

Internal Controls – It's Not Just for Auditors Anymore

Ensuring Accountability in Your Organization



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Learning Objectives

- Highlight the importance of leadership in establishing an ethical organizational culture.
- Understand fraud risks in today's economic environment.
- Understand the importance of good internal control for preventing fraud
- Review examples of internal controls that your organization should have in place



Introduction

Fraud vs. Ethics

Ethics vs. Fraud

- Fraud is a clear example of ethical lapse, but not all ethical lapses are fraud.
 - Fraud is illegal.
- Strong ethics program will assist in preventing/detecting fraud.
- Ethics is more than compliance.
 - Doing the right thing, not just what is legal.

Ethics vs Fraud

Ethics is knowing the difference between what you have a right to do and what is right to do.

– Potter Stewart

Unethical practices - how harmful can it be?

- Media reports
- Loss of integrity/reputation
- Possible
 - Loss of trust of taxpayers/constituents
 - Loss of customers
 - Loss of vendors
 - Loss of employees
- Justification for further “bad decisions”



Ethical Dilemmas – Causes

- Pressure from Management
 - Leaders must set the correct tone.
- Pressures from public/taxpayers/constituents
- Current economy pressures
- Ambition
- Discrimination

Ethical Dilemmas – Solutions

- Entity-wide policies.
- Training / continuous communication of policies.
- Monitoring/reporting tools.
- Assessing current environment/economy.
- Other

Ethical Culture in Current Economy

- Entities should:
 - Identify challenges.
 - Respond appropriately.
- How can the current economy impact your ethical culture?

Ethical Culture in Current Economy

Potential risks/challenges:

1. Maintaining professional competence.
2. Misuse of funds.
3. Being “conservative”.
4. Conducting personal business on company time.
5. Paying employees equally.
6. Social Networking

Establishing an Ethical Culture

- **Strategic Leadership of Ethical Behavior in Business**
- Thomas, Schermerhorn, Dienhart

“The strategic leadership of ethical behavior in business can no longer be ignored. Executives must accept the fact that the moral impact of their leadership presence and behaviors will rarely, if ever, be neutral.

In the leadership capacity, executives have great power to shift the ethics mindfulness of organizational members in positive as well as negative directions.”

Establishing an Ethical Culture

“Rather than being left to chance, this power to serve as ethics leaders must be used to establish a social context within which positive self-regulation of ethical behavior becomes a clear and compelling organizational norm and in which people act ethically as a matter of routine.”

Establishing an Ethical Culture

- Leadership must set tone and example.
 - Character of senior management is critical.
 - ◇ Trustworthy
 - ◇ Transparent
 - ◇ Fair
 - Must adhere to commitments and promises.
 - Support ethical standards and decisions.

Ethical Decision....A Matter of Routine

Watch your thoughts, for they become words. Watch your words, for they become actions. Watch your actions, for they become habits. Watch your habits, for they become character. Watch your character, for it becomes your destiny.

- *Anonymous*

Values are like fingerprints. Nobody's are the same, but you leave 'em all over everything you do.

— *Elvis Presley*



Fraud

In Governments

Fraud in Governments - Examples

- School District CFO. Electricity expense increases due to “hot summer”.
- Federal funds
 - Public Assistance benefits. Giving to family members.
 - Student Financial Aid. Increase enrollment.
 - Obtaining capital assets for personal use/sale
- FTE Changes/overtime to increase salary and “pad” retirement base
- Procurement cards used for personal purchases

Fraud Quiz

The most common type of fraud is:

- a. Fraudulent financial reporting
- b. Misappropriation of assets
- c. Corruption (conflict of interest)
- d. Petty theft
- e. Identity theft



Fraud Quiz

The most common type of fraud is:

b. Misappropriation of assets



Fraud Quiz

The average amount of time from inception to detection of fraud schemes is:

- a. 1-5 months
- b. 6-11 months
- c. 12-23 months
- d. 23-35 months
- e. Greater than 5 years



Fraud Quiz

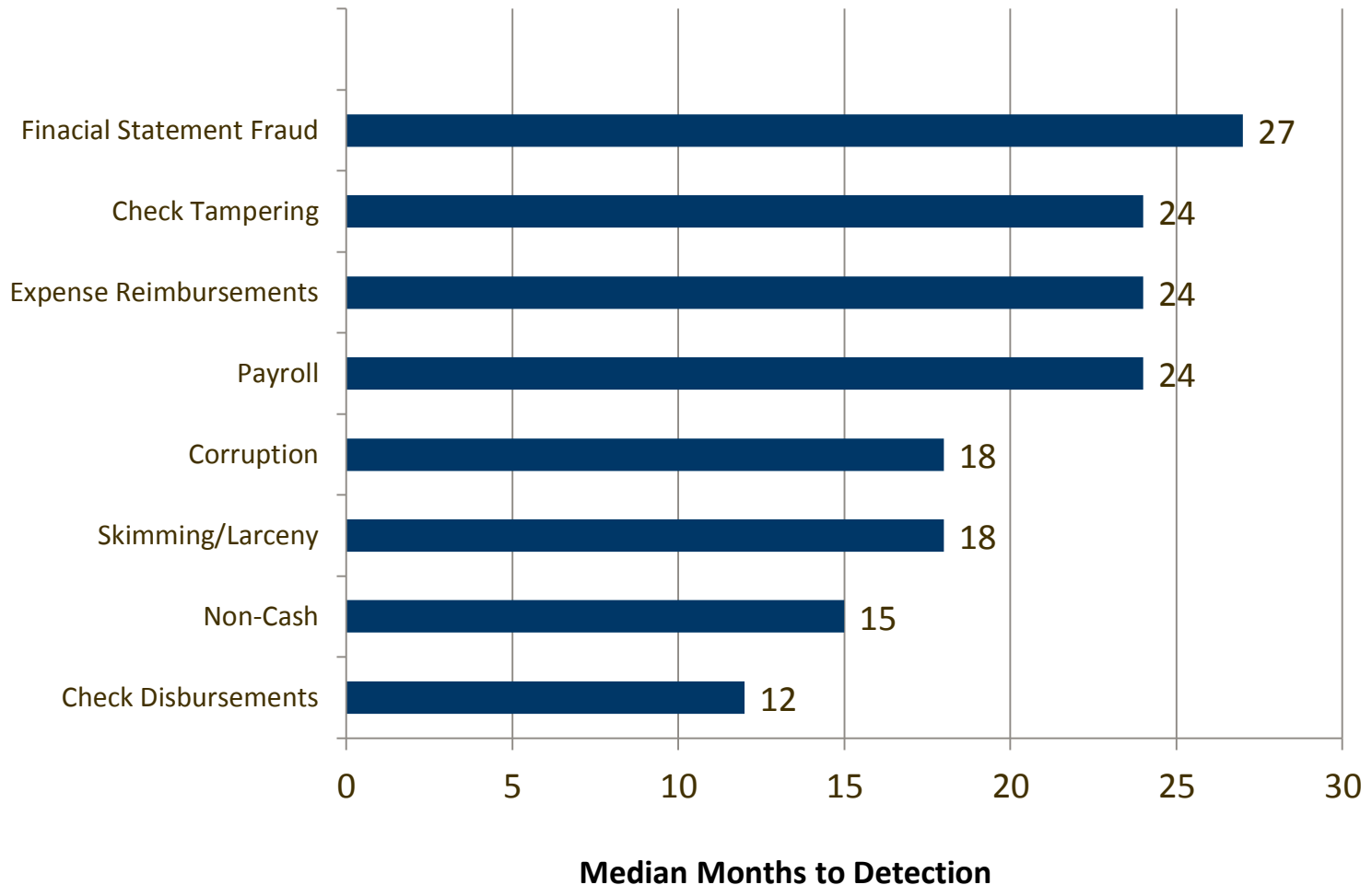
The average amount of time from inception to detection of fraud schemes is:

c. 12-23 months



Fraud Quiz

Median Duration of Fraud Based on Scheme Type



2014 Report to the Nations

- Report to the Nations on Occupations Fraud and Abuse
- Survey conducted by Certified Fraud Examiners.
- Compiled from a study of 1,483 cases of occupational fraud that occurred in more than 100 countries
- Median loss - \$145,000 worldwide and \$100,000 in U.S.
- Approx. 22% of cases resulted in losses exceeding \$1,000,000.

Victims of Fraud

- Industries most commonly victimized:
 - banking and financial services,
 - government and public administration, and
 - manufacturing sectors.
- Presence of anti-fraud controls - significant decreases in cost and duration of fraud schemes.
- Nearly half of victim organizations do not recover any losses due to fraud.

Fraud Quiz

Frauds are generally detected by:

- a. Internal audit
- b. Management review
- c. External audit
- d. By accident
- e. Tip from an employee



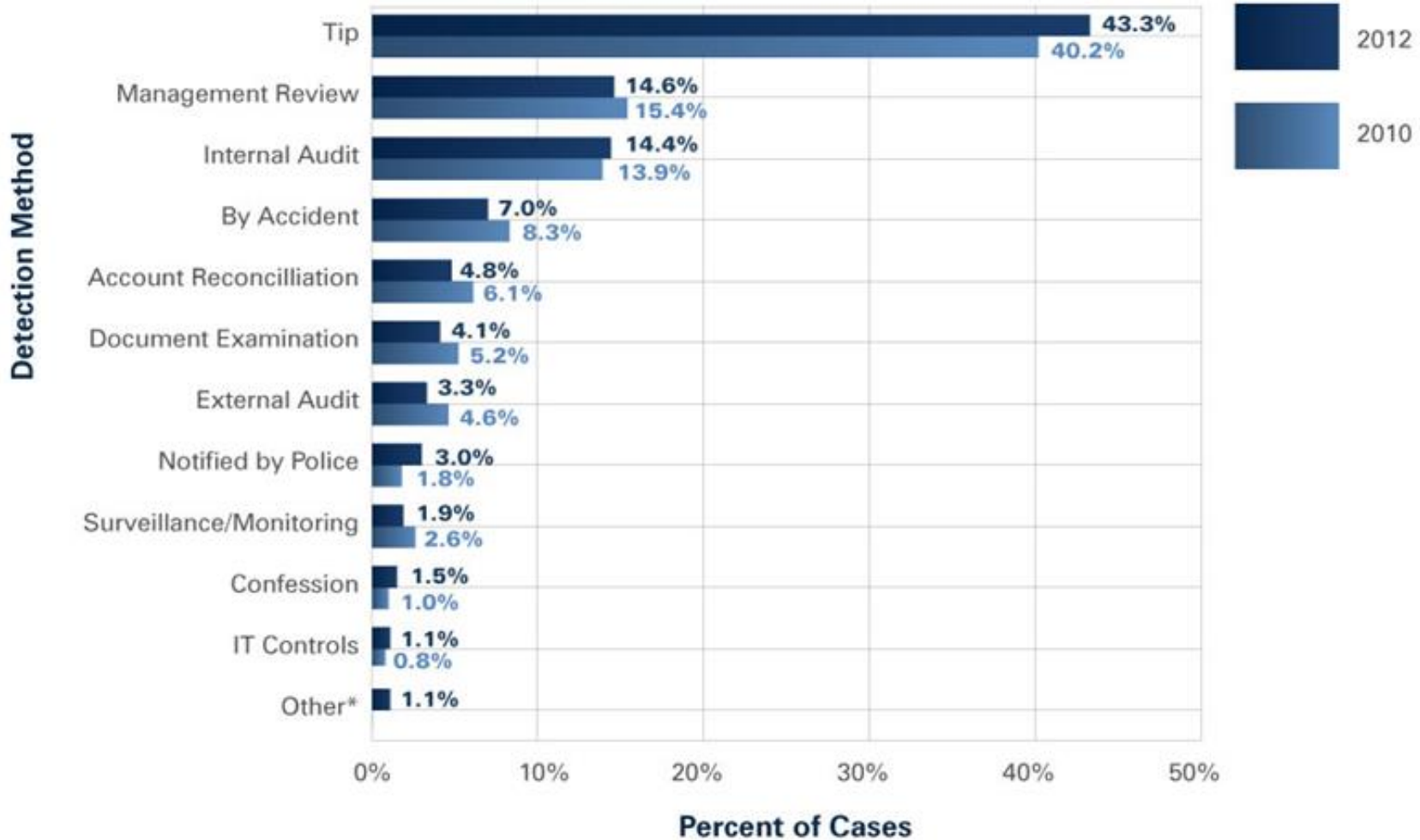
Fraud Quiz

Frauds are generally detected by:

e. Tip from an employee



Detection of Fraud

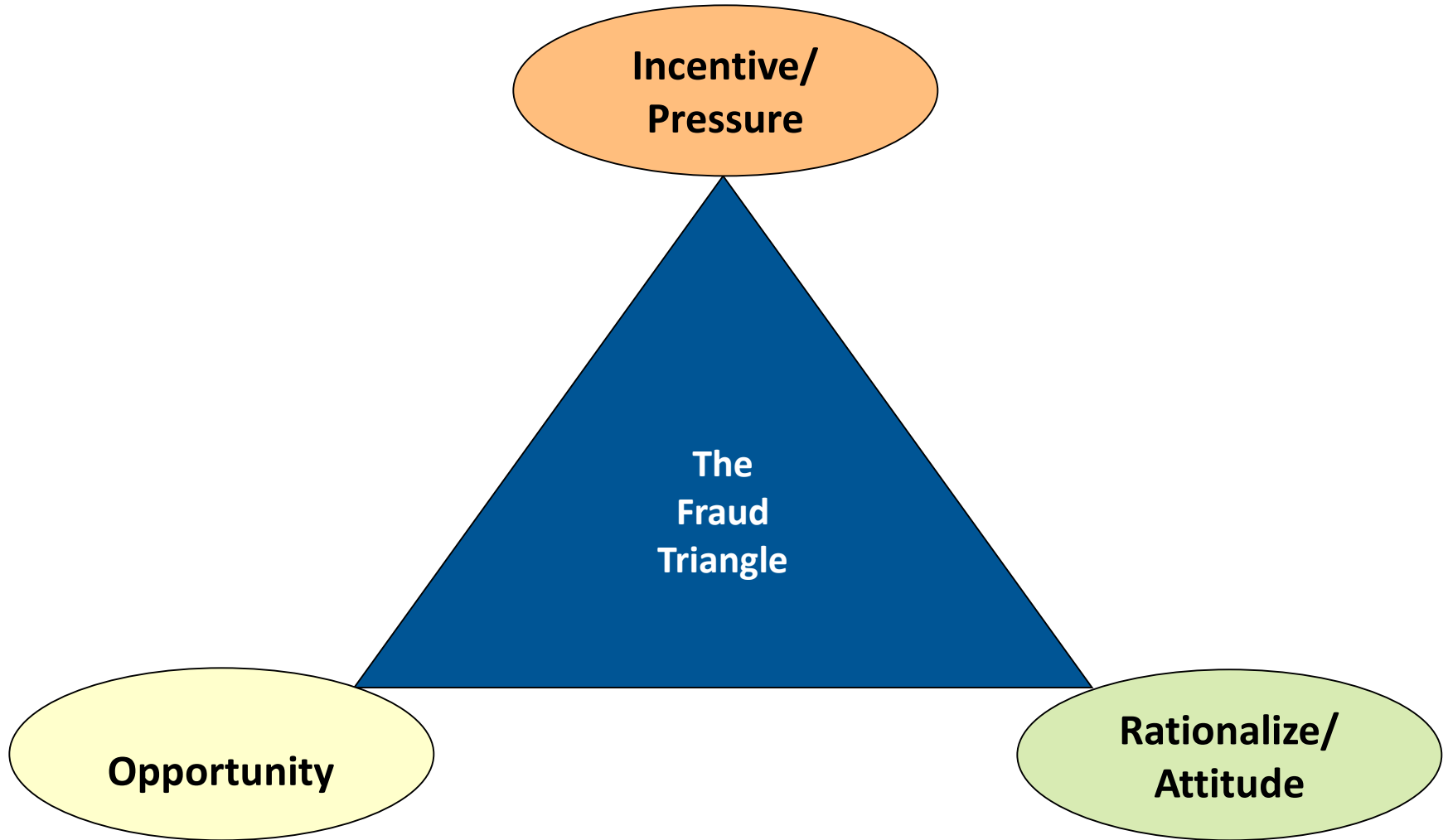


How Harmful Can Fraud Be?

- Loss of assets
- Cost of investigation is very high
- Ability to prosecute can be very low
- Loss of integrity/reputation
- Once the media reports it, possible
 - Loss of trust of taxpayers, constituents
 - Loss of vendors, or at least restrictions
 - Loss of employees
- Loss of focus on operations



Why Fraud Occurs



Fraud Quiz

Which measures are the most helpful in preventing fraud:

- a. Ethics training for employees
- b. Fraud audits
- c. Strong internal controls
- d. Background checks on new employees
- e. Willingness to prosecute



Fraud Quiz

Which measures are the most helpful in preventing fraud:

c. Strong internal controls



Fraud Controls - Prevention

Preventative Controls - designed to prevent fraud before it has occurred.

Examples:

Multiple people or lock boxes for checks

Timely account balancing and reconciling and reviewing

Passwords and physical safeguards

Authorization, approval, and limits

Segregation of duties



Fraud Controls - Detection

Detective Controls - designed to detect fraud after it has occurred.

Examples:

Exception reports

Systems maintenance reports

Documentation reviews

Internal Audit/Periodic Sampling



Controls and Segregation of Duties

- The optimal design for internal controls is separating the 4 significant components of a transaction or activity:
 - Initiation of transaction or activity
 - Authorization of transaction or activity
 - Recording of transaction or activity
 - Reconciliation of transactions or activities

Accounts Payable and Disbursements

- Does your organization use purchase orders?
- Who creates new vendors?
- Does someone else approve new vendors?
- Who has access to the master vendor file?
- Can the same person create a vendor and enter an invoice for payment?
- Can the same person enter an invoice and cut a check?
- Do checks print without a signature on them?
- Who signs the checks?
- Is the check stock blank? Is it kept secured?

Payroll

- Are there proper segregation of duties between HR and payroll functions?
 - New employees approved.
 - Changes in pay rates approved.
- If the reviewer changes pay rate or hours after review, would it be caught?
- Can those in accounting access the payroll system?
- FTE Changes approved?
- Overtime monitored?

Cash Receipts

- Who receives cash in your organization?
- Are two employees present when counting cash?
- Does your organization use duplicate receipts and/or a cash control log?
- Does the person receiving cash have access to record receipts in the I/T system?
- Does someone outside of the accounting department receive bank statements?
- Who prepares the bank deposit? How often?

Fraud Policy

- Definitions of unacceptable behavior.
- Employees' role in:
 - Monitoring behavior of others
 - Detecting potential fraud
- Appropriate communication channels for reporting fraud.

Fraud Policy

- Parties responsible for investigation.
- Statement on confidentiality regarding those reporting potential fraud.
- Statements forbidding:
 - Cover-up.
 - Retaliation against witnesses.
- All investigative activity should be reported to audit committee.

Fraud Policy

- Continuously reinforced through:
 - Requiring employees to acknowledge understanding of policy.
 - Communicating employees channels to report fraud.
 - Reinforcing through strong action against wrongdoing.
 - **Training employees on identifying risk of fraud or potential indicators of fraud.**

Fraud Quiz

The age group that is most likely to commit fraud is:

- a. Less than 40 years old
- b. 36-40 years old
- c. 41-50 years old
- d. 51-60 years old
- e. greater than 60 years old



Fraud Quiz

The age group that is most likely to commit fraud is:

c. 41-50 years old

Fraud Quiz

The education level of people who commit fraud is more likely to be those with:

- a. Post graduate degree
- b. Bachelors degree
- c. High school education
- d. Less than high school education
- e. Education level does not appear to be relevant



Fraud Quiz

The education level of people who commit fraud is more likely to be those with:

- a. Post graduate degree
- b. Bachelors degree**
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How to Identify Embezzlement in Your Employees

- Significant lifestyle changes
- Living beyond their means
- Rarely takes vacation
- Reluctant to provide information to management
- Tireless worker, seems indispensable
- Co-workers are intimidated by them

Signs that Embezzlement is Occurring...

- Increasing Accounts Payable or Receivable
- Expenses unusually high or large increases
- Unexplained adjustments to G/L accounts
- Many journal entries at month end
- Decreasing collection rates
- Increased adjustments on bank reconciliation

Signs that Embezzlement is Occurring...

- Discrepancies between bank deposits and posting
- No cash in deposits
- Untimely deposits
- Frequent transfers
- Unusual payroll increases
- Lack of transparency of accounting information

Fraud Risk Assessment

- Can be informal.
- Performed by management, internal audit personnel, and others with knowledge of Entity.
- Hold interviews or group discussions/brainstorm.
- Consider entity's vulnerability to misappropriation of assets.

Fraud Risk Assessment

Are you asking:

- Who has opportunity?
- Known pressures?
- What assets of are susceptible to misappropriation?
- Known internal control weaknesses?
- How could potential misappropriation of assets be concealed?
- Culture enable management or employees to rationalize committing fraud?

Key Control Questions

The following are questions that every organization should ask themselves when evaluating key internal control areas:



Fraud Prevention Checklist

1. Is ongoing anti-fraud training provided to all employees?
2. Is an effective fraud policy/reporting mechanism in place?
3. Does management make it clear that fraud will not be tolerated?
4. Are fraud risk assessments performed to identify and mitigate vulnerabilities to fraud?
5. Are strong anti-fraud controls in place and operating effectively?

Fraud Prevention Checklist (Continued)

6. Can the internal audit department operate without undue influence from senior management?
7. Does the hiring process include background checks, drug screening, etc.?
8. Are employee support programs in place?
9. Does the culture promote an open-door policy, where employees can speak freely about pressures? Does it promote a strong ethical culture?
10. Are surveys done to assess employee morale?

Real Life Example #1

- Executive Vice President of an entity in Arizona
- Lived a lavish lifestyle
- Created seven false vendors which he used to bill the entity for personal items
- Occurred over a seven-year period
- Employee was writing a book on how to embezzle funds from your employer!
- Theft of \$11 million



Real Life Example #2

- Employee was the secretary of a business
- Handled financial records including check writing
- Ability to transfer from the line of credit to the checking account to handle overdrafts
- Had access to business credit/debit cards
- Embezzlement was more than \$200,000 over a three-year period
- Other staff noticed funds were missing from the business bank account
- Husband had lost job early on



Real Life Example #3

- Representative of Bursar Office handled CPE and night classes
- Payment was required to be done by credit card
- Accounting reconciled credit card deposits to Bursar records (prepared by representative)
- Person was highly trusted
- Person was 45
- Lived a very high level life style



Real Life Examples #3 (Continued)

- The student would pay for classes using their credit card
- The Bursar would take one of their personal credit cards and make a refund for the exact payment
- The student got a receipt and a payment showed on their credit card and the class records were manipulated by the Representative
- One credit card company caught the pattern
- Theft Loss: \$125,000 over one year



Questions





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