Improving Internal Controls and Reducing the Risk of Fraud

AGA Gulf Region PDT
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Session Outline

• Public Expectations for Public Officials/Employees
• Internal Control and Risk
• The Elements of Internal Control
• Weaknesses in Internal Control that can Result in Fraud, Waste and Abuse
• Case Studies
• Reviewing Internal Control and Identifying Fraud, Waste, and Abuse
• Reporting Fraud
• Summary and Questions
Public Expectations for Public Officials/Employees

• High ethical and moral behaviors
• Public employees will conduct business within policy and procedures
• Public resources will not be wasted, lost, or stolen
• Management should conduct operations
  • Economically – at the least cost
  • Efficiently - with the least use of effort or resources
  • Effectively – accomplishing desired program goals and objectives
  • Ethically – perform fairly, faithfully, and with due regard for all rights of program participants
  • Equitably – no partiality shown in the delivery of services

Terms of Importance

• Abuse
• Fraud
• Internal controls
What Is Abuse?

- Improper or inappropriate program management
- Misuse of authority or position
- **Everything that is contrary to good order**
- Can be intentional or unintentional
- Does not have to violate a law, regulation, or contract provision
- Performing an act that falls short of societal expectations

**What are some examples of “Abuse?”**

* - See the Yellow book

What Is Fraud?

- A false representation of a matter of fact
- Concealing that which should be disclosed – deceiving to cause legal injury
- **Intentional** perversion of the truth
- To deceive another such that they rely on a false representation and surrender a valuable thing or a legal right
What is the Cost of Fraud?

**Direct Cost Associated with Fraud:**
- Loss of cash, supplies, or equipment
- Fines and Penalties

**Indirect Costs Associated with Fraud:**
- Bad publicity (citizens remember)
- Loss of public trust
- Injury to the organization’s reputation (Reputational Risk)
- Increased legislation
- Loss of future grants, gifts, and donations
- Decreased enrollment and tuition revenue

What is Internal Control?

- The policies and procedures and plan of organization established by management to promote the accomplishment of organization goals and objectives.
General Objectives of Internal Controls

- Reliability of financial information
- Compliance with laws and regulations
- Efficiency and effectiveness of operations
- Safeguarding of resources against loss due to waste, abuse, mismanagement, errors, and fraud

Components of Internal Control

- Control Environment
- Risk Assessment
- Control Activities
- Information & Communication
- Monitoring
The Five Elements of Internal Control

- Monitoring: Reviewing and managing control systems
- Control activities: Activities to address identified risks
- Risk assessment: Identification and analysis of relevant risks
- Control environment: Setting the ‘tone at the top’

COSO Illustration of Internal Control
(The Committee of Sponsoring Organizations)
Who is Responsible for Establishing the Internal Control System?

Management!!

Who is Responsible for Monitoring the Internal Control System?

Management!!
First Component of Internal Control – **Control Environment**

- The building block for all other components:
  - Integrity & ethical values
  - Commitment to competence
  - Independent audit committee
  - Management philosophy & operating style
  - Organizational structure
  - Assignment of authority & responsibility
  - Human resource policy & practices

- “The Tone at the Top”

Second Component of Internal Control – **Risk Assessment**

- Risks are essentially the opposite of control objectives
- If the objective is to safeguard assets, the risk is that assets will be lost or stolen
- Therefore, without knowing the risk, one cannot decide on the appropriate control activities
- As a manager you should continually **assess** operations to **identify** risk and potential areas for fraud and abuse
Third Component of Internal Control – Control Activities

- Link to objectives
- Accountability for resources
- Direct activity management
- Top level reviews
- **Segregation of duties**
- Physical controls
- Execution & recording of transactions & events

Considerations for Segregation of Duties

- No one person should control all phases of a transaction
- No one person should have physical access to assets and also maintain summary accounting records relating to those assets
- Where adequate controls are not possible due to staffing or resources, there should be compensating controls to mitigate risk. For example, the manager (director) should periodically review records
Fourth Component of Internal Control – Information and Communication

- Information – What types of reports are prepared and how should they be used?
- Communication – who receives the reports prepared and do they know how to use the reports?

Fifth Component of Internal Control - Monitoring

- Ongoing monitoring
- Separate evaluations
- Reporting deficiencies

* Monitoring is a management responsibility
With increasing pressure and decreased internal controls, people will explore more opportunities to create fraud.

Fraud Triangle

Pressure such as a financial need is the “motive” for committing the fraud. Pressure includes living beyond one’s means or family and relationship situations.

Rationalization The person committing the fraud frequently rationalizes the fraud. Rationalizations may include, “I’ll pay the money back”, “They will never miss the funds”, or, “I will just do this just one time” or “They don’t pay me enough.”

Opportunity The person committing the fraud sees an internal control weakness and, believing no one will notice if funds are taken, begins the fraud with a small amount of money. If no one notices, the amount will usually grow larger.

In any organization, the risk of fraud can be reduced.

* Of the above three, the one that management can most control is “__________”
Elements of Fraud

Rationalization:
• It is so easy
• They don’t pay me enough
• My child is sick
• My boss does not follow the rules, so why should I
• I'll pay it back later
• It won’t be missed
• I work extra hours each week that I do not get paid for

Elements of Fraud

Opportunities:
• Poor, weak or lack of internal controls
• Lack of monitoring the controls
• High management turnover
Who Commits Fraud?

- Married
- Between 18 and 36
- Has 2 children
- Owns a home
- Does not have a drug or alcohol problem
- Does not recognize harm to victims
- Bright
- Strong sense of challenge and game playing
- Versed in technology and skillful
- Has a position of trust

Reporting Fraud – Employees Do It Best

Source: Journal of Accountancy

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<td>Tip from employee</td>
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<td>Internal Audit</td>
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<td>Internal controls</td>
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<td>External audit</td>
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<td>Tip from customer</td>
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<td>Anonymous tip</td>
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<tr>
<td>Tip from Vendor</td>
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<tr>
<td>Notification from law enforcement</td>
<td>1.7%</td>
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</table>
Who Has the Responsibility for Detecting/Reporting Fraud?

- Management
- Employees
- External Auditors
- Internal Auditors
- Government Vendors
- Public

Approach to Detecting Fraud

- Exercise professional judgment
- Exercise professional skepticism
  - Balance between a questioning mind and doubting everyone
  - Critical assessment of evidence
Management /Employee Red Flags

**Personal Behavior Red Flags**
- Financial difficulties
- Living beyond means
- Divorce/family problems
- Control issues, unwilling to share duties
- Wheeler-dealer attitude
- Unusually close association with vendor
- Irritability, suspiciousness, or defensiveness
- Past employment-related problems
- Addiction problems
- Past legal problems
- Refusal to take vacations
- Complaining about inadequate pay
- Instability in life
- Excessive pressure from within organization
- Excessive family/peer pressure for success
- Complaining about lack of authority

Management Red Flags

- Reluctance to provide information when requested
- High employee turnover in high risk areas
- Lack of segregation of duties in a high-risk area
- Excessive number of checking accounts
- Increase in purchase of inventory but no increase in productivity
- Abnormal inventory shrinkage
- Lack of physical security over assets
- Payments to vendors not on approved vendor list
**Employee Red Flags**

- Employee lifestyle changes (expensive cars, jewelry, homes, etc.)
- Behavior changes (drug, alcohol, gambling)
- Reluctance to provide information when requested
- Refusal to take vacation or sick leave
- Excessive purchasing of supplies
- Inappropriate overtime hours
- A person that likes to be viewed as indispensable

**Potential Red Flags**

- Erased or crossed out figures
- Inconsistent inks and typefaces
- Unusual dates, amounts, notes, phone numbers, and calculations
- Consecutively numbered invoices
- Excessive voids or refunds
- Invoices in large even sums
- Multiple invoices to the same vendor just under the bid threshold (for example - $999 or $9,999)
Potential Red Flags

(Continued)

• Invoices printed on other than prepared forms
• Vendor address change
• Unusual number of payments to one payee
• Inadequate description of item purchased
• Delay in responding to request for documentation
• Stale invoice dates

Expenditures of Public Funds

• Every expenditure of public funds must serve a public purpose
• It is the responsibility of the person incurring the expense to identify the expressed and/or implied authority relied upon to justify the purchase – the authority to act
• It is the responsibility of the public agency to document the expenditure in the public records so that the pre-auditor, post auditor, and the public can clearly see the basis relied upon to incur the expense
• Every purchase stands on its own
Case Study One

• City Fleet Department

- Parts supervisor could order, receive, and issue parts. Could also open closed work orders and adjust the inventory
- Suspicious transactions with three vendors identified
- Collusion with one vendor
- Losses totaled almost $3 million over five years.
- City employees and vendors prosecuted
- Theft was not material to each year’s internal service fund financial statements
Number of large dollar invoices all for the same amount

Notice instructions Improper
Same Amounts
No Description
Consecutive#

Invoice
Altered with Whiteout
Summary for Case Study Two

- Any weaknesses in:
  - Control environment?
  - Control Risk?
  - Control Activities?
  - Information and Communication?
  - Monitoring?

Where do you Place Responsibility

- With the City?
- With the Vendors?
- With Both?
Case Study Two

• Leon County Research and Development Authority

Case Study Two - Leon County Research and Development Authority

• Organizational Background
• Board Composition – Nine Members
• Staff – An Executive Director and an Office Manager
• External Auditors – Same for several years
• Financial Statements – Clean opinions
• Monthly budget to actual statements - prepared by the office manager
• Treasurer reports – prepared by the office manager
• Audit Committee – well-intentioned but absent a strong charter
Discovery of a $650,000 Fraud

- A change in auditors in 2010 led to the discovery of a $650,000 fraud that spanned 5 years
- The previous audit focused on the revenue side, believing the expenditure side was not a significant risk and therefore doing minimal testing of expenditures

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Number of Fraudulent Checks Written</th>
<th>Total Amount of Fraudulent Checks</th>
<th>Total Operating Expenses – Salaries, Depreciation &amp; Other</th>
<th>Percent Fraud of Total Operating Expenses</th>
<th>Total Other Expenses</th>
<th>Percent of Fraud of Other Expenses (Not Including Salaries and Depreciation)</th>
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<td>2005 – 2006</td>
<td>11</td>
<td>$41,075</td>
<td>$1,014,203</td>
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<td>2006 – 2007</td>
<td>13</td>
<td>$80,947</td>
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<td>$468,114</td>
<td>17.3%</td>
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<td>2007 – 2008</td>
<td>30</td>
<td>$172,948</td>
<td>$1,387,237</td>
<td>12.47%</td>
<td>$628,398</td>
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<td>(1) Note: Salaries and Depr. Were $758,000</td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>2008 – 2009</td>
<td>39</td>
<td>$239,684</td>
<td>$958,736</td>
<td>Approximately 25%</td>
<td>$481,410</td>
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<td>2009 -2010</td>
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<td>$647,451</td>
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</table>
Internal Controls - The Office Manager

- Received and opened the mail to include receiving tenant rental payments, vendor invoices for services provided, and monthly bank statements to include cancelled checks
- Had custody of check stock
- Had signature stamps
- Prepared invoices for payment to include preparing checks for signature by someone other than herself
- Maintained the accounting records and prepared and presented monthly financial and budget reports for meetings
- Reconciled the check book to the bank statement for review by the Executive Director. Cancelled checks were not provided to the Executive Director

What Was Not Known by the Previous Auditors or the Board

- The Office Manager was fired by her former employer and found guilty of a felony for embezzlement of over $100,000
- During the time the Office Manager worked for the Board (during the day), she also performed community service at night at the County jail as part of her previous sentence
- No background check was performed by the Board upon employment of the Office Manager – the previous auditors were aware of no background check through inquiry, noted this in the working papers, but took no further action
The Office Manager

• Drove an expensive vehicle
• Lived in an expensive home
• Was married with children and was a devoted parent
• Was well liked
• Was praised by the previous auditors in their audit report for being helpful to them

Discovery of the Fraud by the New Auditors

• The Office Manager failed to timely respond to records request
• The new auditors observed the Manager’s lifestyle
• The auditors checked and verified through the county records that a criminal history existed
• The auditors noticed a check that appeared unusual
• **The auditors made a direct request to the bank for copies of cancelled checks**
• The auditors notified the Audit Committee Chair of their concern as well as the Board Chair
The Office Manager Asked to Explain Herself at a Board Meeting

- The Office Manager admitted that she did not tell the Board when she was hired that she was previously fired by her former employer for embezzlement – she said she was not asked.
- The Office Manager denied any wrongdoing while with the Board.
- The Office Manager accused one of the Board Members of sexual harassment.
- The Office Manager was subsequently convicted and sentenced to prison.
- To date the Board has received little monies back from the former employee. It recovered $100,000 from its insurance company and additional monies from the previous auditors.
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<tr>
<th>P.O. No.</th>
<th>Item Code</th>
<th>Description</th>
<th>Price Each</th>
<th>Quantity</th>
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<td>8</td>
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<td>HANG. 1200</td>
<td>1.80</td>
<td>10</td>
<td>18.00</td>
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Total: $337.00

Balance Due: $7,011.00

PAID

Date: 5/4/2015
### Invoice 1

**Bill To:**
LEON COUNTY RESEARCH & DEVELOPMENT
751 W PAUL DRACKE DRIVE
TALLAHASSEE, FL, 32310

**Ship To:**
COLLENS BUILDING - 008
211 S PAUL DRACKE DRIVE
TALLAHASSEE, FL, 32319

**P.O. No.:**

<table>
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<tr>
<th>Item Code</th>
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<td>R22 FRIEON</td>
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<td>30.00</td>
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**PLEASE PAY FOR THIS INVOICE.**

**Total:** $333.60

**Balance Due:** $333.60

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### Invoice 2

**Bill To:**
LEON COUNTY RESEARCH & DEVELOPMENT
751 W PAUL DRACKE DRIVE
TALLAHASSEE, FL, 32310

**Ship To:**
MORGAN BUILDING

**P.O. No.:**

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<td>R22 FRIEON</td>
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**PLEASE PAY FOR THIS INVOICE.**

**Total:** $430.00

**Balance Due:** $430.00

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**5/4/2015**
What Was the Board’s (and /or Audit Committee’s) Responsibility

- To ensure that an adequate system of internal control existed
  - The control environment
  - Risk activities
  - Control activities
  - Information and communication
  - Monitoring

- Other specific responsibilities
  - Existence of adequate policies and procedures
  - Meet with the auditors to discuss the planned audit, and any concerns about risk and the system of internal control
  - To follow up on audit findings and recommendations and to take corrective actions
What was the Auditor’s Responsibility

- To conduct the financial statement audit in accordance with Generally Accepted Government Auditing Standards
- To plan the audit to obtain reasonable assurance
- To use professional judgment
- To consider fraud in a financial statement audit and to provide reasonable assurance on whether the f/s are free of material misstatement, whether caused by error or fraud
- To brainstorm about fraud risk

Specific GAGAS

- Follow up on previous significant findings
- Exercise professional skepticism
- Use professional judgment
- Consider lower materiality levels for government entities
- Report on significant deficiencies and material weaknesses in internal control over financial reporting

Opportunities to Detect Fraud

- Confirm vendor payments or year-end payables
- Obtain copies of cancelled checks directly from the bank or review checks on-line. Instead, cancelled checks provided by the Office manager were traced to vendor invoices and accounting records
- Review the organization process for performing background checks
- Requests were made to the accountant to review specific checks. Bank statements were not reviewed
- W/P’s indicate no conditions susceptible to fraud in amounts material to the financial statements
- Audit procedures did not vary from year to year

This was not a complicated fraud – it was a fraud of opportunity and did not involve collusion among employees.
Reputational Risk

• This fraud made the front page of the local paper on numerous occasions
• Previous Board members were embarrassed
• The name of the Board (Park) was linked to the fraud as opposed to its mission for many months
• Subsequent clean audits
• For recent audits, there were no material weaknesses, significant deficiencies, or management comments.

Comment from Office Manager to previous auditor’s inquiry about any knowledge of fraud:

“I can honestly say that I know of none, nor do I know of any allegations of fraud.”
Where Do you Place Responsibility?

- With the Board?
- With the Audit Committee?
- With Management (one person)
- With the Auditors?
- With all of them?

Case Study Two

- Was there a weakness in
  - Control environment?
  - Control risk?
  - Control activities?
  - Information and communication?
  - Monitoring?
Examples of Fraud

- Lack of accountability over ticket sales
- Lack of segregation of duties for receipt of money and the recording of the money
- Writing off accounts receivable and subsequent collection of the money
- Theft of supplies, parts, fuel,
- Theft of equipment – computers, blowers, chain saws, lawn mowers
- Making refunds for fictitious items
- Falsifying a travel voucher for travel not performed or for payments not made
- Collusion in capital construction projects

Other examples?

What are Some Suggestions

- Be aware that fraud and abuse can exist
- Exercise professional judgment and professional skepticism
- Perform background checks
- Discuss risk and fraud with employees and assess the adequacy of mitigating controls
- Brainstorm with staff and supervisors on risk and controls. Document discussions
- Look for persuasive fact-based evidence of asserted controls
- Assess the adequacy of responses to questions
10 Tips on How to Deter Fraud in Your Organization

1. Integrity at the Top
2. Positive Reputation
3. New-hire Screening Process
4. Ethics Programs
5. Written Fraud Program with Expectation of Consequences

6. Communicate Policies to Vendors
7. Proper Handling of Investigations
8. Independent Internal Audit Function
9. Effective Internal Controls and Auditing
10. Open Internal Reporting
What to Do When You Suspect or Discover Fraud?

• Do not pursue or investigate yourself so as not to interfere with potential future investigations or legal proceedings
• Secure documentation
• Do not discuss with fellow employees
• Notify your supervisor
• Notify upper management (department directors) if you do not feel that your concerns have been investigated satisfactorily

Reporting Fraud

• Report fraud as soon as you become aware of it
• Don’t assume someone else will report it
• Prevents fraud from growing
• Discourages others from committing fraud
• Employees who report fraud in good faith are protected from retaliation by Section 112.3187, Florida Statutes (Whistle-blower’s Act)
IMPROVING INTERNAL CONTROLS AND REDUCING THE LIKELIHOOD OF FRAUD

It Starts With You!

Thank you!!!

Sam McCall
850 644-0651
smmccall@fsu.edu
Questions?