

Fraud and Internal Controls

VGFOA - Spring 2019 Conference - Norfolk, Virginia



Overview of Presentation

- ▶ Who is RFC?
- ▶ Introduction to Fraud
- ▶ Why is Fraud Important?
- ▶ What are the Warning Signs?
- ▶ What are Internal Controls?
- ▶ Types of Internal Controls
- ▶ Case Studies
- ▶ Preventing and Detecting Fraud
- ▶ Questions?

Meet the Presenters



- ▶ RFC (Robinson, Farmer, Cox Associates) has worked with local governments in Virginia since 1953
- ▶ Six offices spread across Virginia - Charlottesville, Fredericksburg, Blacksburg, Richmond, Staunton, and Louisa
- ▶ Andrew Grossnickle, CPA, CFE
 - ▶ Graduated from Bridgewater College and received a Masters in Forensic Accounting from Florida Atlantic University
 - ▶ Managing Partner of RFC's Fredericksburg Office
 - ▶ Received Virginia Society of CPA's Top 5 Under 35 Award in 2014
- ▶ Scott Wickham, CPA, CFE
 - ▶ Graduated from Virginia Tech
 - ▶ Partner in RFC's Blacksburg Office
 - ▶ Conducted numerous internal control reviews and assisted Virginia State Police in multiple investigations

Fraud 101

- ▶ Fraud is the INTENTIONAL deception to result in personal gain
- ▶ Types of Fraud: Corruption, Financial Statement Fraud, and Asset Misappropriation
- ▶ Most fraud examiner's build their fraud understanding using Donald Cressey's fraud triangle hypothesis:



Image from ACFE

Corruption

- ▶ Corruption - Dishonest or fraudulent conduct by those in power, often to illicit benefit. Examples include:
 - ▶ Conflicts of Interest
 - ▶ Purchasing Schemes
 - ▶ Sales Schemes
 - ▶ Bribery
 - ▶ Invoice Kickbacks
 - ▶ Bid Rigging
 - ▶ Illegal Gratuities and Extortion

Financial Statement Fraud

- ▶ Financial Statement Fraud - Deliberate misrepresentation of the financial condition of an organization through the intentional misstatement or omission of amounts or disclosures in the financial statements to deceive financial statement users.
- ▶ Net Income Overstatements:
 - ▶ Timing Differences
 - ▶ Fictitious Revenues
 - ▶ Concealed Liabilities and Expenses
 - ▶ Improper Asset Valuations
- ▶ Net Income Understatements:
 - ▶ Timing Differences
 - ▶ Understated Revenues
 - ▶ Overstated Liabilities and Expenses
 - ▶ Improper Asset Valuations

Asset Misappropriation

- ▶ Cash Transactions
 - ▶ Theft of Cash Receipts
 - ▶ Skimming
 - ▶ Kiting
 - ▶ Cash Larceny
 - ▶ Fraudulent Disbursements
 - ▶ Billing Schemes
 - ▶ Payroll Schemes
 - ▶ Expense Reimbursement Schemes
 - ▶ Check Tampering
 - ▶ Register Disbursements (false voids/refunds)
- ▶ Misuse or Stealing of Inventory/Vehicles/Other Assets

Facts on Fraud

- ▶ How is fraud committed?
 - ▶ Asset Misappropriation - 89%
 - ▶ Corruption - 38%
 - ▶ Financial Statement fraud - 10%
- ▶ What is the cost (median loss) of fraud?
 - ▶ Asset Misappropriation - \$114,000
 - ▶ Corruption - \$250,000
 - ▶ Financial Statement fraud - \$800,000

Based on 2,690 cases of fraud from January 2016 to October 2017, per ACFE 2018 Report to the Nations

Facts on Fraud (Cont'd)

- ▶ What is the cost (median loss) of asset misappropriation fraud?
 - ▶ Check and payment tampering - 12% - \$150,000
 - ▶ Billing - 20% - \$100,000
 - ▶ Inventory/Vehicles/Other Assets - 21% - \$98,000
 - ▶ Cash Larceny - 11% - \$75,000
 - ▶ Payroll - 7% - \$63,000
 - ▶ Skimming- 11% - \$50,000
 - ▶ Register Disbursements (fake voids/refunds) - 3% - \$29,000

Based on 2,690 cases of fraud from January 2016 to October 2017, per ACFE 2018 Report to the Nations

Why Care About Fraud?

- ▶ As we just discussed, fraud is costly!
- ▶ Those costs mentioned are the hard costs associated with fraud but there are others including public perception and embarrassment, employee replacement, improved IT capabilities, etc.
- ▶ It can happen to you - **DO NOT BELIEVE THAT YOU ARE IMMUNE**

Warning Signs of Fraud

- ▶ Living Beyond One's Means
- ▶ Financial Difficulties
- ▶ Unusually Close Association with Vendor/Customer
- ▶ Unwilling to share duties
- ▶ Recent divorce or family problems
- ▶ General unethical attitude

Internal Controls Summary

- ▶ **EFFECTIVE** internal control reduces the risk of asset loss and helps ensure the financial statements are complete, accurate, and reliable.
- ▶ Commonly referred to in local government as segregation of duties or checks and balances
- ▶ Internal Controls should include:
 - ▶ Written policies
 - ▶ Board oversight
 - ▶ **DOCUMENTED** review and approvals
 - ▶ **SEPARATING** the asset from the records

Internal Control Components

- ▶ Control Environment
 - ▶ “The atmosphere”
 - ▶ Ethics of the entity as a whole and organizational structure
- ▶ Risk Assessment - risk analysis and managing change
- ▶ Control Activities
 - ▶ Policies and procedures
 - ▶ Checks and balances
- ▶ Information and Communication
 - ▶ Quality of information
 - ▶ Effectiveness of information
- ▶ Monitoring - are we reviewing the information provided and responding accordingly?

Internal Control - Control Environment

- ▶ **Board Responsibilities**
 - ▶ Providing written policies and procedures
 - ▶ Setting an example and making ethical decisions
- ▶ **Management Responsibilities**
 - ▶ Open door policy
 - ▶ Setting an example and making ethical decisions
- ▶ **Employee Responsibilities**
 - ▶ Maintaining personal ethical boundaries
 - ▶ Reporting any actions believed to be inappropriate
 - ▶ Following approved policies and procedures

Internal Control - Risk Assessment

- ▶ **Board Responsibilities**
 - ▶ Requesting periodic risk assessment reports from management and implementing policies/changes accordingly
- ▶ **Management Responsibilities**
 - ▶ Providing the Board with reports noting internal and external risks for the entity
 - ▶ Internal risks could be non-integrated financial software
 - ▶ External risks could be closely related vendors
- ▶ **Employee Responsibilities**
 - ▶ Following policies and reporting concerns to supervisor

Internal Control - Control Activities

- ▶ **Board Responsibilities**
 - ▶ Policies documenting account procedures, cross-training, and required leave
- ▶ **Management Responsibilities**
 - ▶ Ensuring employees are following the policies and approved procedures
 - ▶ Obtaining and reviewing documents provided by employees for accuracy
- ▶ **Employee Responsibilities**
 - ▶ Following policies and procedures

Internal Control - Information & Communication

- ▶ Board Responsibilities
 - ▶ Maintaining an open line of communication (i.e. implementing fraud tip line)
- ▶ Management Responsibilities
 - ▶ Reviewing employee activity
 - ▶ Ensuring the reports are understandable
- ▶ Employee Responsibilities
 - ▶ Double checking data entered for accuracy

Internal Control - Monitoring

- ▶ **Board Responsibilities**
 - ▶ Reading reports and gaining an understanding of them
 - ▶ Following up on noted concerns
- ▶ **Management Responsibilities**
 - ▶ Reading reports and gaining an understanding of them
 - ▶ Determining trends of note and informing Board members
- ▶ **Employee Responsibilities**
 - ▶ Double checking data entered for accuracy

Case Study #1

- ▶ The Principal and Bookkeeper at Unknown High School were best friends growing up.
- ▶ Each month the Bookkeeper provided the bank reconciliation to the Principal for review; however, there are rarely questions or discussions regarding same.
- ▶ The bank balance is often minimal, but there are large deposits in transit.
- ▶ The Bookkeeper is the only person with access to the general ledger.
- ▶ The Bookkeeper prepares and records the deposits and physically takes money to the bank.
- ▶ The Bookkeeper can't sign checks.
- ▶ What concerns are noted or controls are lacking?

Case Study #1 (Cont'd)

▶ Red flags:

- ▶ Lack of segregation of duties:
 - ▶ Limited access to the system
 - ▶ Bookkeeper should not prepare, post, and physically take deposits
- ▶ Large deposits in transit while the bank balance remains small
- ▶ No questions/follow-up based on review of the bank reconciliation process
- ▶ Close friendship and trust of the Bookkeeper and Principal

▶ Results/Conclusions:

- ▶ Opportunity for theft was prevalent based on the relationship - small community, this should have been reviewed and staffing reassigned
- ▶ Fictitious receipts were being posted to the system and subsequently deleted after sign-offs were obtained
- ▶ Bookkeeper confessed to stealing \$30,000 from cash receipts

Case Study #2

- ▶ Town of Few People had one part-time bookkeeper and no other administrative employees.
- ▶ The Bookkeeper handled the entire billing, collection, deposit, and reconciliation process.
- ▶ Bank reconciliations were provided to Town Council for each meeting.
- ▶ The tax and water billing systems were in an accounting software that was separate from the general ledger software.
- ▶ The only reports for revenues were provided to Council from the tax and water billing systems.
- ▶ What concerns are noted or controls are lacking?

Case Study #2 (Cont'd)

▶ Red Flags:

- ▶ Lack of segregation of duties over billings and collections
- ▶ Two different software systems that are not interfaced
- ▶ Reconciliations were not prepared and reviewed for the water and tax revenue software to the general ledger
- ▶ No formal review of bank reconciliations

▶ Results/Conclusions:

- ▶ Through subsequent, detailed review - it was noted that the deposit slips had not included cash for over 12 months
- ▶ Town of Few People fired the bookkeeper under the belief that \$100,000 was missing

Case Study #3

- ▶ NFP applies for and receives federal grant funding
- ▶ Revenues are received on a reimbursement basis and are posted to offset the expenses for the checks that are written
- ▶ Checks are to subrecipients with no supporting documentation
- ▶ The Organization does not require statements of economic interest or have a related party policy
- ▶ The Executive Director of the Organization is an imposing man with a violent temper and often carries a gun to work that is left out in plain sight
- ▶ There has been significant turnover in the Finance Director role
- ▶ The Executive Director and the Finance Director are the check signers
- ▶ What concerns are noted or controls are lacking?

Case Study #3 (Cont'd)

▶ Red Flags:

- ▶ Tone at the top is concerning
- ▶ No subrecipient monitoring performed for grant funding
- ▶ Netting of expenditures and revenues

▶ Results/Conclusions:

- ▶ The Executive Director was on the Board of the subrecipient organization who had been accumulating the federal dollars passed through rather than spending same in accordance with grant requirements
- ▶ The Executive Director was terminated and the Organization was required to remit \$4 million back to the federal government

Preventing and Detecting Fraud

- ▶ Laying the ground work
 - ▶ Tone at the Top
 - ▶ Establishing and communicating expectations effectively
- ▶ Implement Controls
 - ▶ Segregation of duties - Access, recording, and reconciliation at a minimum
 - ▶ Mitigating controls - Oversight and review processes
- ▶ Review and Monitor
 - ▶ Establish performance measures and evaluate based on same
 - ▶ Rewards or disciplines and follow-through of performance measure

QUESTIONS?

- ▶ Please contact us if you have questions on fraud, internal controls, or other audit items:
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 - ▶ Scott Wickham, CPA, CFE - swickham@rfca.com

