

The Case for Internal Controls and Monitoring – “Yes” Fraud Can Strike Any Organization!

Presentation for the Puget Sound Finance
Officers Association
November 14, 2018

Robert Goehring, CFE, CPA, City Auditor
rgoehring@kentwa.gov



Biography

- City Auditor, City of Kent (September 2002 through current)
- Washington State Auditor's Office (August 1987 – August 2002, last three years with Special Investigations)
- Director at Large (six years as President), Pacific Northwest Chapter/ACFE (July 2002 – Current)

Biography – Continued

- Graduate of Central Washington University (Accounting)
 - Enjoys making pies and greeting cards and listening to both kinds of music – Barbara Streisand and Neil Diamond
 - A strong proponent of nuclear power (“Hanford Corner” in office, complete with a Geiger Counter from the Hanford Area)
-

Disclaimer

The views and opinions expressed do not necessarily reflect the views and opinions of the City of Kent, or City elected officials, management or staff

“Trust is not an internal control
or, put another way, trust but
verify”



Source: cartoonstock.com

Agenda

- About the Association of Certified Fraud Examiners (ACFE)
- About the Pacific Northwest Chapter/ACFE
- The ACFE Fraud Triangle
- The ACFE Fraud Tree
- ACFE Report to the Nations - Summary

Agenda - Continued

- Overarching Internal Control Concepts
- Key Internal Control Issues
- Internal Audit Philosophy
- Internal Audit Nightmare Scenarios
- Internal Audit Approach
- Concluding Thoughts

About the ACFE

- www.acfe.com
- Mission - Reduce the incidence of fraud and white-collar crime and to assist Membership in fraud detection and deterrence
- World's largest anti-fraud organization and premier provider of training and education

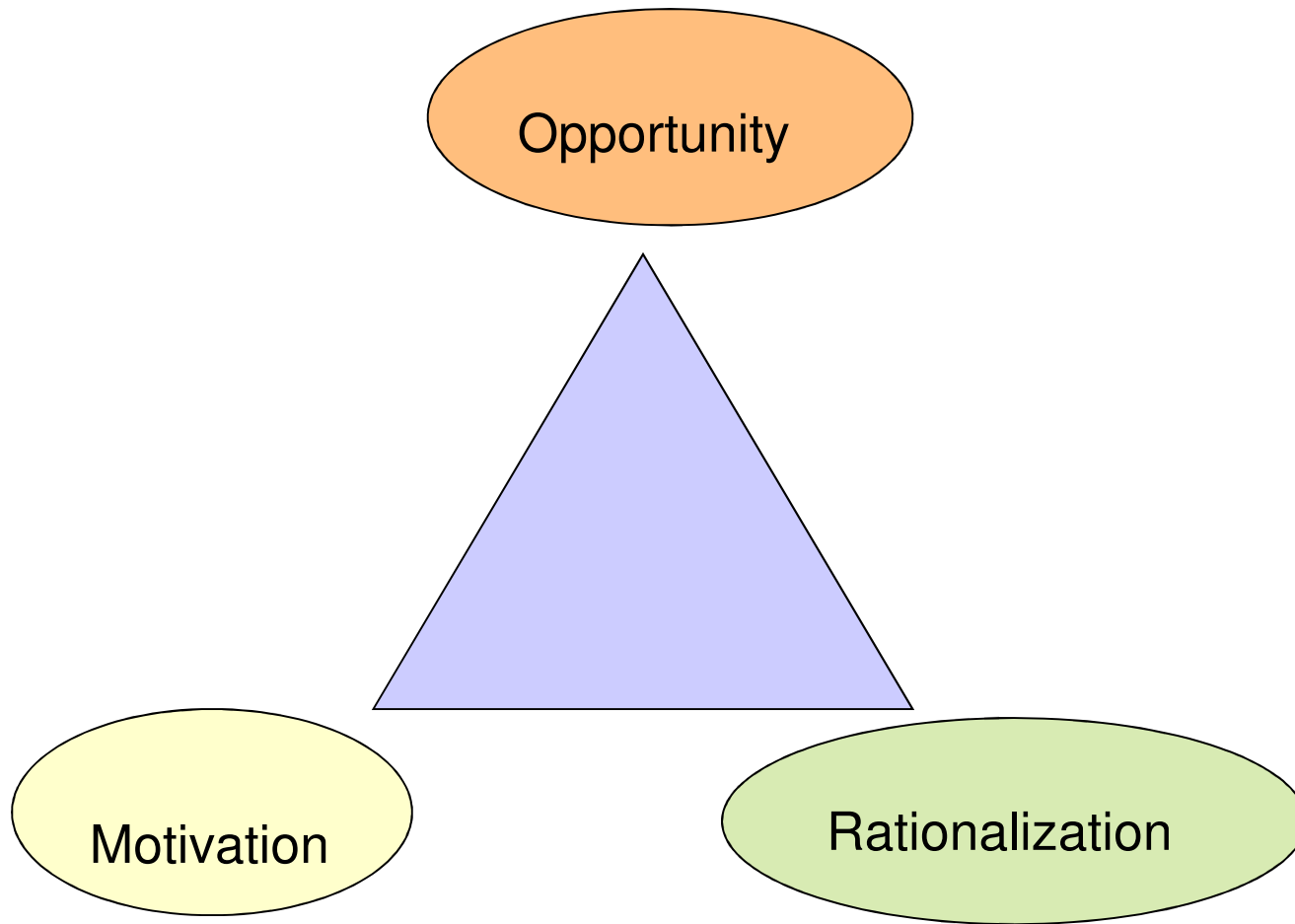
About the ACFE - Continued

- Founded in 1988 by Dr. Joseph Wells, CFE, CPA
- Over 85,000 members
- 183 Local Chapters, including 97 Chapters in the United States
- ACFE Foundation: Richie-Jennings Memorial Student Scholarship Program (27 scholarships totaling \$51,500 for 2017/2018 academic year)

About the PNW Chapter/ACFE

- www.fraud-examiners.org
- Mission – Promote fraud prevention and detection through educational training and student scholarships
- Founded in 1993 (founding members include Joe Dervaes, CFE, ACFE Fellow, CIA)
- 159 Members, including 109 CFEs

The ACFE Fraud Triangle



The ACFE Fraud Triangle - Continued

- Anyone in an organization can commit fraud – Access, Skill and Opportunity
- Fraud is always progressive – often starts small and sometimes by borrowing
- Fraudsters are often the most trusted and hardest working employees – organizations even unknowingly pay overtime for time spent hiding the fraud

The ACFE Fraud Tree



Source:
armedlaughin.blogspot.com

The ACFE Fraud Tree - Continued

- The Fraud Triangle explains the WHY and the Fraud Tree explains the WHAT and the HOW of occupational fraud.
- Occupational fraud is fraud committed by an employee on an employer in the course of their employment.

The ACFE Fraud Tree - Continued

- Fraud is an intentional false representation or concealment of a material fact for the purpose of inducing another to act upon it for the purpose of personal gain.
- Five elements of fraud: False representation, knowledge it was false, intent to deceive, reliance by the victim and actual loss suffered by the victim.

The ACFE Fraud Tree - Continued

- ACFE Occupational Fraud and Abuse Classification System: *
 - ✓ Corruption
 - ✓ Financial Statement Fraud
 - ✓ Asset Misappropriation (point of emphasis of this presentation)
- * The sad story about what could go wrong

The ACFE Fraud Tree - Continued

- Corruption:
 - ✓ Conflicts of Interest
 - ✓ Bribery
 - ✓ Illegal Gratuities
 - ✓ Economic Extortion
- Financial Statement Fraud:
 - ✓ Net Worth/Income Overstatements or Understatements

The ACFE Fraud Tree - Continued

- Asset Misappropriation:
 - ✓ Inventory and All Other Assets
 - Misuse (e.g. personal usage)
 - Larceny (e.g. asset requisitions and transfers)
 - ✓ Cash (point of emphasis) *
- * Includes checks and electronic payments

The ACFE Fraud Tree - Continued

- Asset Misappropriation – Cash:
 - ✓ Theft of Cash on Hand
 - ✓ Theft of Cash Receipts
 - ✓ Fraudulent Disbursements
- Theft of Cash Receipts:
 - ✓ Cash Larceny (stolen after recording to accounting system)
 - ✓ Skimming

The ACFE Fraud Tree - Continued

- Theft of Cash Receipts - Skimming:
 - ✓ Unrecorded and Understated Sales (not recorded to accounting system)
 - ✓ Refunds and Other (e.g. fictitious and overstated refunds and false voids)

The ACFE Fraud Tree - Continued

- Theft of Cash Receipts – Skimming Continued:
 - ✓ Receivables:
 - Unauthorized write-offs/adjustments
 - Lapping schemes (B's payment applied to A's account to conceal theft of A's payment)
 - Unconcealed (no attempt to hide fraud)

The ACFE Fraud Tree - Continued

- Fraudulent Disbursements:
 - ✓ Billing Schemes:
 - Shell company (owned or under the control of the fraudster)
 - Non-accomplice vendor (e.g. intentional overpayment and theft of refund)
 - Personal purchases
-

The ACFE Fraud Tree - Continued

- Fraudulent Disbursements - Continued:
 - ✓ Payroll Schemes (falsified wages, ghost employee and commission [e.g. false/inflated sales] schemes)
 - ✓ Check and Payment Tampering (e.g. altered payee)
 - ✓ Register Disbursements (false voids and refunds)

The ACFE Fraud Tree - Continued

- Fraudulent Disbursements - Continued:
 - ✓ Expense Reimbursement Schemes
 - Mischaracterized Expenses (personal expenses)
 - Multiple Reimbursements (e.g. paid by organization to vendor)
 - Overstated Expenses
 - Fictitious Expenses

ACFE Report to the Nations

- <https://www.acfe.com/report-to-the-nations/2018>
- About the Report:
 - ✓ 10th Bi-Annual edition
 - ✓ The most comprehensive and widely quoted global study on occupational fraud

ACFE Report to the Nations - Continued

- About the Report - Continued:
 - ✓ Explores the costs, schemes, victims and perpetrators of occupational fraud
 - ✓ Report based on online survey of all CFE's comprised of 76 questions for each case

ACFE Report to the Nations - Continued

- About the Report - Continued:
 - ✓ 7,232 responses were received (2,690 cases used for report)
 - ✓ Report based on cases from 125 countries and involving 23 major industries investigated between January 2016 and October 2017

ACFE Report to the Nations - Continued

- Key Findings:
 - ✓ On average, organizations lose an estimated 5% of their annual revenues to fraud (no change from prior reports)
 - ✓ Over \$7.1 billion in total losses
 - ✓ 22% of cases over \$1 million

ACFE Report to the Nations - Continued

- Key Findings - Continued:
 - ✓ \$130,000 median loss per case, including \$125,000 for Government and Public Administration
 - ✓ Average duration – 16 months
 - ✓ Asset Misappropriation Schemes - 89% of cases (\$114,000 median loss)

ACFE Report to the Nations - Continued

- Key Findings - Continued:
 - ✓ Recovered all financial losses (15%)
 - ✓ Most common schemes for Government and Public Administration (184 cases):
 - Corruption (50%)
 - Non-cash, e.g. inventory (22%)
 - Billing (15%)

ACFE Report to the Nations - Continued

- Key Findings - Continued:
 - ✓ Internal control weaknesses - 50% of fraud cases
 - ✓ Most common method of detection:
 - Tip (40%)
 - Internal Audit (15%)
 - Management Review (15%)

ACFE Report to the Nations - Continued

- Key Findings - Continued:
 - ✓ Only 4% of fraudsters had a prior fraud conviction
 - ✓ Termination of employment of fraudster (only 65% of cases)
 - ✓ Referrals for prosecution declined by 16% over the past 10 years (top reason – fear of bad publicity)

FIG. 6 What asset misappropriation schemes present the greatest risk?

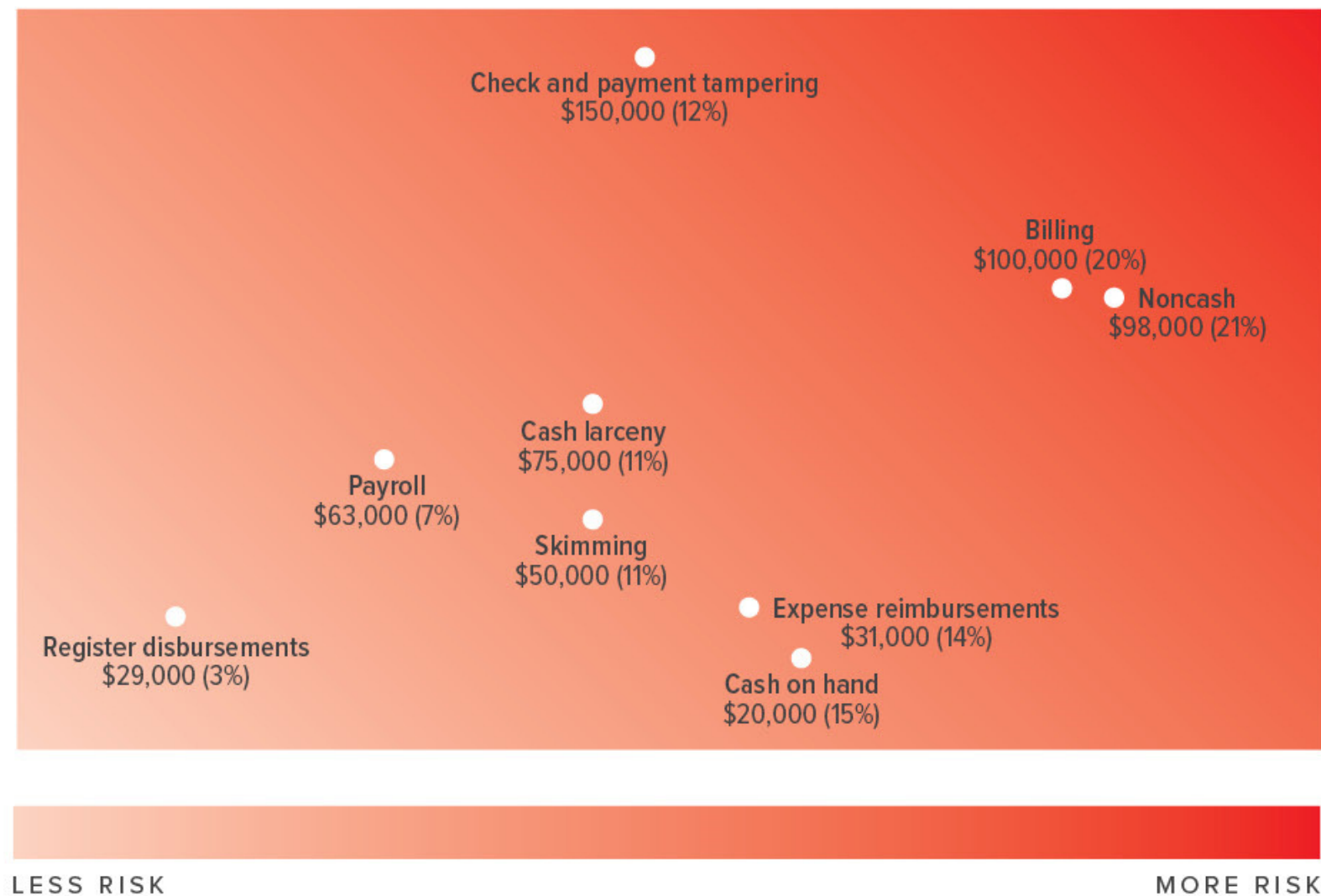


FIG. 2 How much does an occupational fraud cost the victim organization?

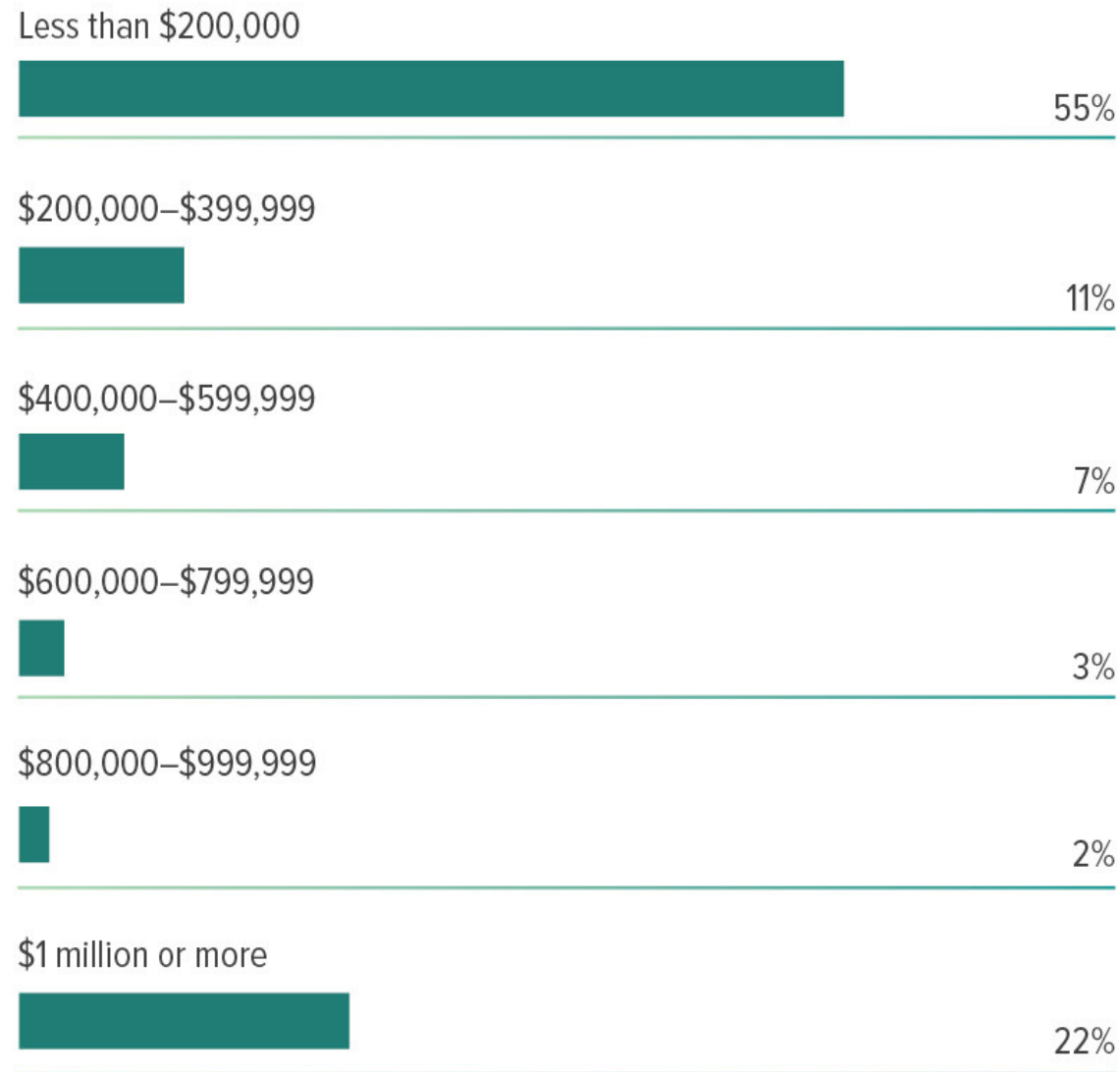


FIG. 9 How is occupational fraud initially detected?

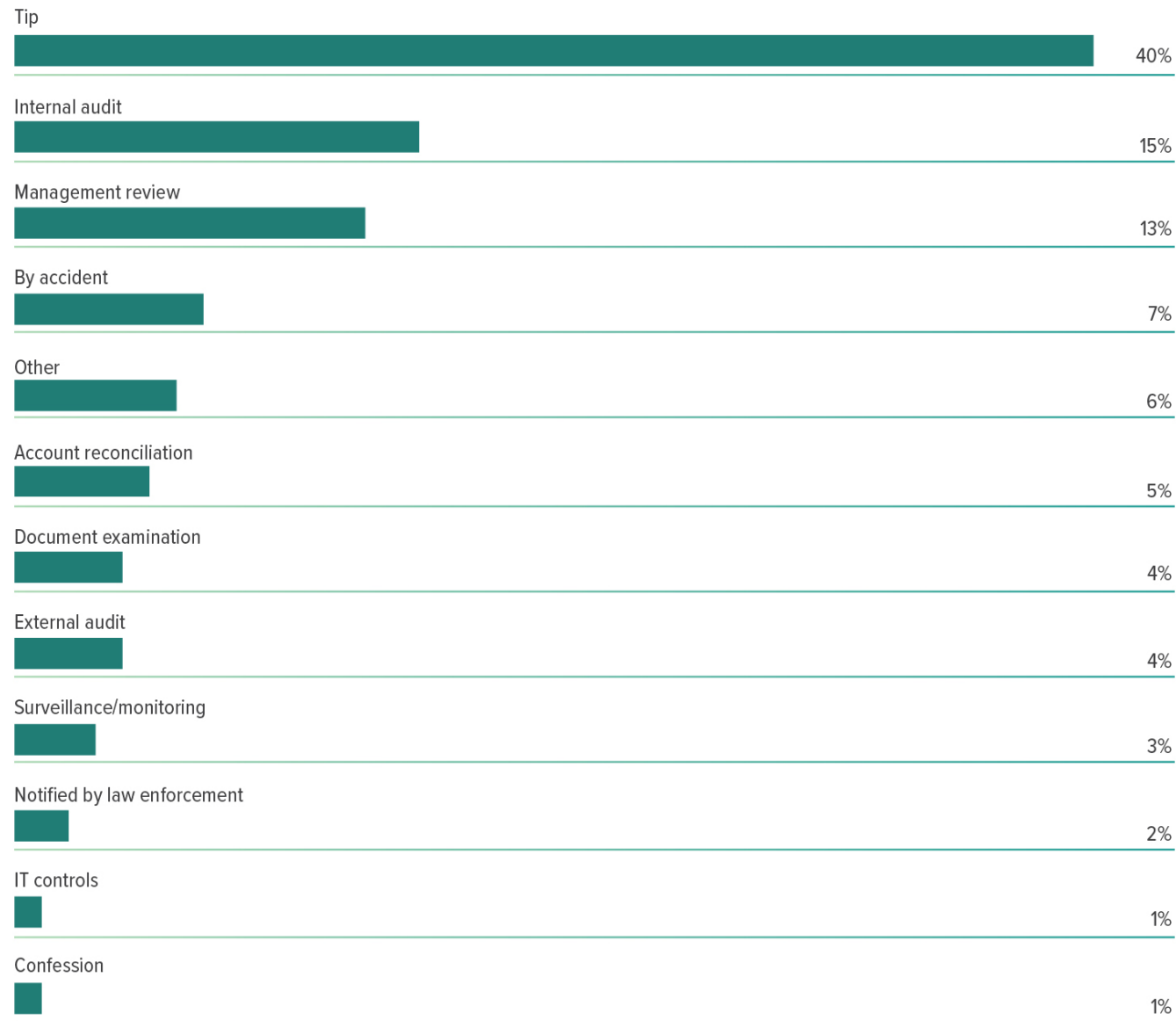


FIG. 23 How do internal control weaknesses vary by scheme type?

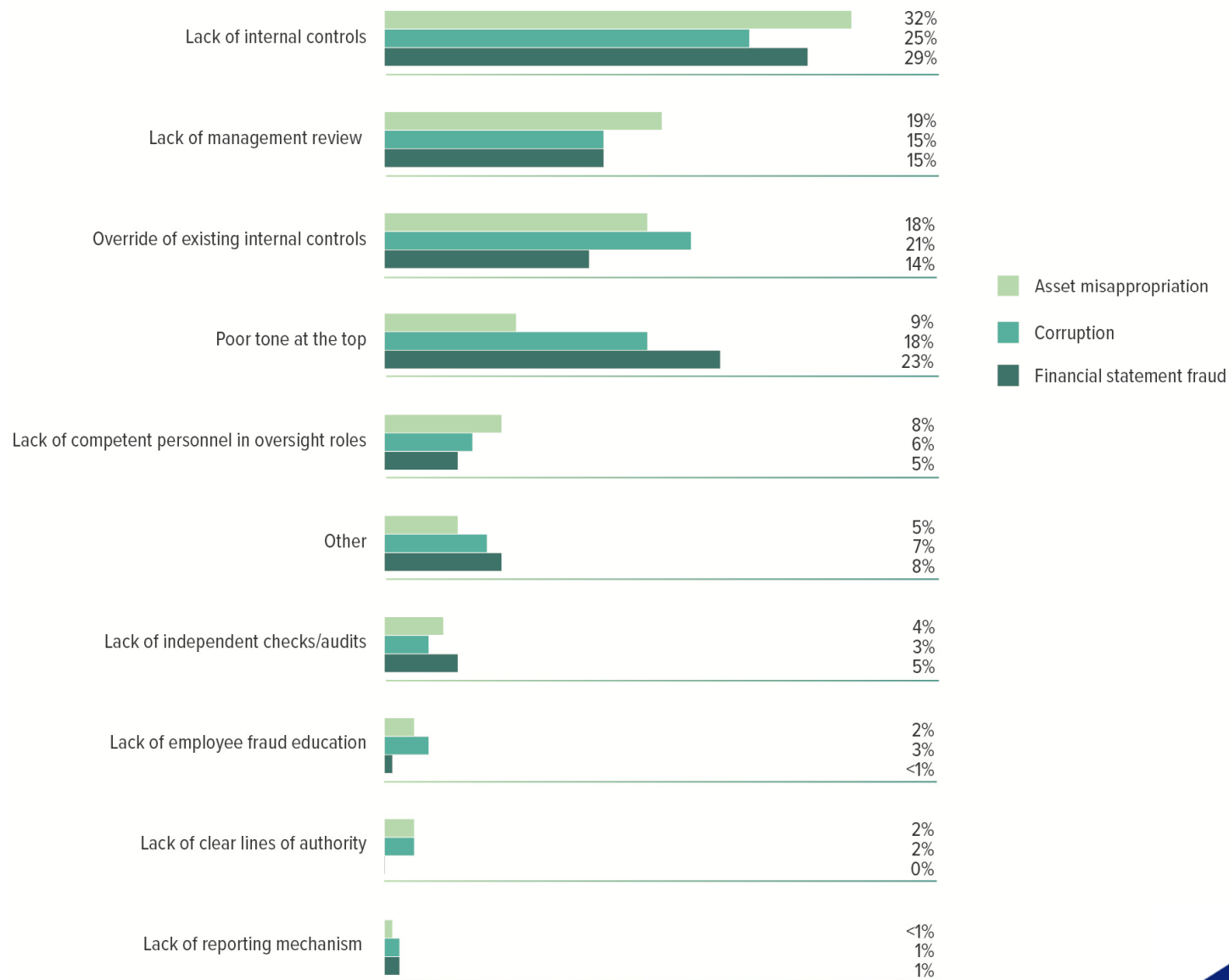
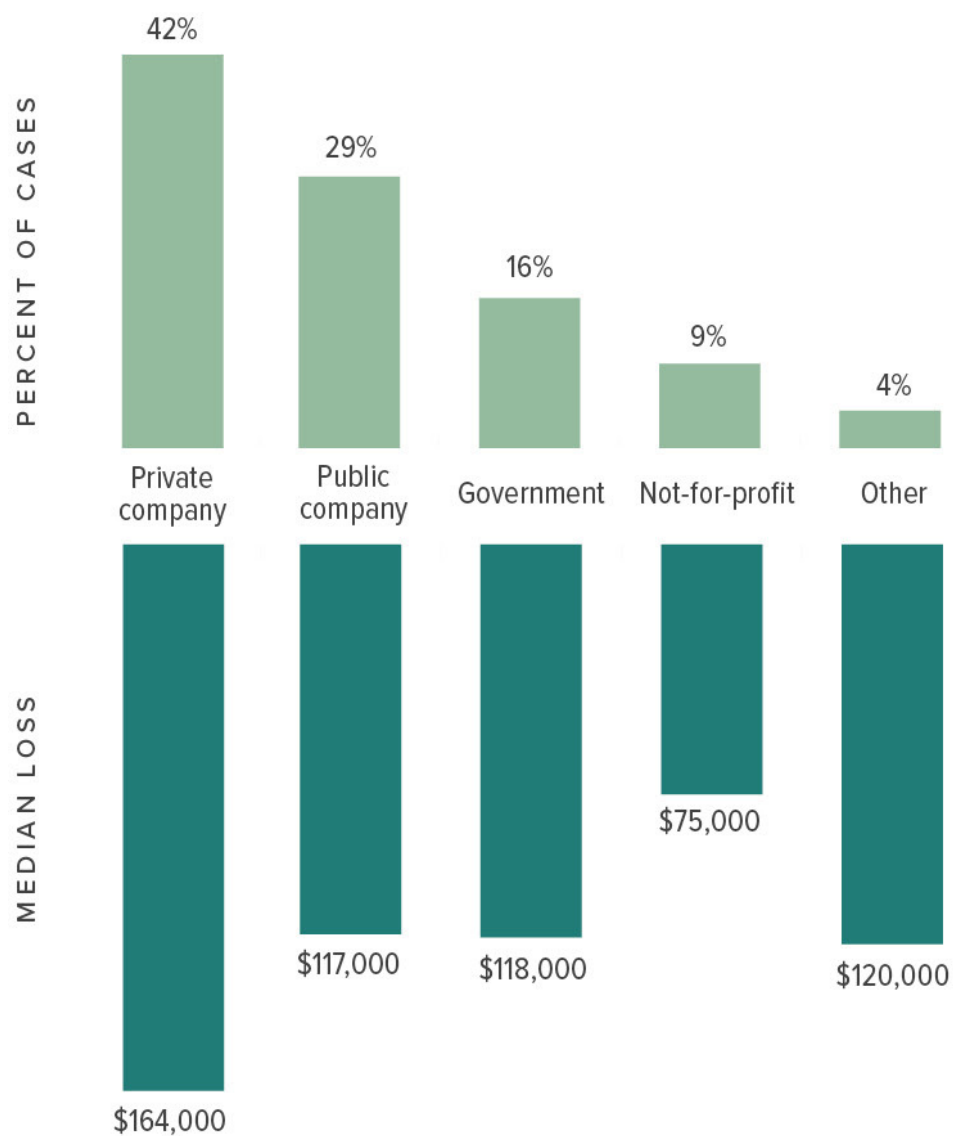
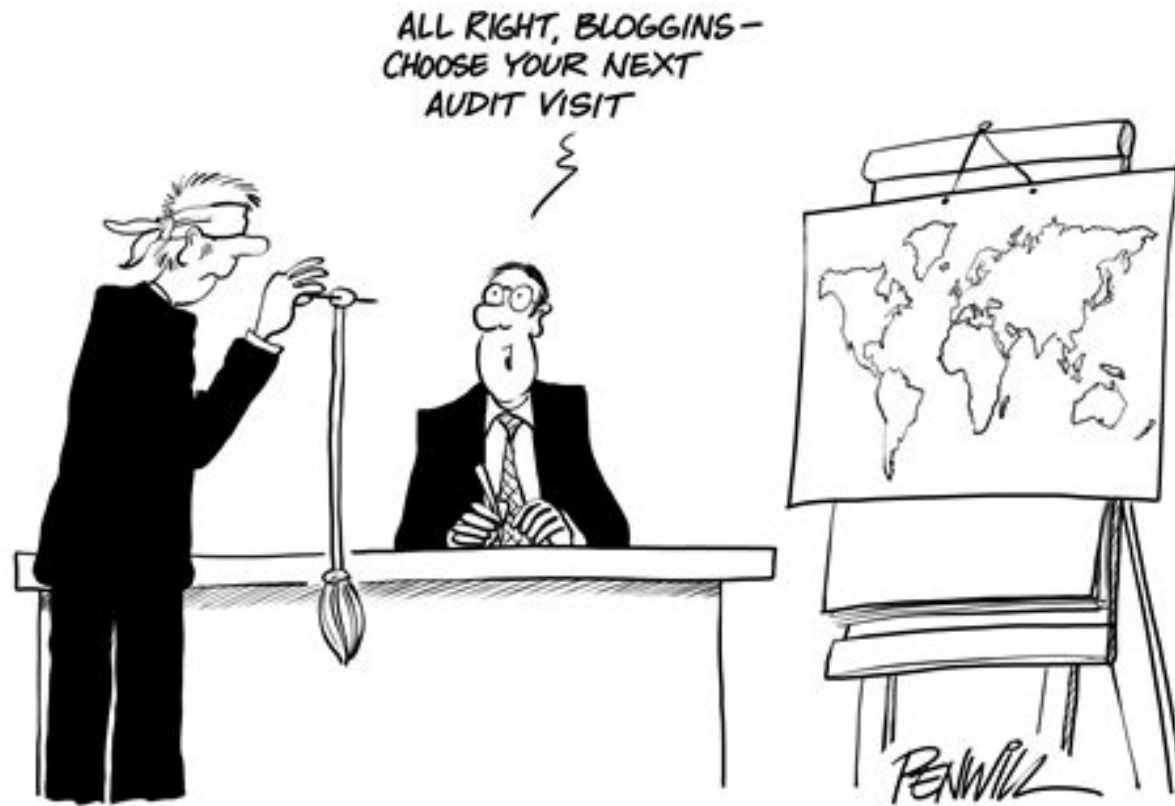


FIG. 12 What types of organizations are victimized by occupational fraud?



Internal Audit - Let's Talk Turkey



Overarching Internal Control Concepts

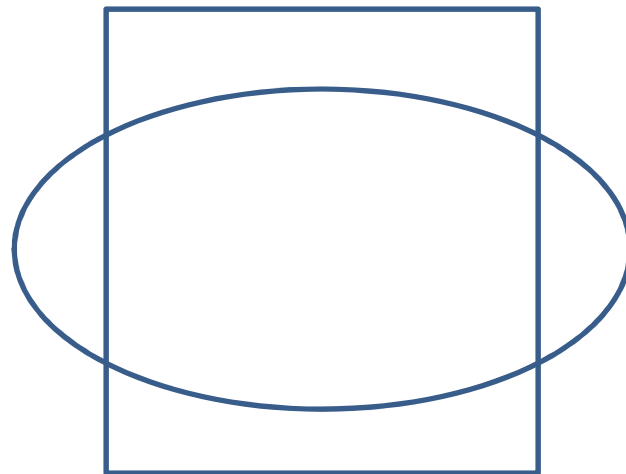
- Tone at the Top:
 - ✓ Fraud will NOT be tolerated
 - ✓ Walk the talk
 - ✓ Openness, transparency and proper handling of all financial transactions required
 - ✓ Applies to all levels of the organization

Overarching Internal Control Concepts - Continued

- Employees respect what you inspect, not what you expect:
 - ✓ Fraudsters do not play by the rules – they ignore and/or compromise internal controls
 - ✓ The organization should expect openness, transparency and proper handling of all financial transactions

Overarching Internal Control Concepts - Continued

- Circle – Your internal control procedures
- Square – What the employees really do
- Outside of Area – Potential for fraud



Overarching Internal Control Concepts - Continued

- Customer service and accountability – cannot have one without the other
- Trust is not an internal control
- Employees respect what you inspect, not what you expect (“trust but verify”)
- Internal controls are positional and situational, not personal

Overarching Internal Control Concepts - Continued

- Internal control is all about protection of staff, not controlling staff
- Proper documentation is necessary to demonstrate the validity and proper handling of any financial transaction
- Accountability should be assigned to a single person, at a single point of time, all of the time

Key Internal Control Issues

- The “kiss of death” in any financial operation is not addressing the following:
 - ✓ What could go wrong?
 - ✓ What is the organization doing to address the risk in a cost-effective manner?
 - ✓ Are these expectations met?

Key Internal Control Issues - Continued

- Know your financial operations:
 - ✓ Identify significant revenues and other high risk revenues both at the entity-wide and at the departmental level
 - ✓ Identify key programs and activities

Key Internal Control Issues - Continued

Ensure openness, transparency and accountability in financial operations:

- Establishment of a proper segregation of duties
- Establishment of a proper audit trail to ensure that the “financial story” is timely, complete, accurate and properly supported.

Key Internal Control Issues

- Continued

- Establishment of a proper transfer of accountability for assets assigned to a specific person at a specific point in time all of the time.

Key Internal Control Issues - Continued

- Monitoring:
 - ✓ Develop financial expectations based on non-financial factors where possible
 - ✓ Perform timely monitoring and timely follow-up on exceptions
 - ✓ Ask yourself – does this make sense?

Internal Audit Philosophy

- An audit is NOT an opportunity to beat up people or an organization in an attempt to make headlines
- An audit IS a collaborative process designed to ensure that conclusions reached are accurate and complete and that recommendations, if any, achieve objectives in a cost-effective manner

Internal Audit Nightmare Scenarios

- Auditing the wrong thing the right way (e.g. auditing the supply cabinet)
- Auditing the right thing the wrong way (e.g. not verifying check/cash composition to a bank validated deposit ticket)
- Result: Lack of value added to the internal audit process

Internal Audit Approach

- Openness and transparency in the audit selection and audit process (i.e. with limited exceptions, no surprises)
- Risk-based audit approach (i.e. don't spend dollars chasing dimes)
- Recognize that the department is the subject-matter expert in the area under audit

Internal Audit Approach - Continued

- Understand the operation, e.g. “what could go wrong?”
- Effective financial analysis to expectations
- Development and proper execution of an dynamic audit plan
- Timely and effective communication with auditee

Concluding Thoughts

- Taxpayers expect that public funds are reasonably safeguarded from waste, theft and abuse, and are used for valid and allowable purposes.
- Employees expect that they are reasonably protected from being falsely accused of waste, theft and abuse of public funds.

Concluding Thoughts - Continued

- Fraud happens, even in state and local government
- The keys to fraud prevention are awareness of financial operations, effective internal controls and timely and effective monitoring

Additional Resources

- City of Kent Internal Audit – Annual Revenues and Other Financing Sources (WA Cities and Counties) *
 - Association of Certified Fraud Examiners (www.acfe.org)
 - Washington State Auditor's Office (www.sao.wa.gov)
- * Provided at the front door

Questions?

Robert Goehring, CFE, CPA
City Auditor
City of Kent Finance Department
rgoehring@kentwa.gov
(253) 856-5262

