
OAPT Conference

Understanding Internal Control & Fraud Prevention

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Rea & associates
a brighter way



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Agenda

-  Internal Controls
-  Fraud Triangle
-  Current Fraud Statistics
-  Emerging Trends
-  Fraud Risk Assessment
-  Fraud Prevention Tips



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What is the definition of Internal Control?

Internal Control can be defined as the sum of:

→ An accounting procedure or system designed to promote :

- Efficiency and effectiveness
- Ensure the implementation of a policy
- Safeguard of assets
- Reduce risk of fraud
- Minimize errors



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Five components of Internal Control

Control Environment

Risk Assessment

Information and Communication

Control Activities

Monitoring




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Internal Control – Control Environment

 **Definition** – Management’s attitudes, awareness, and actions concerning the importance of a control.


- The Environment sets the “tone” of the entity
- Influences the control consciousness of it’s people
- Serves as the foundation for all internal control components, providing components, discipline, and structure.

 The best *designed* policies and procedures have little hope of being effective without the proper “tone at the top”.

- Management must lead by example. Controls are not limited to staff.

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Internal Control – Risk Assessment

 **Definition** – The entity’s identification and analysis of relevant risks to the achievement of its objectives, forming a basis for determining how the risk should be managed.

- This is an *ongoing* process. The risks of yesterday may not be the risks of today or tomorrow.
- Risks must not only be identified, but must be *anticipated* so they can be avoided or mitigated. (analogy – installation of lights at a railway crossing *before* an accident occurs).
 - Managements focus on *identifying risk* should start with change:
 - Change in operating environment
 - Change in personnel
 - Change in information systems and technology
 - New programs or services provided
 - Change in structure

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Internal Control – Risk Assessment con't

- Management should also focus on the *inherent risks*
 - *Complexity*
 - *Cash receipts*
 - *Third-party beneficiaries*
 - *Prior problems*
 - *Prior unresponsiveness to identified control weaknesses*
 - *Payroll withholdings*
 - *Fake vendors*
 - *Credit/purchase cards*
 - *Central garage/storage locations*
- Proper training, ongoing efforts, responsiveness and commitment to ongoing assessment will strengthen internal controls to ensure a strong framework.

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Internal Control – Information & Communication

- **Definition** – The identification, capturing, and exchange of information in a form and on a timely basis to enable employees to carry out their responsibilities.
 - Management must be able to obtain reliable information to determine and *assess risk* and communicate policies and other information to those who need it.
 - Potential issues effected by *information*:
 - The entity's performance evaluation vs strategy or goal
 - Impact on efficiency and effectiveness
 - Management decisions on use of resources (financial or human)
 - Management can develop the best internal control environment, policies and procedures, etc., however if not properly *communicated* they may as well not exist.
 - Written policies and procedures distributed
 - Training programs established
 - New hire orientations
 - Policies posted on websites for easy access

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Internal Control – Information & Communication con't

- Potential issues facing *communication* of information:
 - Effectiveness and efficiency in the performance of the duties of employees
 - Lack of communication channels available to employees to report suspected improprieties
 - Lack of timeliness making information less useful in decision making



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Internal Control – Control Activities

- 🌀 **Definition** – The policies and procedures that help ensure management directives are carried out.
 - As a result of ongoing *risk assessment* and the strategies to *communicate information*, management must develop policies and procedures to carry out and meet the goals and strategies of the entity.
 - Traditionally, control-related policies and procedures related to finance are classified into one of the following categories:
 - Authorization
 - Properly designed records
 - Security/safeguarding of assets and records
 - Segregation of duties
 - Periodic reconciliations
 - Analytical review

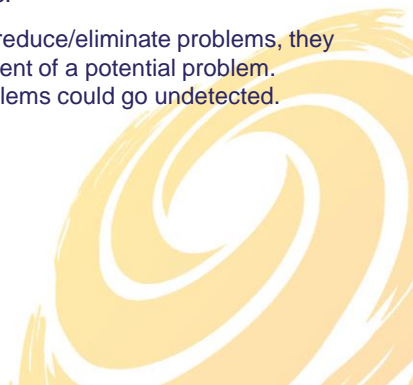


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Internal Controls – Monitoring

 **Definition** – The process used by those charged with governance (management AND the elected taxing authority) to assess the quality of internal control over time.

- The best developed control policies and procedures require changes over time as the environment changes.
- Not only are controls implemented to reduce/eliminate problems, they should be designed to alert management of a potential problem. Without proper monitoring, these problems could go undetected.

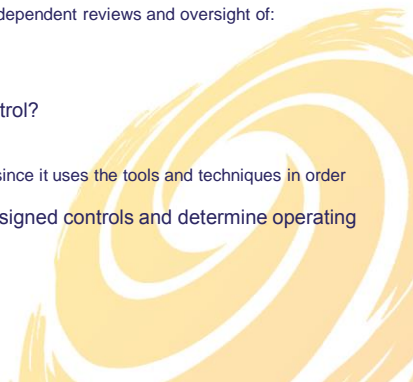


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Internal Controls – Monitoring con't

 The Roles in *monitoring* internal controls

- Who is “ultimately” responsible for internal control?
 - THE GOVERNING BODY
 - It's the job of the governing board to ensure that management meets all of it's responsibilities.
 - How can this be achieved? Establish an “audit committee”
 - Audit Committee responsibilities may include independent reviews and oversight of:
 - Reporting processes
 - Internal controls
 - Independent auditors
- Who is “primarily” responsible for internal control?
 - MANAGEMENT
 - Fundamentally a management concern since it uses the tools and techniques in order to achieve managements objectives
- Who's role is it to “validate” the success of designed controls and determine operating effectiveness.
 - YOUR AUDITORS



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Internal Controls – Inherent Limitations

- 🌀 No internal control framework can be perfect.
- 🌀 Inherent limitations include:
 - Management over-ride of controls (policies and procedures)
 - Collusion
 - Cost of the control (policy or procedure) should not cost more than the benefit it is expected to achieve
 - Human judgment can be faulty, human errors and mistakes
 - Limitation on segregation of duties based on number of employees

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Internal Controls - Examples

- 🌀 Disbursements
 - Written approval of authorization to purchase
 - Review of account coding by knowledgeable employee
 - Written receipt of goods/services (okay to pay)
- 🌀 Payroll
 - Process for hiring/termination of employees
 - Review of account coding by knowledgeable employee
 - Approval of timecards
 - Approval of pay rates

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Internal Controls - Examples

Receipts

- Finance office receiving adequate support
- Segregation of duties
- Trend analysis

Manual Journal Entries (Memo/Correcting Entries)

- Segregation of duties
- Formal approval by management
 - Treasurer, Council/Board

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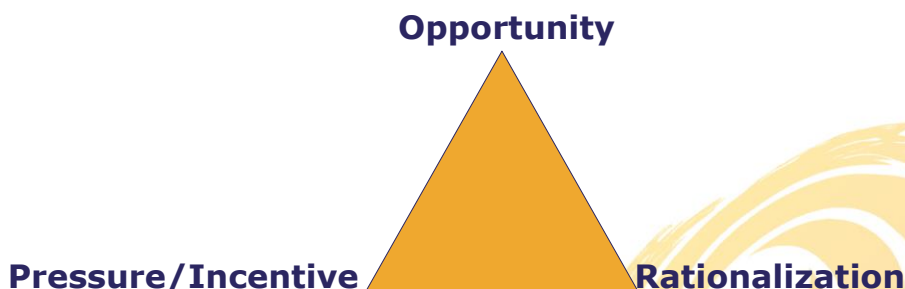
Fraud

Defined by Merriam-Webster

- as the intentional perversion of truth in order to induce another to part with something of value or to surrender a legal right
- An act of deceiving or misrepresenting
 - *Intent is the key consideration here.*

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Cressey's Fraud Triangle – Concept that dates back over half a century. Generally for fraud to occur, three things must be present:



Source: ACFE 2012 Report to the Nations on Occupational Fraud and Abuse

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Fraud Triangle

- 🌀 **Pressure** – Financial need that is often unwilling to be shared (addictions, debt, etc.) or that emotions have impacted the person (sick child or “keeping up with the Joneses”)
- 🌀 **Opportunity** – The ability to commit a fraudulent activity must exist (weaknesses in internal control or the ability to override them)
- 🌀 **Rationalization** – When a person has the ability to justify their actions (I’m underpaid, I’ll pay it back, or the health of my child is more important)

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Fraud Diamond



David T. Wolfe and Dana R. Hermanson

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Capability

Individual traits and characteristics

- Having the right organizational position or function to take advantage of fraud opportunities.
- Having the appropriate expertise to take advantage of fraud opportunities.
- Having the confidence or ego to take advantage of fraud opportunities.
- Being able to coerce others to participate in fraudulent activities.
- Being able to deal with the stress associated with committing fraud.
- Being a good liar.

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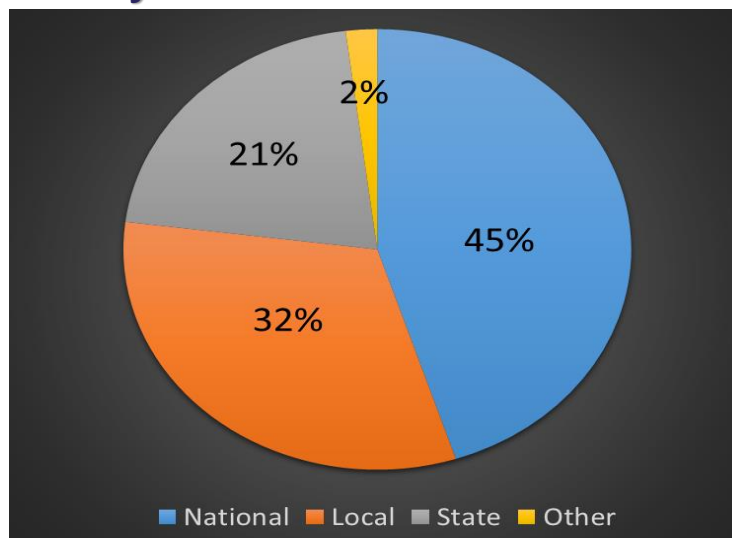
Pre-pandemic Fraud Statistics

🌀 Statistics per the ACFE's 2020 Report to the Nations

🌀 Governments continue to be one of the most targeted industries

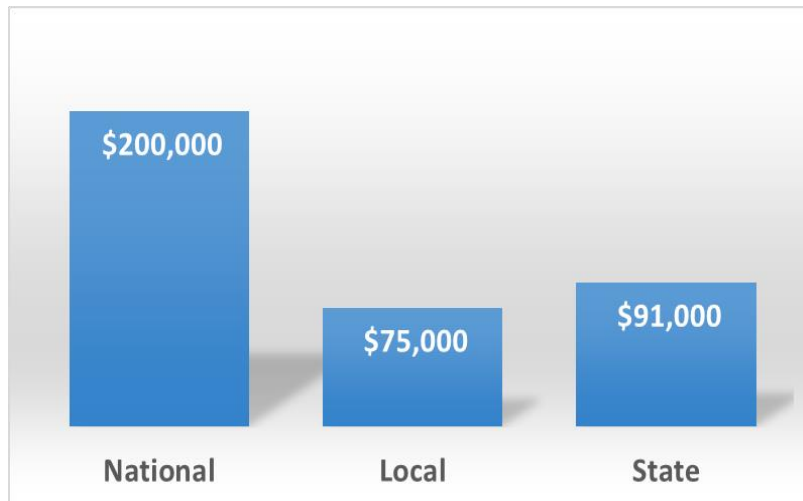
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Fraud by Level of Government



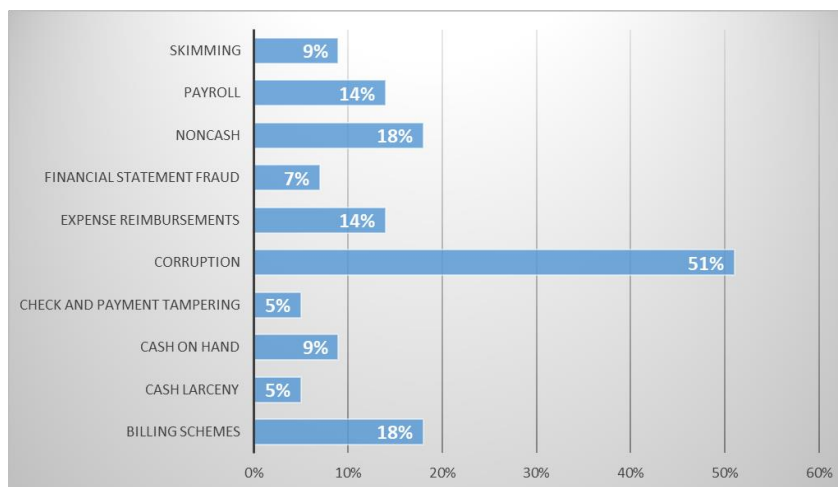
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Median Loss by Government Type



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Fraud Cases by Scheme



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Fraud Schemes

 **Skimming (9%)** – Theft of cash prior to entering into system. “Off the books” fraud.

- Obviously most common in areas where cash is accepted and limited ability to track activity or number of customers
 - Recreation dept's – pools, concession stands, etc...

 **Payroll (14%)** – Manipulate payroll system to receive payments they haven't earned

- Timecard fraud
- Pay rate fraud
- Ghost employees
- Withholding theft
- One of the current, more common themes is fraudsters contacting payroll departments to change employees direct deposit information

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Fraud Schemes

 **Noncash (18%)** – theft of inventory and equipment, misappropriation of assets




 **Financial Statement (7%)** – Intentional misrepresentation for personal or organizational gain

- More prevalent where employees receive bonuses for financial performances
- Increased risk when entities are benchmarked against one another
- Typically low risk area for governments because little to no incentive to misstate

 **Expense Reimbursements (14%)** – Personal expenses, over-stated expenses, fictitious expenses, double dipping



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Fraud Schemes

-  **Corruption (51%)** – Conflict of interests, kickbacks, contract steering, bid rigging
 - Typically a much higher dollar amount involved with this type of fraud
 - More difficult to address internally because typically involves senior management
-  **Check and Payment Tampering (5%)** – intercepting, forging or altering checks
-  **Cash on Hand (9%)** – theft of petty cash or any other cash on hand.

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Fraud Schemes

-  **Cash Larceny (5%)** – Theft of cash already accounted for in system, “on the books” fraud.
 - Theft from cash register
 - Often will involve “adjusting” entries or voided transactions to conceal theft
 - One of the easier schemes to detect because of the trail left
-  **Billing Schemes (18%)** – cause organization to issue fraudulent payments
 - Shell companies or fictitious vendors
 - Non-accomplice vendors – existing legitimate vendors but submit fake invoices for payment
 - Personal purchases on company card.

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COVID-19 Impact

🌀 Pandemic presented many challenges and increased fraud risks were just one of those challenges

- Remote working environment
- CARES Act funding created new opportunities
- Increased financial pressure and uncertainty
- New factors leading to rationalization
- Cyber threats increased significantly



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Emerging fraud risks

🌀 Authorized push (wire transfer) fraud

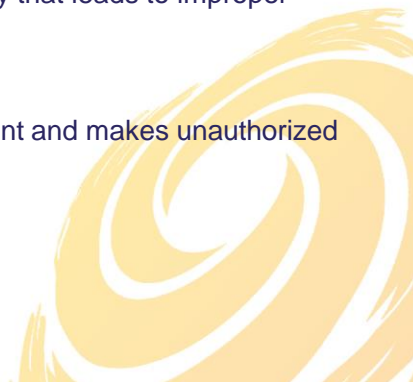
- Often involves social engineering to “tricking” victims to make payments.
- Typically a high sense of urgency that leads to improper payments

🌀 Account takeover fraud

- Fraudster gains access to account and makes unauthorized transactions.

🌀 Unemployment fraud

- Exploded due to CARES Act



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Emerging fraud risks

- 🌀 Ransomware continues to be a significant risk
 - Colonial pipeline
- 🌀 Less focus on customary transactional fraud and increased focus on data and information
- 🌀 Cyber environment continues to be biggest risk facing governments
 - Consider the type of information you currently have, what it could be used for and how it's protected

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Top 5 Fraud Schemes Predicted to Increase as direct result of pandemic

- 🌀 1. Cyberfraud
- 🌀 2. Payment Fraud
- 🌀 3. Unemployment Fraud
- 🌀 4. Fraud by vendors/sellers
- 🌀 5. Health Care Fraud

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Areas where less fraud may be expected

- 🌀 Cash on hand/skimming – less in-person interaction
- 🌀 Expense reimbursements – significantly less travel



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Recent Case Study 1



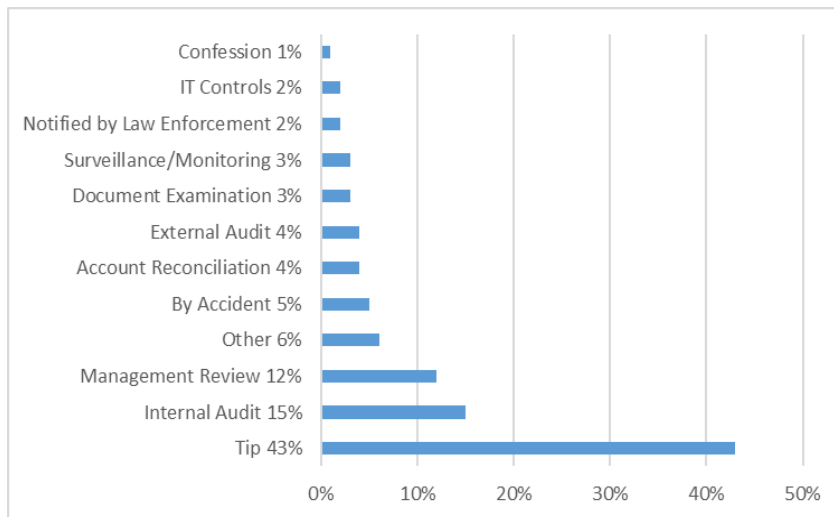
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Recent Case Study 2



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Who's detecting fraud



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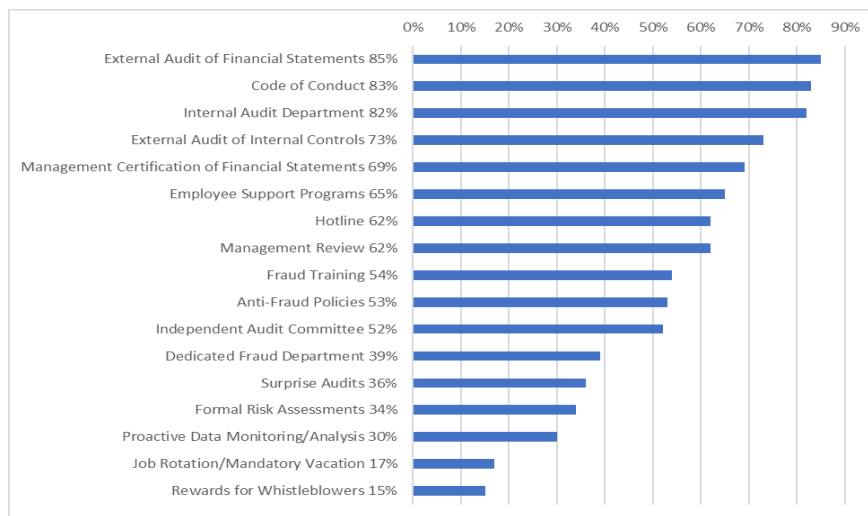
Where are the tips coming from?

- 🌀 Employee – 50%
- 🌀 Customer – 22%
- 🌀 Anonymous – 15%
- 🌀 Vendor – 11%
- 🌀 Other – 6%
- 🌀 Competitor – 2%
- 🌀 Shareholder/Executive – 2%



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Most commonly cited anti-fraud internal controls



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What is Fraud Risk Assessment?

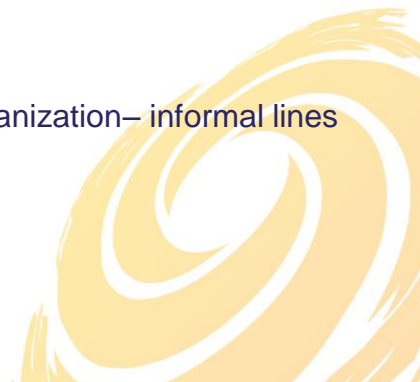
- 🌀 Proactive approach to mitigating fraud in your organization
- 🌀 Analyzing where fraud can occur in your organization
- 🌀 Fraud Prevention vs. Fraud Detection
 - Prevention = Proactive
 - Detection = Reactive



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Who is Responsible for Risk Assessment

- 🌀 Governing Body
 - Audit or Finance Committee
- 🌀 Mayor/Administrator
- 🌀 Finance Director/Treasurer
- 🌀 Executive Staff
- 🌀 Everyone throughout the Organization– informal lines of communication



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Definition of Fraud

- 🌀 “Intentional perversion of truth in order to induce another to part with something of value or to surrender legal right.” (Mirriam-Webster’s online dictionary)
- 🌀 Association of Certified Fraud Examiners (ACFE)
 - Misrepresentation of material facts
 - Concealment of material facts
 - Bribery
 - Conflicts of Interest
 - Theft of money and property
 - Breach of Fiduciary Duty



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Risk Assessment Includes:

- 🌀 Risk Identification
- 🌀 Risk Likelihood
- 🌀 Significance Assessment
- 🌀 Risk Response



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Risk Identification

Risk Identification

- Gathering information from both internal and external sources
 - **Brainstorming**
 - Interviews
 - Outside training
 - Analytical Procedures
 - Trend analysis: vendor example
 - Monthly financial reports (budget vs actual, etc.)
- Where are the inherent risks?
 - Cash collection points
 - Lack of oversight



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Risk Identification cont.

Risk Identification

- Incentives/Pressures
 - Budget constraints
 - Performance Bonuses
- Opportunities
 - Cash collection points
 - Segregated accounts
 - Access to create vendors



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Risk Likelihood

Risk Likelihood

- Financial exposure
- Public opinion
- Designed controls vs. Inherent risks
 - Is there a gap?



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Risk Response

Consider cost-benefit

- Cost of Inaction

How will council/management respond

- Increased Training
- Surprise Audits
- Change in Policy and Procedure



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Additional considerations for risk assessment

Who's committing fraud and at what levels of the organization?

Behavioral Red Flags



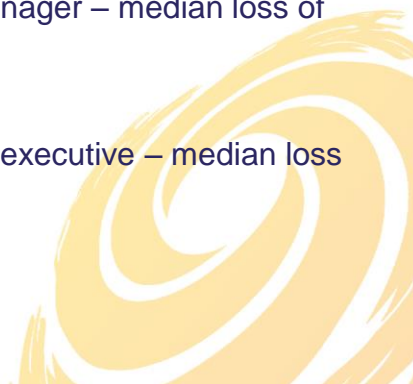
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Fraud by Level of Authority

41% of cases identified were committed by an employee – median loss in those cases was \$50,000.

38% of cases committed by manager – median loss of \$135,000.

18% of cases committed by an executive – median loss of \$264,000.



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Most common departments for Fraud

- 16% in general operations
- 11% accounting
- 10% executive/upper management
- 8% administrative support
- 7% purchasing



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Profile of Fraud Perpetrator

- Average age of 45 – age does not appear to be a significant factor
- 73% of frauds noted were committed by men with an average median loss of \$142,000.
- Median loss for females was \$45,000.



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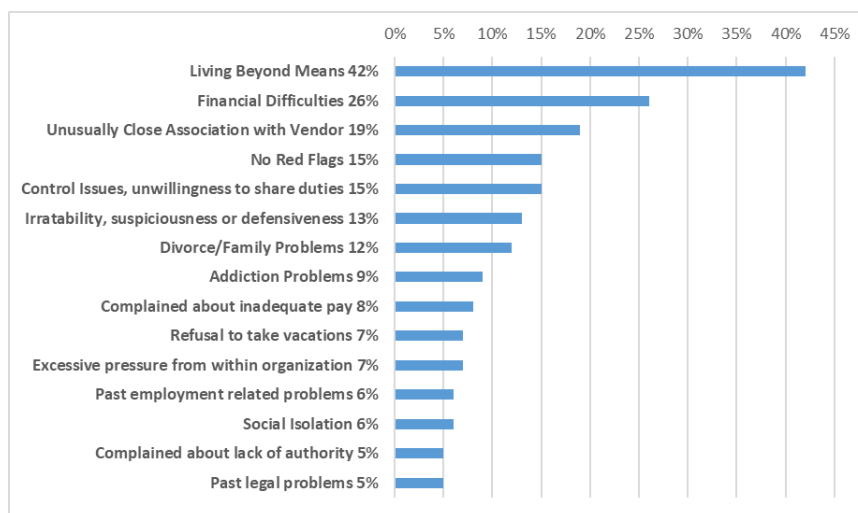
Collusion

46% of cases involved just one perpetrator with median loss of \$69,000

54% involved 2 or more people and median losses jump to \$250,000

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Behavioral Red Flags



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Group Discussion Case 1



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Group Discussion Case 2



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Effective Fraud Deterrents

Written Fraud Policy

- Policy sets expectations
 - Zero Tolerance
- Review and sign-off by each employee for personnel file
- Include Reporting Process
 - Whistleblower Protection
 - Issues addressed consistently and timely

Ethics Policy, Conflict of Interest Policy

Training

Continuous Risk Assessment

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Steps to Reduce Fraud Risk

- Fraud risk analysis performed
- Educate
- Tone at the Top
- Conflict Disclosures (Council and Management)
- Establish whistle-blower hotlines
- Rotation of job duties
- Zero tolerance
- Background checks for new hires – don't hire crooks
- Keep eyes and ears open regarding employee behavior
- Discuss concerns with auditors
- Establish effective Internal Audit division
- Use of Data Mining Software
- Surprise audits


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It Could Happen to You

- 🌀 Skimming of Cash Collections
 - 🌀 Missing Evidence
 - 🌀 IT Equipment and Purchases
 - 🌀 Off-the Books Bank Accounts
 - 🌀 Visit the AOS website for numerous stories and findings
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Highlights

- 🌀 Understand the Five Components of Internal Control
 - 🌀 Everyone is responsible for effective and efficient control development and/or application
 - 🌀 Train your Team(s)
 - 🌀 Ongoing evaluation of controls and fraud risk assessment
 - 🌀 Fraud Statistics
 - 🌀 Fraud Prevention tips
 - 🌀 Trust is never a control!
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QUESTIONS?

