CPIM Academy

CPIM

Center For Public Investment Management

A PROGRAM BROUGHT TO YOU BY:

Josh Mandel

Treasurer of Ohio

CASH 120

Internal Controls / Fraud Prevention

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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:

<u>Lying</u>

<u>Cheating</u> and

<u>Stealing</u>

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 - Prevention

Ethics and Fraud are so inter-connected. Without a strong ethical culture, fraud risk exponentially increases.

In most fraud cases uncovered, indicators that a fraud was occurring were evident to others. However, human nature is to continue to trust those around us even when faced with evidence to the contrary.

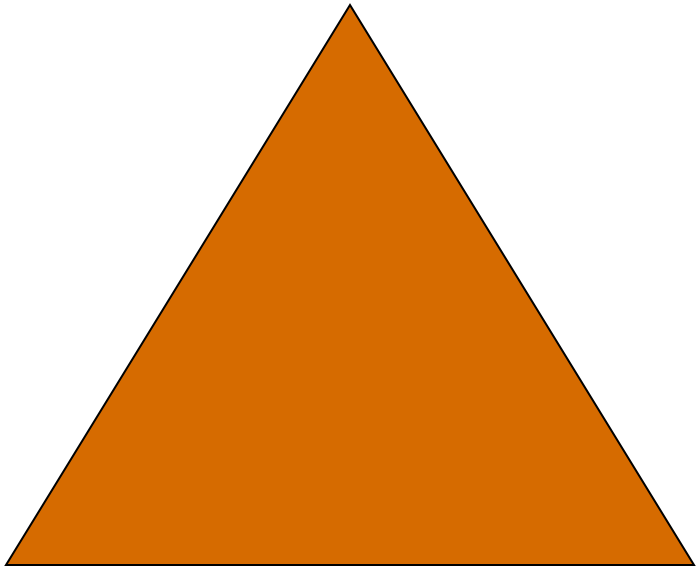
Misplaced Trust is a Great Facilitator of Fraud

Fraud – The Basics

The Fraud Triangle

Rationalization

(Justification of Act)



Opportunity

(Process and Controls)

Need/Pressure/ Motivation

(Influences /Incentives)

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,

<u>taxpayers pay the price.</u>

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)

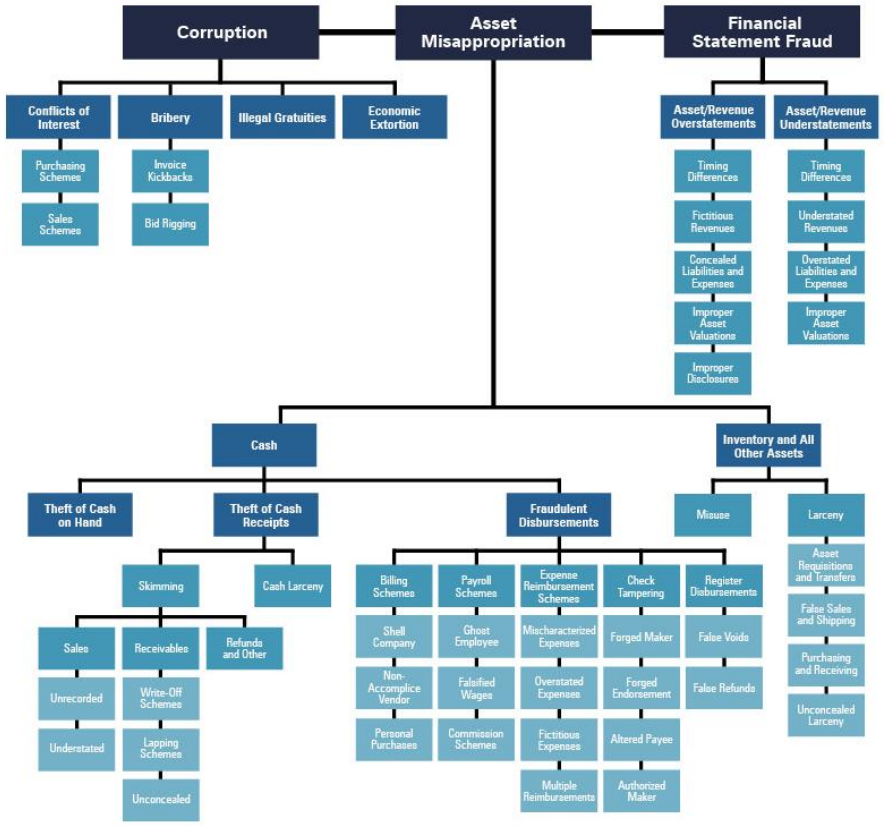
Fraud – The Statistics

- 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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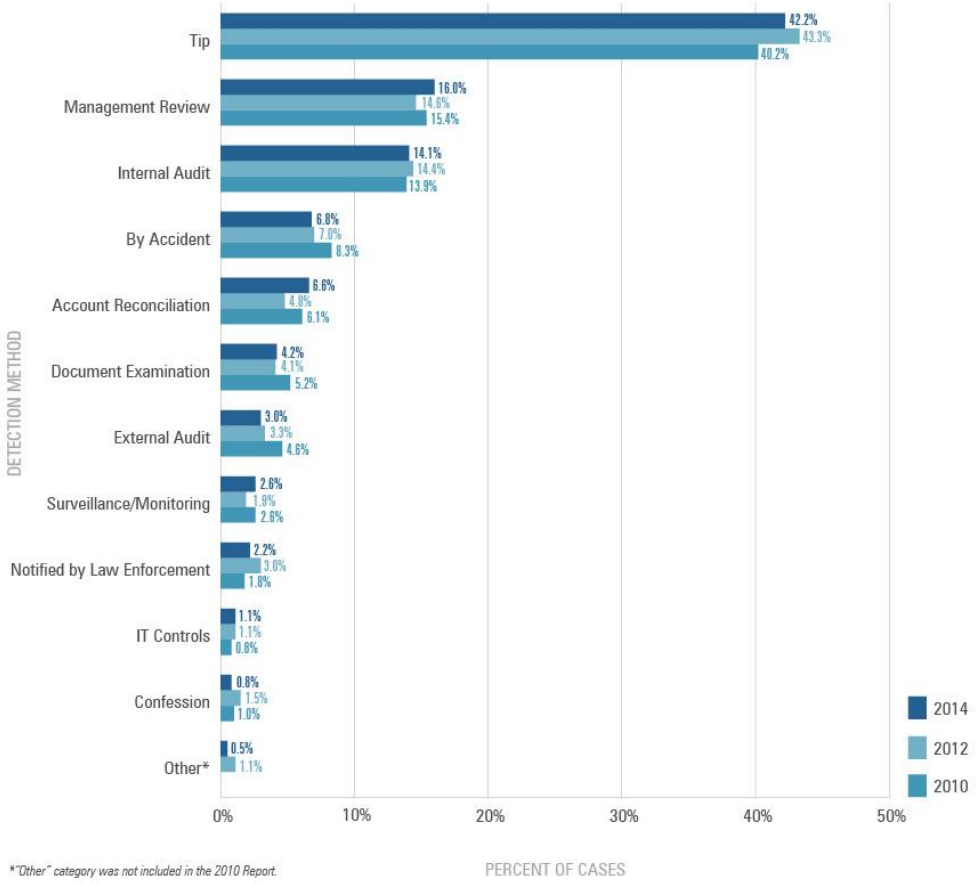
Fraud – Sources of Detection

Figure 11: Initial Detection of Occupational Frauds



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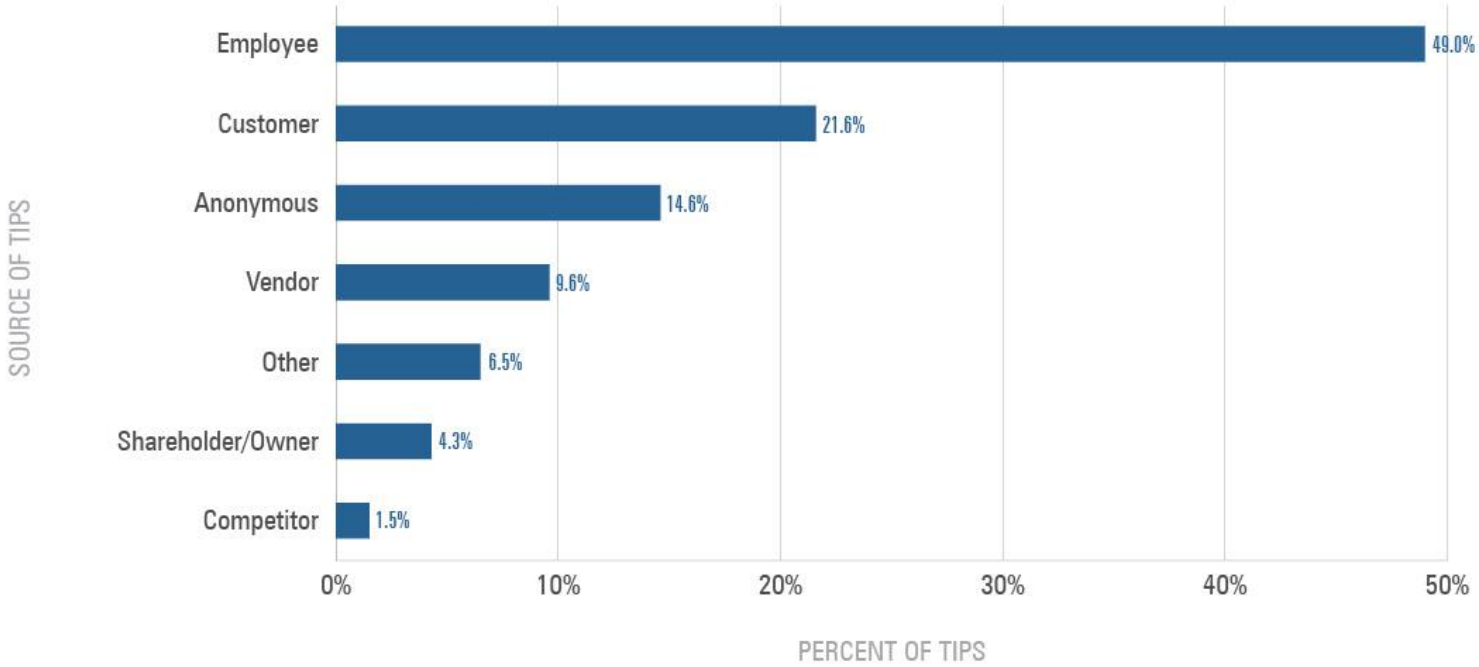
Fraud – Sources of Tips

Figure 13: Source of Tips



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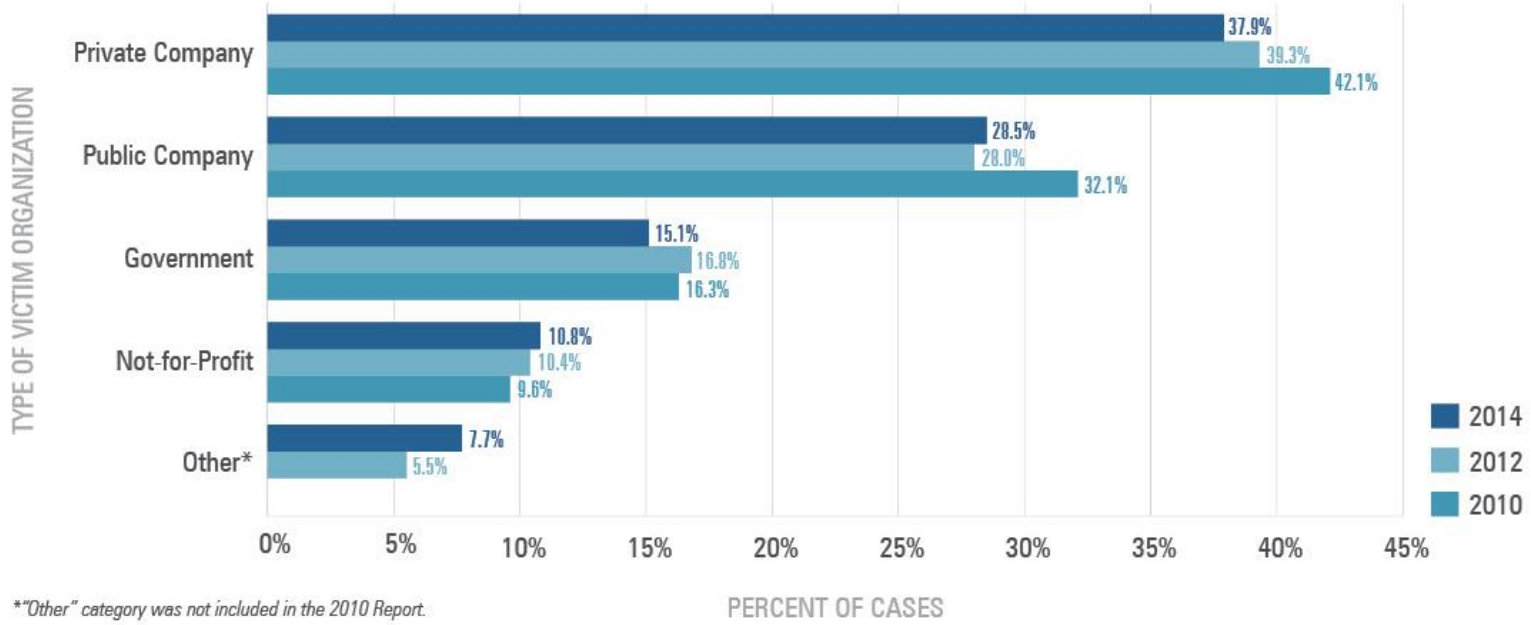
Fraud – Type of Victim Organization

Figure 17: Type of Victim Organization — Frequency



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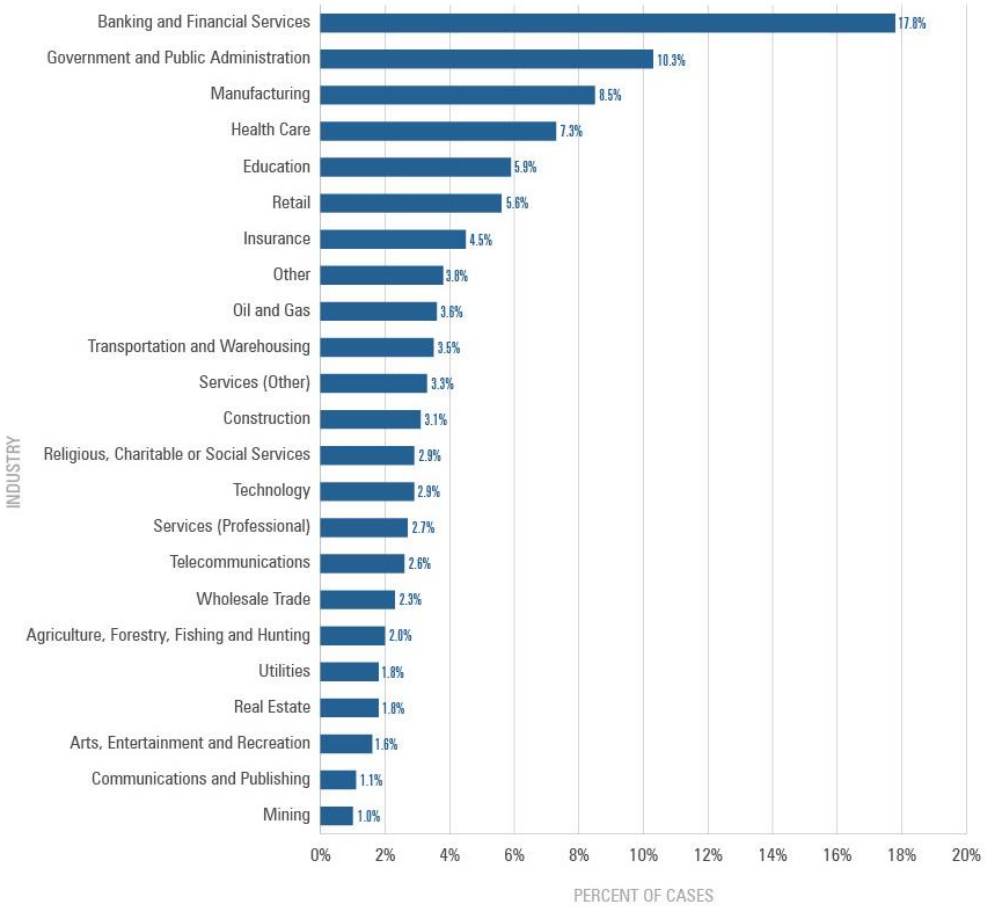
Fraud – Industry of Victim Organization

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 <u>required</u> 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

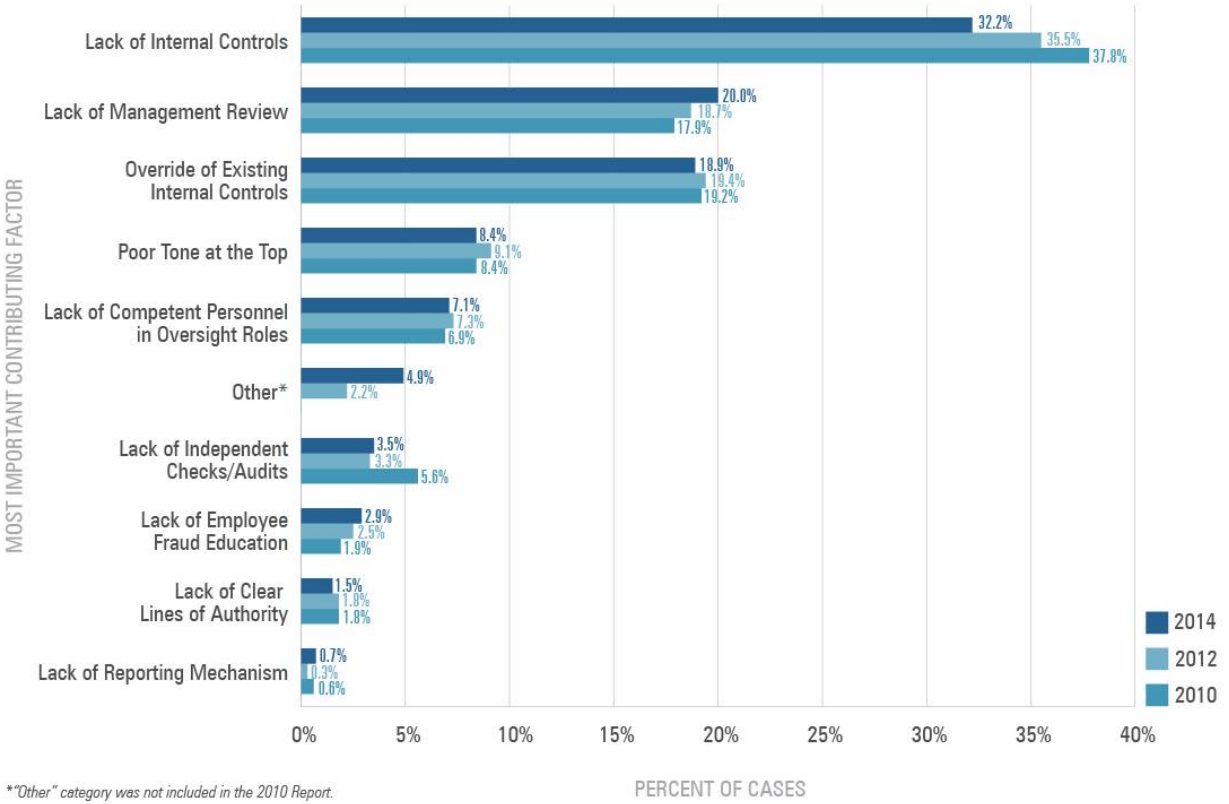
Fraud – Basic Prevention Techniques

- **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

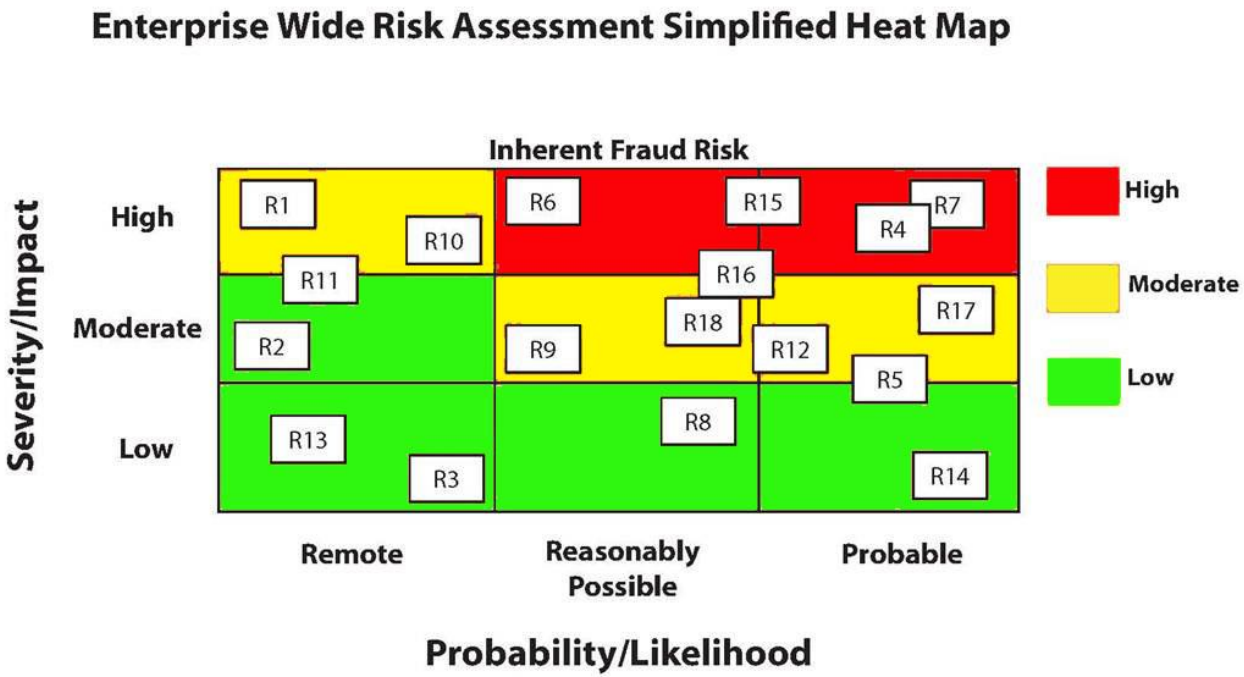
The Fraud Risk Assessment

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



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/rttn.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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