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Fraud, Internal Controls, & Audit Testing

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Fraud Statistics

- ▶ It is estimated that the typical organization loses 5% of its annual revenue to fraud.
- ▶ The average fraud lasted an average of 18 months before being detected.
- ▶ Frauds are most likely to be detected by tip
- ▶ Small organizations are most commonly victimized due to lack of anti-fraud controls
- ▶ Anti-fraud controls appear to reduce the cost & duration of fraud schemes
- ▶ Industries most commonly victimized are banking/financial services, manufacturing, and government/public administration

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3 Main Classifications of Fraud & Abuse

Corruption	Asset Misappropriation	Fraudulent Statements
<ul style="list-style-type: none"> • Conflicts of interest • Bribery • Illegal Gratuities 	<ul style="list-style-type: none"> • Cash • Non-Cash 	<ul style="list-style-type: none"> • Financial • Non-Financial

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Fraud Statistics

- ▶ High-level perpetrators cause the greatest damage. Frauds committed by owners/executives were more than 3x as costly as frauds committed by managers, and more than 9x as costly as employee frauds.
- ▶ Executive-level frauds took much longer to detect.
- ▶ More than 80% of the cases were committed by individuals in one of six departments: accounting, operations, sales, executive/upper management, customer service, or purchasing.

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Fraud Statistics

- ▶ More than 85% of fraudsters had never been previously charged or convicted for a fraud-related offense.
- ▶ Fraud perpetrators often display warning signs.

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Behavioral Red Flags of Perpetrators

- ▶ Living beyond means
- ▶ Financial difficulties
- ▶ Control issues, unwillingness to share duties
- ▶ Unusually close association with vendor/customer
- ▶ Wheeler-dealer attitude
- ▶ Divorce/family problems
- ▶ Irritability, suspiciousness, or defensiveness
- ▶ Addiction problems

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Behavioral Red Flags of Perpetrators

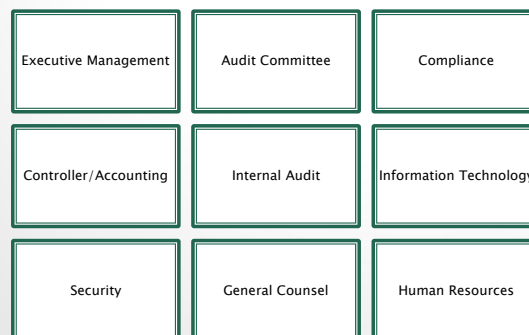
- ▶ Refusal to take vacations
- ▶ Past employment-related problems
- ▶ Complained about inadequate pay
- ▶ Excessive pressure from within organization
- ▶ Past legal problems
- ▶ Instability in life circumstances
- ▶ Excessive family/peer pressure for success
- ▶ Complained about lack of authority

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Implementing an Anti-Fraud Program

- ▶ It is important to involve many departments in the implementation of the anti-fraud program, such as:



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Implementing an Anti-Fraud Program

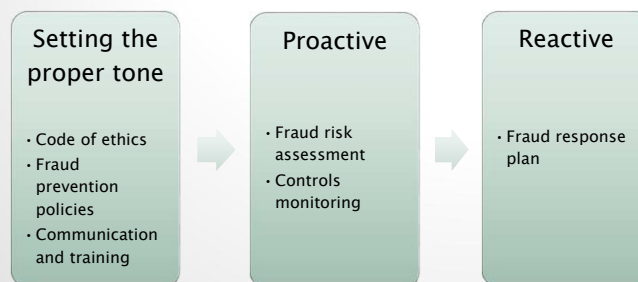
- ▶ Once the team is established, each person should clearly articulate their role and responsibilities to avoid duplication of efforts.
- ▶ It is also very important to constantly communicate with each other openly and honestly.

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Implementing an Anti-Fraud Program

- ▶ Anti-fraud programs should consist of three categories:

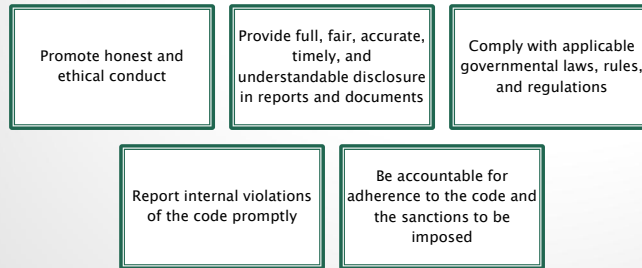


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Implementing an Anti-Fraud Program

▶ Setting the Proper Tone: Code of Ethics

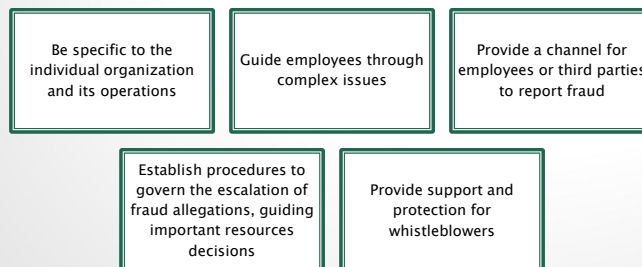


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Implementing an Anti-Fraud Program

▶ Setting the Proper Tone: Fraud Prevention Policies



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Implementing an Anti-Fraud Program

▶ Setting the Proper Tone: Communication and Training

Educate employees regarding the government's code of ethics

Understand the protocols for reporting suspicious activity

Communicate the disciplinary actions that may be taken in the event of fraud

Raise awareness of fraud schemes and scenarios that are specific to the City

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Implementing an Anti-Fraud Program

▶ Proactive: Fraud Risk Assessment

Identify common types of fraud schemes that could occur within any organization

Specify fraud schemes that are industry, and sector, specific as well as geographic

Create a road map for future areas to analyze with analytical procedures and determine if controls are sufficient to mitigate

Provide annual and real-time updates to fraud risk assessment work plan to address change in business environment, acquisitions, current issues, etc.

Consider all areas of the organization to identify areas of weakness

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Implementing an Anti-Fraud Program

▶ Proactive: Controls Monitoring

Rank fraud schemes identified within the risk assessment

Develop action plans to assess, improve, and/or monitor the controls associated with the risks identified

Report the results of the action plans to executive management and/or the audit committee

Challenge prior year controls and analytics protocols to update with current state issues and effective use of technology

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Implementing an Anti-Fraud Program

▶ Reactive: Fraud Response Plan

Establish investigation protocols

Coordinate remediation action steps across business units

Maintain consistent disciplinary procedures

Help "set the tone" within the government with respect to fraud

Develop investigation protocols for internal and external resources

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General Controls

- ▶ Segregation of Duties
- ▶ Cross Training
- ▶ Documented independent approvals for everything
- ▶ Examine items for reasonableness – Ask questions!!!
- ▶ Perform analytical reviews
- ▶ Document policies in all areas & adhere to those policies

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Banking

Bank Transfers

- ▶ Set limitations with the bank to only allow transfers to other City accounts or authorized vendors if doing online payments
- ▶ Have the bank require two authorizations

Bank Reconciliations

- ▶ Independent person from the check writing process should prepare the bank reconciliation or at least review
- ▶ Prepare bank reconciliations timely and investigate differences
- ▶ Investigate old outstanding checks

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Cash Receipts – General

- ▶ Centralize cash receipts if possible
- ▶ Make timely deposits
- ▶ Two people should sign off on every cash count & reconciliation with source reports
- ▶ Pre-numbered receipt books (make sure to reconcile receipt books to deposit)
- ▶ Investigate voided pre-numbered items
- ▶ Investigate adjustments of any kind
- ▶ Track over/short by employee if possible
- ▶ Account for all credit cards reversals (two people should approve all reversals)
- ▶ Follow up on old receivables

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Cash Receipts – Court

Reconcile:

- ▶ Court receivables monthly
- ▶ Bonds payable monthly
- ▶ Bond cash and bonds payable
- ▶ Tickets issued by ticket number (recommended by state auditor)
- ▶ Police bond book with court deposit
- ▶ Adjustments – verify approval with judge or docket

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Cash Receipts – Parks

- ▶ Reconcile deposits to monthly reports if possible
- ▶ Monitor park usage – users vs receipts
- ▶ Monitor inventory – compare inventory decreases to receipts
- ▶ Reconcile adjustments or voids

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Payroll

- ▶ Document approval for wage increases
- ▶ Have someone independent enter new employees & restrict access for this
- ▶ Manually pass out paychecks/stubs a few times a year
- ▶ Make sure all time is approved & OT appears reasonable
- ▶ Have another person review & approve before payday

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Credit Card Purchases

- ▶ Reconcile all receipts with the monthly statement
- ▶ Document approval for all purchases
- ▶ Receipts should state valid business purpose for purchase (restaurant receipts should state who attended & what was discussed)
- ▶ Set limits with the CC company regarding credit limits, restrictions on cash advances, and what items can be purchased, if possible

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Cash Disbursements

- ▶ Document approval on all invoices
- ▶ Restrict access for entering new vendors
- ▶ Perform new vendor checks (Google or phone book)
- ▶ The check signer should be independent & they should review the invoices while signing
- ▶ Check that bidding procedures were appropriate

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Gasoline Procedures

- ▶ Track gasoline usage by vehicle and employee
- ▶ Analyze miles per gallon
- ▶ Require employees to enter correct odometer readings
- ▶ Restrict access to fuel pumps

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The Church Lady

- ▶ Worked 8 years in accounts payable for the roman catholic archdiocese of New York and embezzled more than \$1 million over 7 years
- ▶ Colleagues praised her for dedication and hard work, her charity work, she prayed often, and attended church daily
- ▶ No one questioned the hundreds of small checks she wrote for office supplies and utility bills
- ▶ Her weakness: expensive dolls
- ▶ The mail woman stated they received an extremely high volume of packages
- ▶ Flags raised during annual audit
- ▶ 468 checks to her son. After check was printed, she would change the GL to legitimate vendor
- ▶ Less than \$2,500 each to avoid supervisor approval
- ▶ Didn't do background check on her, but she has been previously convicted of grand larceny in one case and pleaded guilty to a misdemeanor in another

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Auto Dealer Controller

- ▶ Took \$10 million over 7 years – salary = \$50,000
- ▶ More than 800 Wire transfers to her personal accts & recorded fake inventory
- ▶ Her reason: she felt like a “horrible daughter, wife, mother, and friend” and the gifts were a way to “earn their Love” because she wanted to see “what happiness looks like.”
- ▶ Lavish spending – 4 houses, 10 vehicles, Louis Vuitton luggage, jewelry, prepaid travel funds, private jet charters and commercial airfare, vacations, vip tours and luncheons, super bowl tickets, meals with celebrities, etc
- ▶ Plead guilty, expect to recover only \$1 million

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Fraud Prevention Checklist

- ▶ Is ongoing anti-fraud training provided to all employees of the organization?

Do employees understand what constitutes fraud?

Have the costs of fraud to the company and everyone in it – including lost profits, adverse publicity, job loss, and decreased morale and productivity – been made clear to employees?

Do employees know where to seek advice when faced with uncertain ethical decisions, and do they believe they can speak freely?

Has a policy of zero tolerance for fraud been communicated to employees through words and actions?

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Fraud Prevention Checklist

- ▶ Is an effective fraud-reporting mechanism in place?

Have employees been taught how to communicate concerns about known or potential wrongdoings?

Is there an anonymous reporting channel available to employees, such as a third party hotline?

Do employees trust that they can report suspicious activity anonymously and/or confidentially and without fear of reprisal?

Has it been made clear to employees that reports of suspicious activity will be promptly and thoroughly evaluated?

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Fraud Prevention Checklist

- ▶ To increase employees' perception of detection, are the following proactive measures taken and publicized to employees?

Is possible fraudulent conduct aggressively sought out, rather than dealt with passively?

Does the organization send the message that it actively seeks out fraudulent conduct through fraud assessment questioning by auditors?

Are surprise fraud audits performed in addition to regularly scheduled fraud audits?

Is continuous auditing software used to detect fraud and, if so, has the use of such software been made known throughout the organization?

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Fraud Prevention Checklist

- ▶ Is the management climate/tone at the top one of honesty and integrity?

Are employees surveyed to determine the extent to which they believe management acts with honesty and integrity?

Are performance goals realistic?

Have fraud prevention goals been incorporated into the performance measures against which managers are evaluated and that are used to determine performance-related compensation?

Has the organization established, implemented, and tested a process for oversight of fraud risks by the board of directors or others charged with governance (for example, the audit committee)?

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Fraud Prevention Checklist

- ▶ Are fraud risk assessments performed to proactively identify and mitigate the company's vulnerabilities to internal and external fraud?
- ▶ Are strong anti-fraud controls in place and operating effectively, including the following?

Proper segregation of duties

Use of authorizations

Physical safeguards

Job rotation

Mandatory vacations

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Fraud Prevention Checklist

- ▶ Does the internal audit department, if one exists, have adequate resources and authority to operate effectively and without undue influence from senior management?
- ▶ Does the hiring process include the following?

Past employment
verification

Criminal and
civil background
checks

Credit check

Drug screening

Education
verification

References
check

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Fraud Prevention Checklist

- ▶ Are employee support programs in place to assist employees struggling with addiction, mental/emotional health, family, or financial problems?
- ▶ Is an open-door policy in place that allows employees to speak freely about pressures, providing management the opportunity to alleviate such pressures before they become acute?
- ▶ Are anonymous surveys conducted to assess employee morale?

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