



Hochschild, Bloom & Company LLP
Certified Public Accountants

Preventing Fraud & Establishing Strong Internal Controls

Michelle Barefield, CPA
March 15, 2017

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

Association of Certified Fraud Examiners' survey

Hochschild, Bloom & Company LLP
Certified Public Accountants



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.

Hochschild, Bloom & Company LLP
Certified Public Accountants



3 Main Classifications of Fraud & Abuse

Corruption	Asset Misappropriation	Financial Statement Fraud
<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

Financial Statement fraud caused by far the greatest median loss per scheme. 75% - financial statement fraud, 15% corruption & 10% asset misappropriation.

Hochschild, Bloom & Company LLP
Certified Public Accountants



Fraud Statistics

- ▶ Victim Organizations that lacked anti-fraud controls suffered greater average losses – twice as much

- ▶ Schemes with largest dollar losses
 - Billing
 - Non cash items (parts, supplies)
 - Expense reimbursements
 - Check tampering
 - Cash on Hand
 - Payroll

Hochschild, Bloom & Company LLP
Certified Public Accountants



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.

Hochschild, Bloom & Company LLP
Certified Public Accountants



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
- ▶ Irritability, suspiciousness, or defensiveness
- ▶ Addiction problems

Hochschild, Bloom & Company LLP
Certified Public Accountants



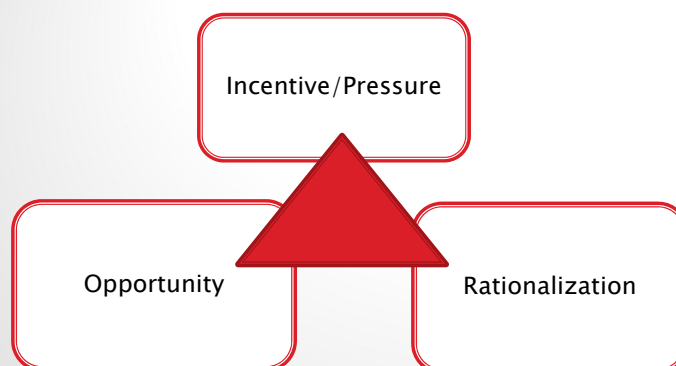
Behavioral Red Flags of Perpetrators

- ▶ 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

Hochschild, Bloom & Company LLP
Certified Public Accountants



Fraud Triangle



Hochschild, Bloom & Company LLP
Certified Public Accountants



Prevention – 1st Line of Defense

- ▶ Fraud policy statement
- ▶ Fraud control plan and training
- ▶ Policy and procedure guidelines
- ▶ Effective whistle blower process
- ▶ Effective screening of potential employees (legal search/verification of qualifications)
- ▶ Annual declarations by employees and service providers
- ▶ Annual distribution of fraud policy & whistle blower process

Hochschild, Bloom & Company LLP
Certified Public Accountants



Prevention – How to Enhance Whistle Blower Process

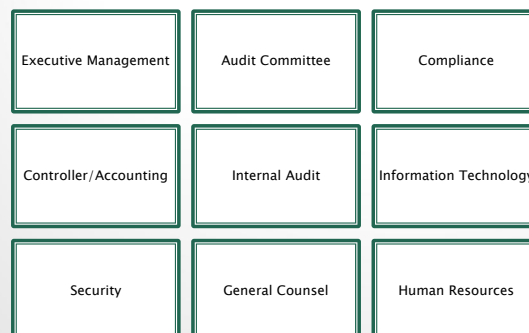
- ▶ Tips uncover more fraud than other methods
- ▶ Staff awareness of process
- ▶ Proper maintenance of communication channel (ie. active/monitored e-mail address)
- ▶ Ensure confidentiality
- ▶ Promote trust in process so that employees do not have concerns for their continued employment after reporting fraudulent suspicions

Hochschild, Bloom & Company LLP
Certified Public Accountants



Implementing an Anti-Fraud Program

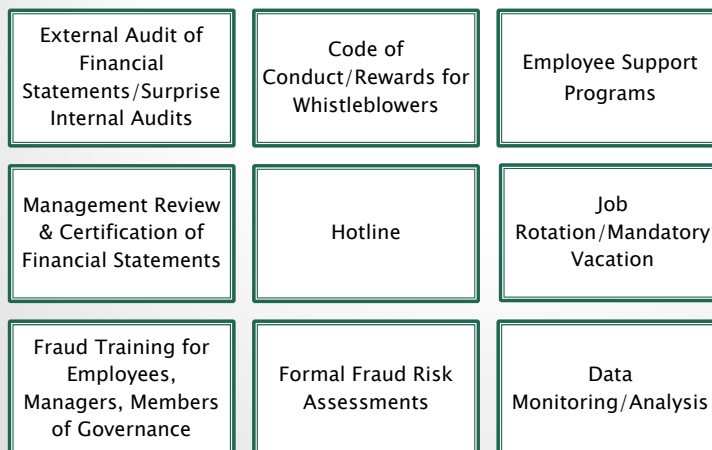
- ▶ It is important to involve many departments in the implementation of the anti-fraud program, such as:



Hochschild, Bloom & Company LLP
Certified Public Accountants



Anti-Fraud Controls



Hochschild, Bloom & Company LLP
Certified Public Accountants



Implementing an Anti-Fraud Program

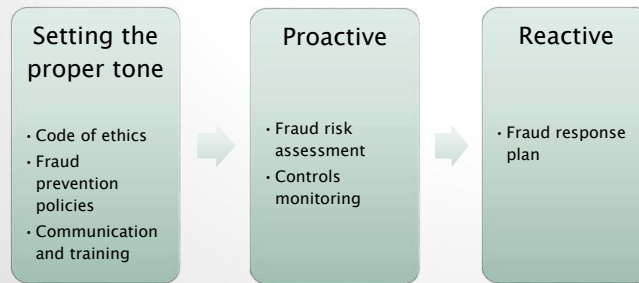
- ▶ Once the team is established, each person should clearly articulate their role and responsibilities to avoid duplication of efforts.
- ▶ It is also very important to constantly communicate with each other openly and honestly.

Hochschild, Bloom & Company LLP
Certified Public Accountants



Implementing an Anti-Fraud Program

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

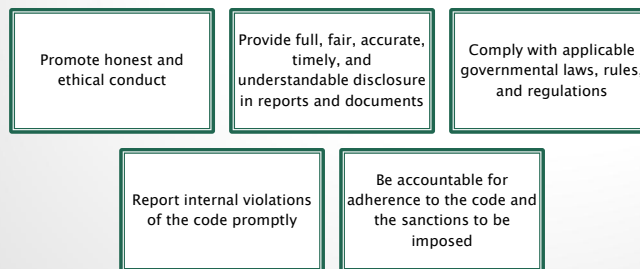


Hochschild, Bloom & Company LLP
Certified Public Accountants



Implementing an Anti-Fraud Program

- ▶ Setting the Proper Tone: Code of Ethics
- ▶ Involvement of Governance to set tone at the top



Hochschild, Bloom & Company LLP
Certified Public Accountants



Implementing an Anti-Fraud Program

▶ Setting the Proper Tone: Fraud Prevention Policies

Be specific to the individual organization and its operations

Guide employees through complex issues

Provide a channel for employees or third parties to report fraud

Establish procedures to govern the escalation of fraud allegations, guiding important resources decisions

Provide support and protection for whistleblowers

Hochschild, Bloom & Company LLP
Certified Public Accountants



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

Hochschild, Bloom & Company LLP
Certified Public Accountants



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

Hochschild, Bloom & Company LLP
Certified Public Accountants



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

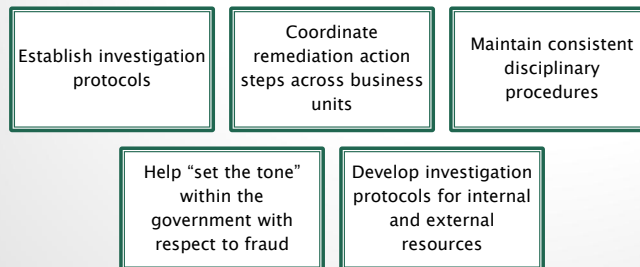
Challenge prior year controls and analytics protocols to update with current state issues and effective use of technology

Hochschild, Bloom & Company LLP
Certified Public Accountants



Implementing an Anti-Fraud Program

▶ Reactive: Fraud Response Plan



Hochschild, Bloom & Company LLP
Certified Public Accountants



What are Internal Controls?

- Methods and procedures used to provide reasonable assurance that the systems of policies and procedures:
 - Protect the assets of an organization
 - Ensure the validity of financial records and reporting
 - Promote adherence to policies and procedures, as well as compliance with laws and regulations
 - Achieve effective and efficient operations

Hochschild, Bloom & Company LLP
Certified Public Accountants



High Risk Areas for Internal Control (partial listing)

- ▶ General Controls
- ▶ Banking
- ▶ Cash Receipts
 - General
 - Court
 - Parks
- ▶ Payroll
- ▶ Credit Card Purchases
- ▶ Cash Disbursements
- ▶ Fuel Procedures

Hochschild, Bloom & Company LLP
Certified Public Accountants



General Controls

- ▶ Are there segregation of duties?
- ▶ Are employees cross trained?
- ▶ Are there documented independent approvals for everything?
- ▶ Are analytical reviews performed – comparing current results to prior year and to budget?
- ▶ Are questions asked of appropriate area if there are questions during the analytical review?
- ▶ Are policies and procedures documented?

Hochschild, Bloom & Company LLP
Certified Public Accountants



Segregation of Duties

- ▶ Segregation of duties is critical for effective internal controls
 - ❖ Reduces the risk of both erroneous and inappropriate actions
 - ❖ Is a deterrent to fraud because it requires collusion with another person to perpetrate a fraudulent act.

Hochschild, Bloom & Company LLP
Certified Public Accountants



Segregation of Duties – Continued

- ▶ When assessing adequate segregation of duties, no one person should:
 - ❖ Initiate transaction
 - ❖ Approve transaction
 - ❖ Record transaction
 - ❖ Reconcile balances
 - ❖ Handle assets
 - ❖ Review reports

Hochschild, Bloom & Company LLP
Certified Public Accountants



Segregation of Duties – Continued

- ▶ At a minimum, the approval function, the accounting/reconciling function, and the asset custody function should be separated among employees.
- ▶ When these functions cannot be separated, a detailed supervisory review of related activities is required as a compensating control activity.

Hochschild, Bloom & Company LLP
Certified Public Accountants



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 deposits and checks

Hochschild, Bloom & Company LLP
Certified Public Accountants



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

Hochschild, Bloom & Company LLP
Certified Public Accountants



Cash Receipts – Court

Are court receipts collected by non-court personnel?

Is someone reconciling?:

- ▶ 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

Hochschild, Bloom & Company LLP
Certified Public Accountants



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

Hochschild, Bloom & Company LLP
Certified Public Accountants



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

Hochschild, Bloom & Company LLP
Certified Public Accountants



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

Hochschild, Bloom & Company LLP
Certified Public Accountants



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 followed

Hochschild, Bloom & Company LLP
Certified Public Accountants



Fuel Procedures

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

Hochschild, Bloom & Company LLP
Certified Public Accountants



Implementing an Anti-Fraud Program – Examples of Data Analysis Techniques

- ▶ Identify an unusual relationships between vendors and employees (same bank accounts/addresses)
- ▶ Identify unusual payments
 - Payments made before invoice date
 - Payments posted after hours
 - Rounded amounts or frequent, repetitive payment amounts
 - Scan vendor payment lists
 - Verify employees listed on payroll register
- ▶ Review any purchase orders that have been split to possibly avoid necessity of supervisory authorization.

Hochschild, Bloom & Company LLP
Certified Public Accountants



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

Hochschild, Bloom & Company LLP
Certified Public Accountants



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

Hochschild, Bloom & Company LLP
Certified Public Accountants



Summary Action Points

- ▶ Ensure fraud risk assessments are comprehensive and not just “tick the box” exercise
- ▶ Regularly update assessments to reflect changes, especially if new programs are introduced
- ▶ Fraud plan should include nomination of a person responsible for assessment, implementation, monitoring risk and consideration of alternative controls to mitigate risk
- ▶ Use data analytics for fraud detection
- ▶ Staff managing payments, procurement and contracting processes should participate in fraud training.
- ▶ Involvement of members of Governance.

Hochschild, Bloom & Company LLP
Certified Public Accountants



Hochschild, Bloom & Company LLP
Certified Public Accountants

BEST PRACTICES

Presentation Outline

- ▶ Financial reports per statutes and regulations
- ▶ GFOA best practices
- ▶ Pitfalls to avoid –
 - Restricted amounts
 - Auditors
 - IRS

Hochschild, Bloom & Company LLP
Certified Public Accountants



Missouri Revised Statutes Chapter 105 Public Officers and Employees--Miscellaneous Provisions

Section 105.145.1

Political subdivisions to make annual report of financial transactions to state auditor.

1. The following definitions shall be applied to the terms used in this section:

- (1) "Governing body"....;
- (2) "Political subdivision"....

2. The governing body of each political subdivision in the state shall cause to be prepared an annual report of the financial transactions of the political subdivision in such summary form as the state auditor shall prescribe by rule, except that the annual report of political subdivisions whose cash receipts for the reporting period are ten thousand dollars or less shall only be required to contain the cash balance at the beginning of the reporting period, a summary of cash receipts, a summary of cash disbursements and the cash balance at the end of the reporting period.

Hochschild, Bloom & Company LLP
Certified Public Accountants



15 CSR 40–3.030 Annual Financial Reports of Political Subdivisions (cont.)

- ▶ (4) The annual financial report shall be mailed to the State Auditor's Office at PO Box 869, Jefferson City, MO 65102, or emailed to PolySubFS@auditor.mo.gov.
- ▶ (5) An unaudited annual financial report shall be submitted within six (6) months after the end of the political subdivision's fiscal year; an audit report prepared by a certified public accountant shall be submitted within six (6) months after the end of the political subdivision's fiscal year.

Hochschild, Bloom & Company LLP
Certified Public Accountants



RSMo – Semiannual statements

- ▶ **Fourth Class Cities 79.160** – The board of aldermen shall semiannually each year, at times to be set by the board of aldermen, make out and spread upon their records a full and **detailed account and statement of the receipts and expenditures and indebtedness of the city for the half year** ending with the last day of the month immediately preceding the date of such report, which account and statement shall be published in some newspaper in the city.
- ▶ **Third Class Cities 77.110** – The council shall publish a full and detailed statement of the **receipts and expenditures and indebtedness of the city at the end of each fiscal year and six months after the end of each fiscal year** in a newspaper of general circulation in the city. Each such statement shall be for the six-month period preceding the date of the statement.

Hochschild, Bloom & Company LLP
Certified Public Accountants



Best Practices

GFOA has many (180+) Best Practices/Advisories

<http://www.gfoa.org/best-practices>

Selected Ten Commonly Discussed

1. Appropriate level of fund balance - MINIMUM 2 months or 17% of annual expenditures
2. Audit committees
3. Capitalization threshold for capital assets
4. Controls for items not capitalized
5. Credit cards
6. Documenting accounting policies and procedures
7. Enhancing tax abatement transparency
8. Getting management involved in internal control
9. Practical steps to avoid, limit, or eliminate internal control deficiencies identified in an audit
10. Questionable practices/fraud reporting

Hochschild, Bloom & Company LLP
Certified Public Accountants



Illustrative Disclosure (GASB 77)

Note X. Tax Abatements

The Village enters into property tax abatement agreements with local businesses under

the state Economic Development Opportunity Act of 20X1. Under the Act, localities may grant property tax abatements of up to 50 percent of a business' property tax bill for the purpose of attracting or retaining businesses within their jurisdictions. The abatements may be granted to any business located within or promising to relocate to the Village.

For the fiscal year ended June 30, 20X7, the Village abated property taxes totaling \$146,480 under this program, including the following tax abatement agreements that each exceeded 10 percent of the total amount abated:

- A 40 percent property tax abatement to a grocery store chain for purchasing and opening a store in an empty storefront in the business district. The abatement amounted to \$97,500.
- A 50 percent property tax reduction for a local restaurant increasing the size of its restaurant and catering facility and increasing employment. The abatement amounted to \$21,750.

Hochschild, Bloom & Company LLP
Certified Public Accountants

Pitfalls To Avoid

Restricted revenues should be used per restriction and a system should be in place to monitor expenditures and balances:

- ▶ Grant money – Grant revenue should be in same fund that spent the money.
- ▶ Have a system to track restricted revenues and related expenditures for:
 - Capital Improvements tax, Parks/Stormwater tax, Fire tax, Economic Development tax, Road and Bridge tax, Gasoline tax, Motor Vehicle Sales/Fee Increase taxes, etc.

Hochschild, Bloom & Company LLP
Certified Public Accountants



Pitfalls To Avoid

IRS Quick Reference Guide For Public Employers

www.irs.gov/pub/irs-pdf/p5138.pdf

Hochschild, Bloom & Company LLP
Certified Public Accountants





Hochschild, Bloom & Company LLP
Certified Public Accountants

POLICY & PROCEDURES MANUAL

Arts & Science to Compiling a Policy & Procedures Manual

- ▶ Detail exact precise procedures
- ▶ Use copies of real forms used & screen shots
- ▶ Procedures should be detailed enough to allow someone with knowledge of the software and organization in general to be able to perform the function
- ▶ Not too detailed but detailed enough:
 - Individual key strokes are not often needed
 - Depending on the function, it is a good idea to make sure you “error on the side” of too detailed.

Hochschild, Bloom & Company LLP
Certified Public Accountants



What To Include:

- ▶ Introduction
- ▶ Date last updated
- ▶ Responsible position/person
- ▶ List of functions/Table of contents
- ▶ How to perform the functions/Procedures
- ▶ Policies
- ▶ Sample forms and screen shots
- ▶ City codes, ordinances, resolutions, etc. that are applicable

Hochschild, Bloom & Company LLP
Certified Public Accountants



Additional Items to Consider:

- ▶ Purchasing policies
- ▶ Investment policies
- ▶ Record retention policy/manual
- ▶ Should be readily available to all employees
- ▶ Should be evaluated annually and updated periodically, no less than once every three years.

Hochschild, Bloom & Company LLP
Certified Public Accountants



Other Issues:

- ▶ Does it have to be adopted by the Board or ordinance or resolution?
- ▶ Additional items to consider:
 - 1099s, W2s (fringe benefits reported on W2–life insurance, auto, 457 plan, uniforms)
- ▶ Computer backup policy
- ▶ Computer access and updates
- ▶ Each person should update list of their functions annually

Hochschild, Bloom & Company LLP
Certified Public Accountants



Questions and Discussion

Michelle Barefield, CPA
Audit Manager

Hochschild, Bloom & Company LLP, CPA's
15450 South Outer Forty Road, Chesterfield, Mo
1000 Washington Square, Washington Mo
(636) 532-9525

mbarefield@hbclp.com



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?

Hochschild, Bloom & Company LLP
Certified Public Accountants



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?

Hochschild, Bloom & Company LLP
Certified Public Accountants



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?

Hochschild, Bloom & Company LLP
Certified Public Accountants



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)?

Hochschild, Bloom & Company LLP
Certified Public Accountants



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

Hochschild, Bloom & Company LLP
Certified Public Accountants



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

Hochschild, Bloom & Company LLP
Certified Public Accountants



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?

Hochschild, Bloom & Company LLP
Certified Public Accountants

