financial Reporting	H	H	H	Insert Control 1 Insert Control 2		L	
Willfully miscalculating tax liabilities	Understating tax liabilities	Financial Reporting/Procurement/Tax	Fraudulent Financial Reporting/Corruption	H	L	L	Insert Control 1		L	
Theft fixed assets	Taking of inventory without authorization, improper disposal of fixed assets	Fixed Asset Management/Financial Reporting	Fraudulent Financial Reporting/Misappropriation of Assets	H	L	L	Insert Control 1 Insert Control 2 Insert Control 3 Insert Control 4 Insert Control 5		L	
Embezzlement	Check kiting; forgery	Procurement	Misappropriation of Assets	M	M	M	Insert Control 1 Insert Control 2 Insert Control 3		L	
Vendor abuse	Bribery, related-party collusion, extortion, kickbacks, preferential treatment, skimming, fictitious vendor billings	Procurement/Legal	Corruption/Misappropriation of Assets	H	L	M	Insert Control 1 Insert Control 2 Insert Control 3		L	
Related party transactions	Transactions not at "arms-length"	Procurement/Legal	Corruption	H	L	L	Insert Control 1		L	
Theft of proprietary confidential information	Trade secrets and customer lists sold to a competitor	Sales Management, Production	Theft of Sensitive Data	M	H	M	Insert Control 1 Insert Control 2 Insert Control 3		L	
Use of company assets for personal gain	Using company vehicles at side-business	Fixed Asset Management	Misappropriation of Assets	M	L	L	Insert Control 1		L	
Theft from company's operating account	Fraudulent disbursements to fictitious vendors	Cash and Treasury Management/ Accounts Payable	Fraudulent Financial Reporting	H	H	H	Insert Control 1		M	
Intentional manipulation, corruption and/or destruction of data	Destruction of customer records	Data Processing	Theft of Sensitive Data	H	M	H	Insert Control 1		M	

The Fraud Risk Assessment

Fraud Risk Assessment Heat Map

Enterprise Wide Risk Assessment Simplified Heat Map



Threat	Level	Risks
High		5
Moderate		8
Low		5

Internal Controls – Development

- ◉ Designing and Implementing Controls
 - **Control Design**
 - Aligned with relevant fraud risks
 - Executed by competent and objective individuals
 - **Control Effectiveness**
 - Evidence available to support whether control is operating as intended
 - Control executed at a frequency appropriate to the fraud risk

Internal Controls – The Basics

- **Preventive** – Intended to reduce the risk of fraud occurring to an acceptable level
- **Detective** – Intended to flag potential risk that a fraud occurred in a timely manner
- **Persuasive** – Tone and culture of the organization, its belief system

Internal Controls – The Basics

- **Preventive Controls**
 - Human Resources procedures
 - Recruiting/hiring – smart, honest, ethical
 - Background investigations
 - Anti-fraud training
 - Exit interviews
 - Restricted Access
 - Segregation of duties (limit keys to the kingdom)
 - Authority limits
 - Transaction-level controls – approvals, reviews

Internal Controls – The Basics

◉ **Detective Controls**

- Variance analysis – with communication and follow-up on unusual variances or items outside of thresholds
- Comparison of internal data to external sources
- Reconciliations
- “Surprise” audits
- Whistleblower hotline
- Exit interviews (HR)

Internal Controls – The Basics

- ◉ **Detective Controls**
 - Independent reviews
 - Physical inspections and counts
 - Special audits – (e.g., expense reports, P-card activity)

Internal Controls – The Basics

- **Persuasive Controls**
 - Formal code of ethics/conduct
 - Management setting appropriate example
 - Positive workplace environment
 - Honest and constructive feedback and recognition
 - Eliminate fear of delivering “bad news”
 - Treat employees with fairness
 - Organizational responsibilities clearly defined
 - Strong communication practices and methods
 - Direct communication vs. innuendo

Case Study #1

◦ **School Employee**

- Tax Evasion
- Embezzlement of federal funds
- Did not have signature authority, BUT had the trust of the supervisor with the signature authority
- Supervisor signed blank checks
- Payable to “cash” or fictitious employees
- Concealment – false check register entries

Case Study #2

- **Chief Technology Officer of a municipality**
 - Wire fraud, bribery and falsified tax return
 - Manipulated procurement system for programs receiving federal funds
 - Receiving kickbacks and bribes for payment for technology services to a particular vendor

Case Study #3

- **Vendor Fraud**
 - Embezzlement of public funds paid to a vendor
 - Direction of funds paid to the vendor to a personal bank account

Resources

- **Ohio Auditor of State**
 - <https://ohioauditor.gov/fraud.html>
 - fraudohio@ohioauditor.gov
 - Call 1-866-Fraud-OH (1-866-372-8364)
 - 88 East Broad Street, PO #1140, Columbus, OH 43215

Resources

- **U.S. Government Accountability Office (GAO)**

- <http://www.gao.gov/fraudnet/fraudnet.htm>
- fraudnet@gao.gov
- Call 1-800-424-5454
- GAO FraudNet
441 G Street NW
Mail Stop 4T21
Washington, DC 20548

Resources

- ◉ **Association of Certified Fraud Examiners (ACFE)**
 - <http://www.acfe.com/rtnn.aspx>
 - Report to the Nations on Occupational Fraud and Abuse – 2014 Global Study
 - Download the full report or illustrations

Resources

- **The Association of Government Accountants (AGA)**
 - <https://secure.agacgfm.org/tools/fraudprevention/>
 - Fraud Prevention Toolkit

Contact Information

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