

Fraud Deterrence & Internal Controls:

What You Don't Know Could Hurt You

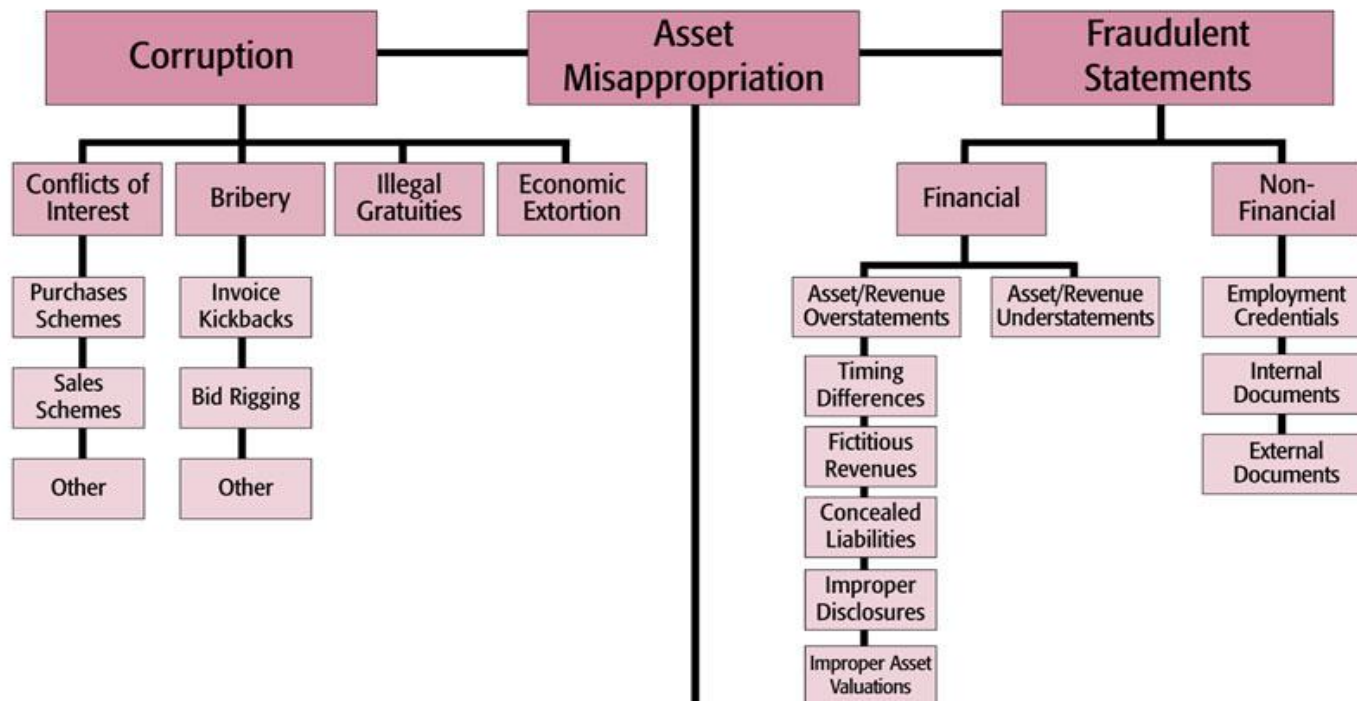
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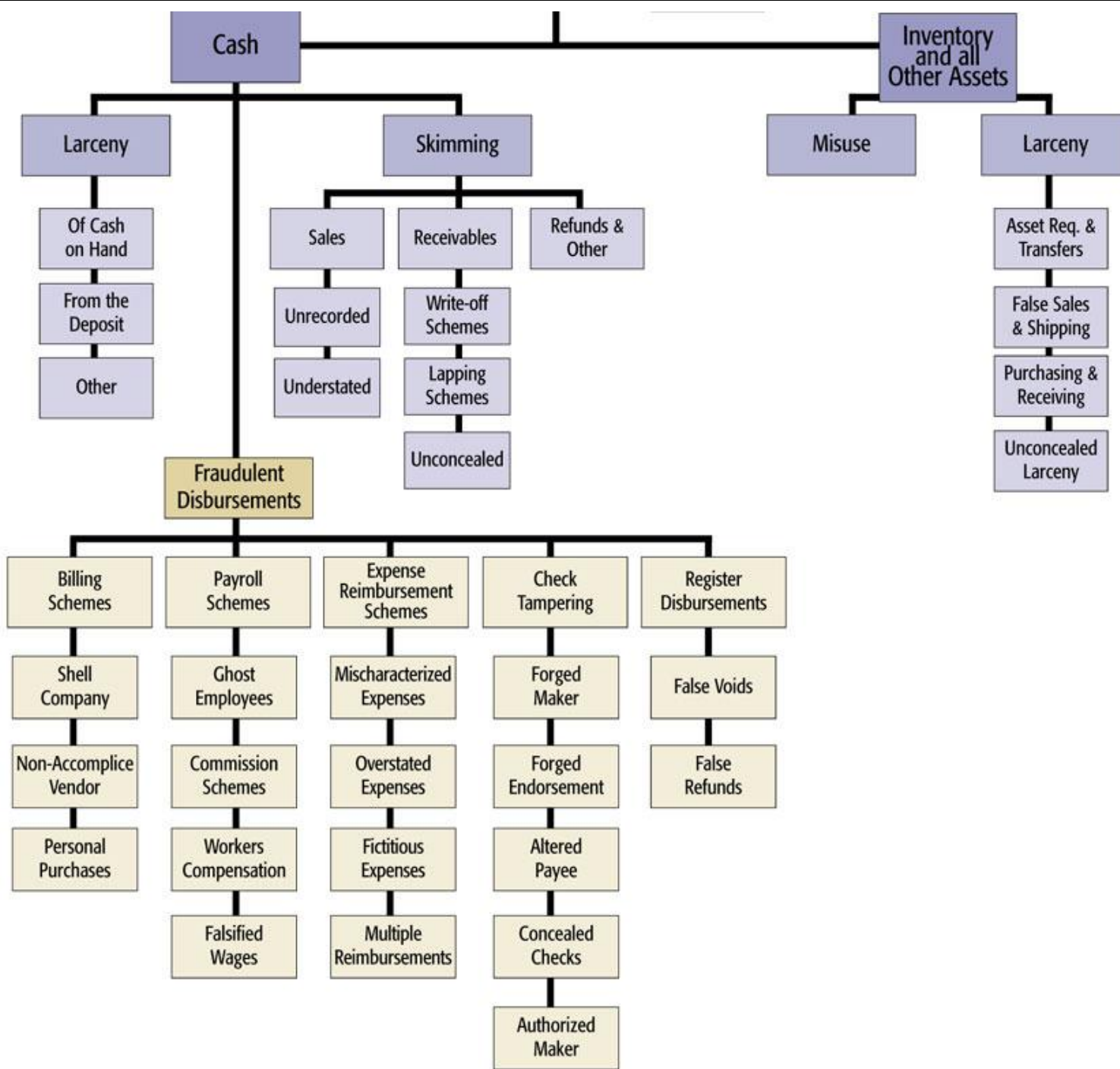
Today we will discuss:

- The “Fraud Triangle”
- Components of Internal Controls and Fraud (Prevention and Detection)
- Review Fraudulent Disbursements
- Fiscal Responsibility and Budgets- why are they important to you?

Forms of Occupational Fraud

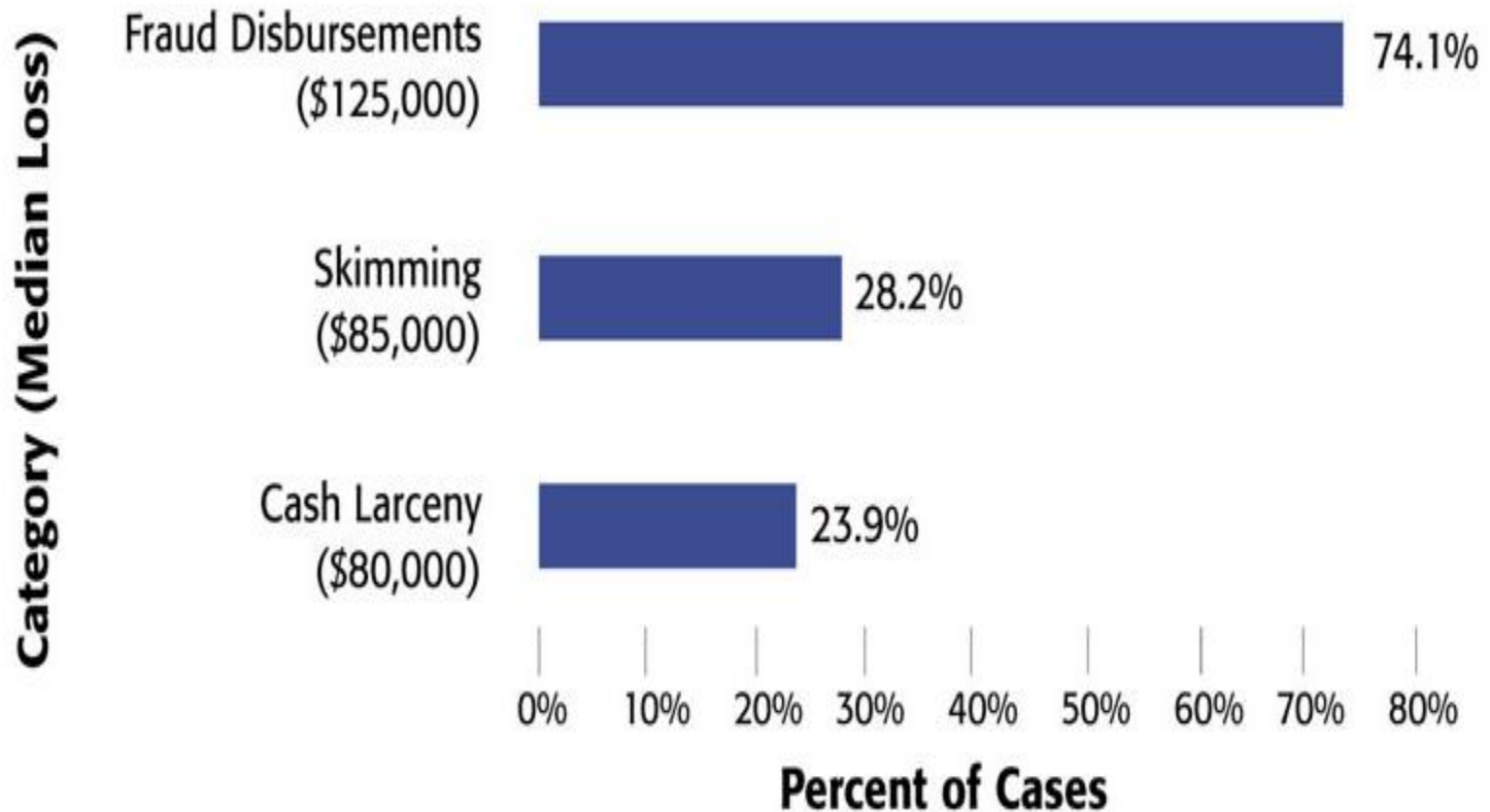
Uniform Occupational Fraud Classification System





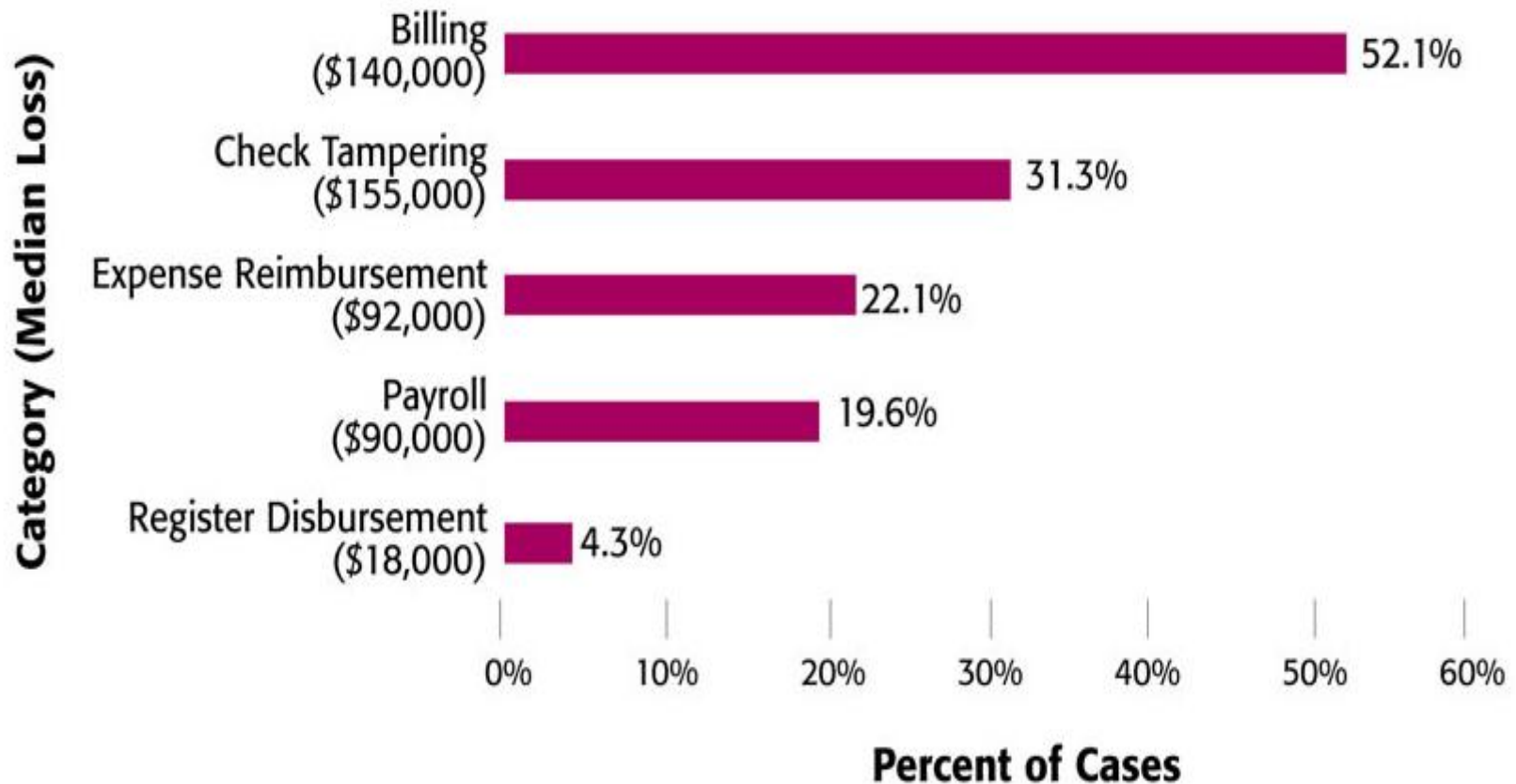
Forms of Occupational Fraud

Breakdown of Cash Misappropriations ⁷



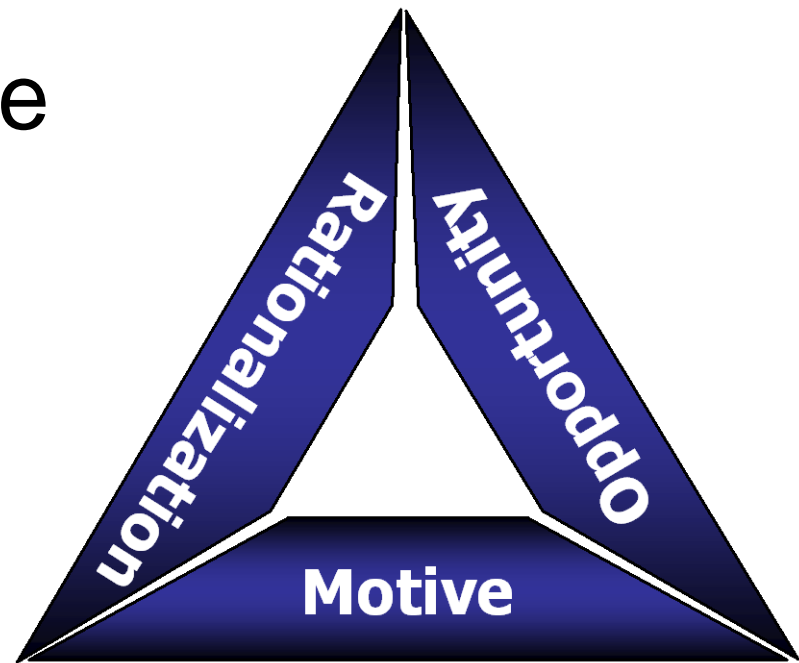
Forms of Occupational Fraud

Breakdown of Fraudulent Disbursements ⁸



Fraud Triangle

- Describes the 3 elements which are present in every fraud situation:
 - Motive/Pressure
 - Rationalization
 - Opportunity



Fraud Triangle – Motive/Pressure

- Does something compel a person to commit fraud? Or is that person simply dishonest?
 - Consider a study done by Patterson and Kim:
 - Question: “What would people do for \$10 million”
- 7% - would kill a stranger
- 25% - would abandon their families
- GREED can be a powerful Motivator

Fraud Triangle – Motive/Pressure

- **External Motives:** very little a Company can do to eliminate; however, very important to know your employees
- Lifestyle needs or Maintain Lifestyle
 - Automobiles, houses, restaurant meals, friends
- Illicit behavior
 - Drugs, gambling
- Health problems (including family members)

Fraud Triangle – Motive/Pressure

- **Internal Motives:** some can be controlled, while others may not
- Employee subjected to harassment or abuse by a supervisor
- Employee feeling unfairly treated in performance evaluations
- Employee feeling under compensated

Fraud Triangle - Rationalization

- Keeps someone from turning themselves in and also aids in continuation of the fraud:
- Sense of justification (they owe this to me; believe under paid)
- Convincing themselves that they will repay the money (short term solution to a short term problem)
- Feeling one's embezzlement is small in comparison to the size of the Company
- A feeling others are doing it, so why shouldn't they

Fraud Triangle - Opportunity

- Opportunities to commit fraud generally depend upon the quality of the internal controls
- Real or perceived opportunities to commit fraud can be classified into three categories:
 - Weaknesses in the design of controls
 - Weaknesses in the application of controls
 - Potential for overriding the controls

Fraud Triangle - Opportunity

- Weaknesses in the Design of Controls: typically relate to essential policies and procedures not instituted
- **Preventive:** failure to require a clerical check of the mathematical and pricing accuracy of vendor invoices prior to approving them for payment
- **Detective:** failure to require the bank reconciliation be performed by someone who does not have responsibility for preparing, signing, or recording checks

Fraud Triangle - Opportunity

- Weaknesses in the Application of Controls: refer to a company's failure to follow its own policies and procedures
- A supervisor providing rubber stamp approvals on timesheets and expense reports submitted by employees
- An accounts payable clerk failing to verify that a vendor invoice is properly approved prior to payment

Fraud Triangle - Opportunity

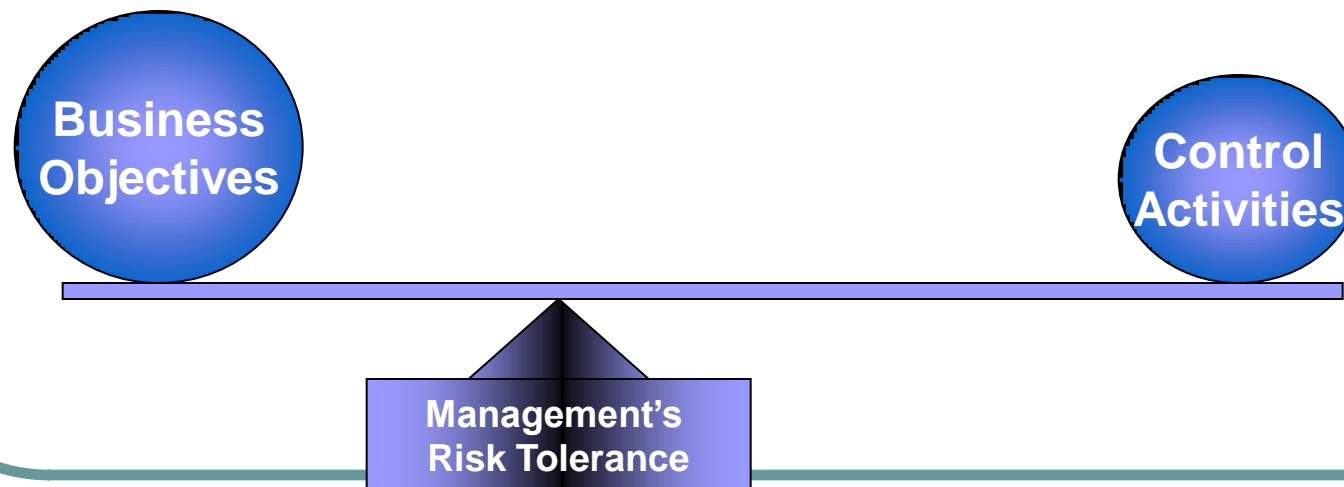
- **Overriding the Controls:** ability to circumvent established policies and procedures
- Collusion between two or more employees, in which key controls (i.e. authorization or review) maybe rendered worthless
- Fraudulently documenting a control procedure (i.e. forged authorization on an expense report)
- Senior management override: forces a departure from standard operating procedures

Fraud Triangle – Financial Reporting

- The Fraud Triangle still applies to financial reporting fraud
- **Motive** (Incentive or Pressure)
 - The compelling need for the ill gotten gains
 - The motivation to achieve financial results
- **Rationalization** (Attitude)
 - Justification in the mind of the perpetrator for the act
- **Opportunity** (Opportunity)
 - The control lapse or situation that allows the event to occur
 - Missing or inappropriate internal controls
 - Management overrides

The Need for Balance

- This does not necessarily mean that a tremendous amount of new controls should be imposed upon the organization.



Risk Management

- Four aspects of Risk Management as it relates to fraud:
 - **Assessment:** identify potential internal and external risks
 - **Reduction:** establish policies and procedures designed to prevent or detect fraud
 - **Transfer:** use of insurance or other means transfer the risks
 - **Acceptance:** level of exposure to risk a Company is willing to accept

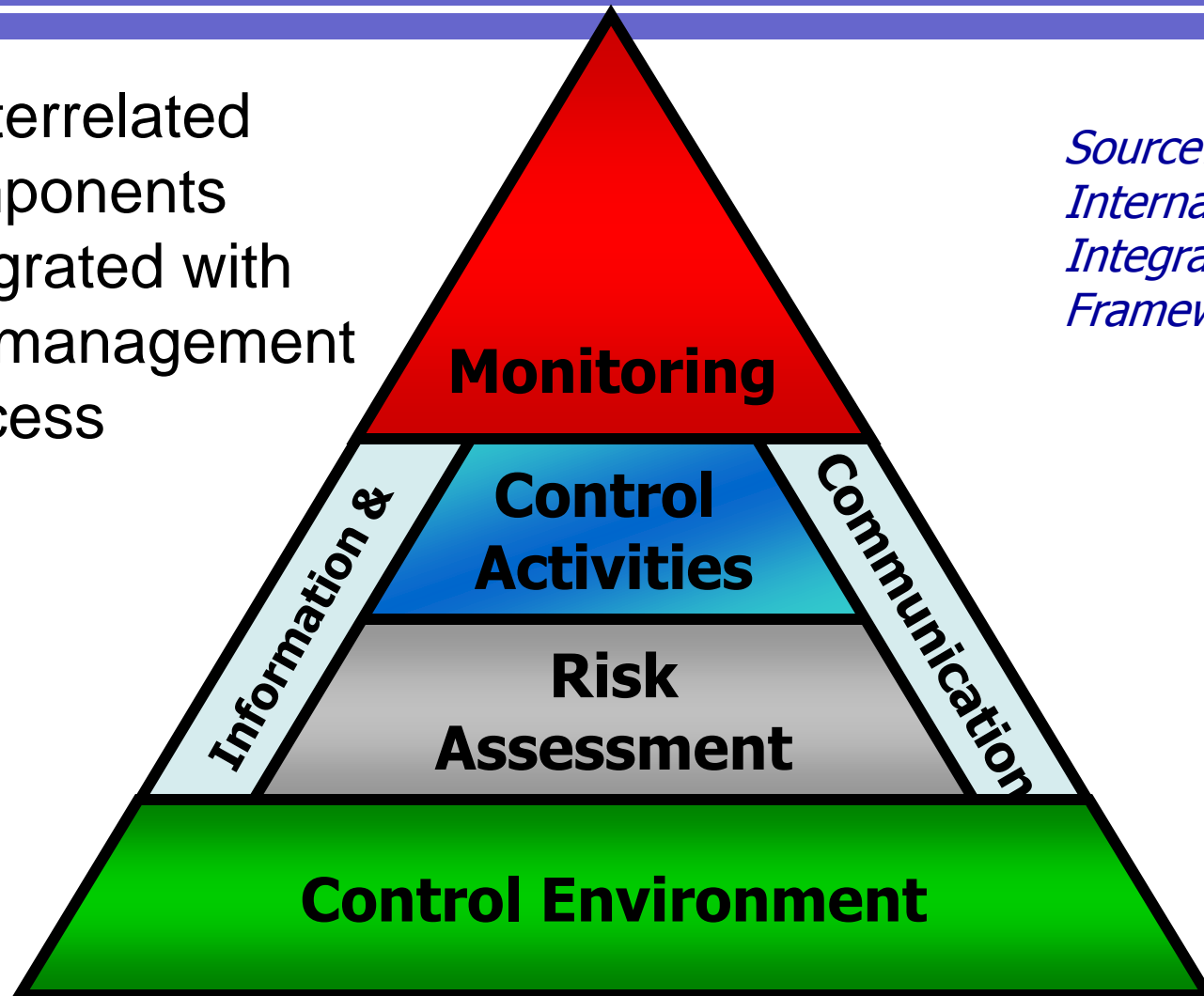
Relationship of Internal Controls to Fraud

- **The GOAL:** Reduce acceptable risk to a level that is practical and affordable
 - PREVENT as much fraud as possible within the reasonable constraints of TIME and MONEY
 - DECTECT - design appropriate procedures which detect frauds in a timely manner

Components of Internal Control

- 5 interrelated components integrated with the management process

*Source: COSO
Internal Control
Integrated
Framework*



Comprehensive Model

- A company-wide model of fraud deterrence involves three components:
 - Internal Controls
 - Non-financial Systems
 - Management oversight and behavior

Internal Controls

- *Preventive Controls:*
 - Locks on filing cabinets or doors
 - Use of passwords
 - Requiring approvals (i.e. invoices, timesheets)
- *Detective Controls:*
 - Performing and reviewing monthly bank reconciliations
 - Reconciling actual results with expected results
 - Mandatory vacations

Potential control shortfalls

Control activities not sufficiently defined:

- Lack of basic internal control measures
- Controls not modified to meet changing environment
- Controls not redesigned as business process and system changes made
- Controls not updated as the organization grows
- Controls not adequate for workforce employed
- Lack of staff to separate duties
- Lack of system / security controls

**Financial
Statement
Fraud**

**Asset Related
Fraud**

Controls defined, but ignored/not enforced:

- Lack of process and control monitoring, system reports
- Lack of management oversight
- Process workarounds, including time crunches
- Temporary job duties
- Staffing changes without appropriate change in authorizations
- Misunderstanding of system controls / poor system controls
- Management misunderstanding of actual business process and control activities

...exist where controls are not defined, or not enforced

Non-Financial Systems

- Non-financial systems which are critical:
 - Human resource policy and procedures (i.e. hiring practices, leave policies, training)
 - Information technology
 - Physical security
 - Communication systems (i.e. whistleblower)
 - Insurance (CFE study – 40%)

Management Oversight & Behavior

KEY COMPONENTS:

- “Tone at the Top” (code of conduct)
- Financial Analysis (big picture analysis)
- Communication of expectations (develop policies)
- Internal and/or External audit functions
- Board of directors
- Audit committees

Fraudulent Disbursements

- One Element of Internal Control:

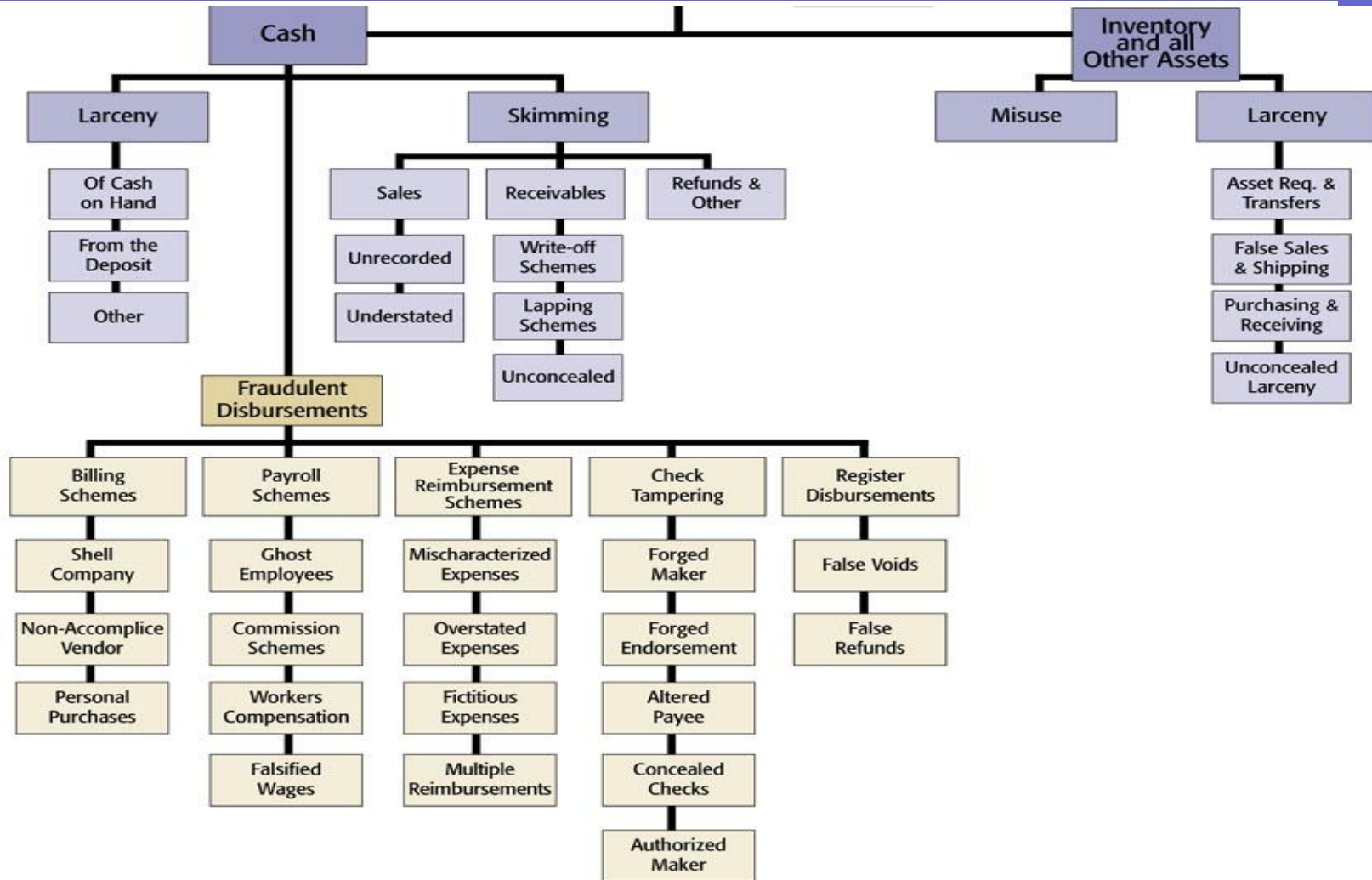
Segregation of Duties

- Duties of Approval (purchase requests & authorizations)
- Receiving functions
- Recording accounts payable
- Approval of vendor invoices
- Check writing or EFT's
- Recording disbursements
- Mailing of checks
- Reconciliation of payable ledger
- Reconciliation of bank account

Safeguarding the Check Writing Process: Basic Measures

- Pre-numbered checks
- Prohibit check signing in advance
- Limiting and safeguarding signature stamps
- Requiring two signatures
- Verify and update authorization signers
- Mail checks promptly
- Physical safeguards
- Reconcile and review monthly bank statements (resolve reconciling items in a timely manner) **SIMPLE – BUT OFTEN OVER LOOKED**
- Properly safeguard voided checks (tear off signature line)
- Segregation of duties (approval process, check prep, check recording & reconciling process)

Billing Scheme



Fictitious Vendor Schemes

- Break down of segregation of duties (i.e. authorization, check writing, create vendor)
- Recorded as services: soft costs (consulting)
- Vendors name & address: (i.e. Initials, P.O. Box)
- Valid Vendor – no longer providing services

Fictitious Vendor Schemes

Preventive Controls:

- Requiring vendor information (paid in excess threshold)
- Verify vendor existence
- Segregate duties of invoice approval and check preparation
- Use of a Authorized Vendor List
- Periodically purge vendor list

Fictitious Vendor Schemes

Detecting Controls:

- Review the Master Vendor List
- Review vendor payment histories for irregularities (i.e. vendor invoices number, billing more than monthly)
- Expected financial expense account balances (i.e. compare to budgets, prior periods)

EFT Schemes

Prevention Controls:

- Use office wide or Company passwords that identifies organization to the bank
- Restrict access to software and use passwords (if applicable)
- Establish a fixed list of “transfer to” account numbers with the bank (i.e. tax payments)
- Establish a dollar limit (i.e. per transaction, per day, per employee) and communicate with bank
- Require second person authorization
- Require confirmation from bank for each transfer (i.e. immediate call back, daily report)
- Segregate duties

EFT Schemes

- **Detecting Controls:**
 - Timely review of monthly bank statements
 - Closely review daily confirmations or reports of transfers

Fraud Discovered

Concerns

- Whistleblower protection
- Legal counsel
- Cooperate with investigators
- Communicate with Accountants/Auditors
- Fraud examination
- Insurance

How BC Can Help?

- ID Risk and Exposure
 - High-level assessment via Q&A and process/procedure walk-through
 - Detailed analysis / testing of a specific risk factor or transaction cycle
- Recommend actions to reduce or mitigate risk exposure

Fiscal Responsibility and Budgets

- A budget is an essential tool to translate abstract or general plans into specific action oriented goals and objectives.
- By adhering to the budgetary guidelines, the expectation is that the identified goals and objectives can be fulfilled.

Fiscal Responsibility and Budgets

- Responsibility accounting is the concept under which units and their managers are held accountable for their transactions and events under their direct influence and control.
- Budgets should provide enough detail to allow the managers to see what is expected of them.
- When budgets are not met by a particular unit, management should be able to explain/justify deviation

Importance of communicating with Accounting

- Avoid the “blame-game”
 - When budgets are not met, it is always “someone else’s fault”
 - If proper communication with the accounting department has been an ongoing procedure, there will be no fingers to point

Resources

- American Institute of CPAs (AICPA) - www.aicpa.org
- Association of Fraud Examiners (ACFE) - www.cfenet.com
- Information Systems Audit and Control Association – www.isaca.org
- The Institute of Internal Auditors – www.theiic.org
- Institute of Management Accountants – www.imanet.org

QUESTIONS???

Thank You.