



KERKERING
BARBERIO





Kerkering, Barberio & Co.
Certified Public Accountants

1990 Main Street, Suite 801, Sarasota, FL 34236

6320 Venture Drive, Suite 203, Lakewood Ranch, FL 34202

941-365-4617 • www.kbgrp.com



ESSENTIAL INTERNAL CONTROLS TO MINIMIZE RISK: Staying Above Water in a Tough Economy

June 29, 2010

Presented by:

SHARELLE TURNER, CPA/CFF/CFE/CDFA and PATRICIA ENTSMINGER, CPA



**Kerkering, Barberio & Co.
Shareholder**

**(941) 365-4617
sturner@kbgrp.com**

SHARELLE TURNER, CPA/CFF/CFE/CDFA™

Areas of Practice

Ms Turner's areas of practice include litigation support services involving fraud/embezzlement engagements, dissolutions of marriage, contract disputes, personal injury, wrongful death and wrongful termination.



**Kerkering, Barberio & Co.
Shareholder**

**(941) 365-4617
pentsminger@kbgrp.com**

PATRICIA ENTSMINGER, CPA

Areas of Practice

Ms Entsminger concentrates her practice in business assurance, advisory, and audit of large nonprofits and manufacturers. Other areas of specialization include the analysis and design of internal control systems, forensic accounting, and developing programs to assess compliance with governmental regulations including federally funded contracts and grants.

Overview

The three most important things that you can do to protect your organization and to minimize risk are:

1. Educate yourself and your employees about fraud and how it could affect your organization
2. Take steps to prevent fraud
 - Create a culture of honesty and high ethics
 - Perform fraud risk assessments and develop procedures to address these risks
3. Implement fraud detection procedures



Topics



1. Fraud Education

- Statistics
- Fraud and NFP Organizations
- Types of fraud
 - Internal fraud
 - External fraud
 - Financial reporting fraud
 - Asset misappropriation
- Elements of fraud
 - Pressure
 - Rationalization
 - Opportunity



Topics



2. Fraud Prevention

- Organizational culture
- Fraud risk assessment
 - Identifying risks
 - Assessing likelihood & significance
 - Respond to risks
- Internal control best practices

3. Fraud Detection





Fraud Education

- Management and employee education is the foundation of preventing and detecting occupational fraud
- Staff members are an organization's top fraud detection method
- Should be trained in what constitutes fraud, how it effects the organization and everyone in it, and how to report questionable activity
- What you need to know about fraud is discussed next



Fraud Statistics

- The typical organization victimized by fraud loses 5 - 9% of annual revenues to fraud
- Approximately 15% of fraud cases reported involve NFP organizations
- Most frauds are committed by individuals in the accounting department or upper management
- Smaller organizations are more victimized by fraud than larger organizations
- Of frauds committed, 90% of cases involved asset misappropriation
- Of typical fraud schemes reported, detection did not occur for 18 – 24 months



Characteristics of NFP Organizations

- Not for Profit organization's tend to be dominated by people who are passionate about the mission
- More trust is put into individuals because those assume that all others have the same passion and integrity
- Tendency to ignore checks and balances
- Limited funding and emphasis on maximizing program related expenses put strain on proper "segregation of duties"



Characteristics of NFP Organizations

- NFP organizations have a duty to donors and the general public to ensure that funds are used for their intended purpose
- Community places trust in NFP organizations
- Good reputation = donor's trust and confidence = sustained or increased contributions



Types of Fraud

External fraud: Committed by persons outside the organization

Includes

- Fraudulent billings by vendors – charging for services or goods not received, charging phony fees
- Service organizations: third parties outsourced who accept vendor kickbacks, charge for false services
- Sub-recipients of grants funds – report false information regarding the use of funds received
- Financial assistance fraud – individuals who receive assistance based on false information

Types of Fraud



Internal fraud

- Committed by those within the organization
- Generally more costly and more common
- Focus of this presentation

Two types of internal fraud

- I. Fraudulent financial reporting
- II. Asset Misappropriation



I. Fraudulent Financial Reporting

Intentionally making false assertions or statements relating to financial statements in order to mislead

- Not complying with funding requirements
- Charging unallowable costs to grants / awards
- Failing to disclose significant related party transactions
- Failing to disclose non-compliance with debt covenants
- Misclassifying donor restrictions or not complying with restrictions
- Holding books open to inflate revenues
- Misclassifying functional classification of expenses to mislead
- Failing to correctly value assets and / or liabilities
- Excluding payables to understate expenses or not reporting other obligations



I. Asset Misappropriation

Asset misappropriation schemes

- A. **Skimming:** Cash is stolen from an organization before it is recorded as revenue on the books
- B. **Larceny:** Cash is stolen after it's been recorded, but before it has been deposited into the bank
- C. **Billing:** Payment is issued for an invoice for fictitious goods, inflated invoices or invoices for personal purchases
 - Fictitious vendor schemes
- D. **Expense Reimbursements:** Employee makes a claim for personal, fictitious, or inflated expenses
- E. **Credit Card abuse:** Use of company cards for personal use or use of donor credit card numbers
- F. **Check tampering:** Checks received are forged and deposited into personal account, company checks stolen and forged, or altering a signed check



I. Asset Misappropriation

- G. Payroll:** Involves false claims for compensation by overstating hours worked or adding ghost employees
- H. Cash Disbursements:** False entries are made into the accounting records to conceal removal of cash, such as voiding transactions
- I. Cash on Hand:** employee steals cash from petty cash or cash vault
- J. Personal use:** Use of organization's computers, software, printers, long distance telephone, copier, etc for personal projects
- K. Non-cash:** Theft of assets
 - PP&E
 - Supplies
 - Donated assets used for fundraising
 - Inventory



I. Asset Misappropriation

- Breakdown of asset misappropriation schemes in non-profits
 - 29% - Personal use
 - 28% - Expense reimbursements
 - 28% - Billing
 - 24% - Check tampering or forgery
 - 24% - Skimming
 - 17% - Cash larceny
 - 14% - Non cash theft
 - 13% - Payroll
 - 5% - Fraudulent statements and wire transfers

Sum of percentages exceed 100% because most fraud cases involve multiple schemes.



Who Commits Fraud?

- One study found that fraudsters generally had more characteristics in common with a college student than with incarcerated criminals convicted of other property charges
- Fraud perpetrators are likely to be
 - Educated
 - Trusted employees
 - Loyal, long time employees
 - Mentally stable
- Individuals who commit fraud are normal individuals who are presented with the right mix of the elements of fraud

Elements of Fraud



The fraud triangle is representative of the three elements that must be present for fraud to occur.

THE FRAUD TRIANGLE



Combining the right level of pressure and rationalization with opportunity allows an individual to commit fraud.



Elements of Fraud

Pressure: the perceived need or motivation to commit fraud

- Financial pressures
 - Overwhelming debt, poor credit, living beyond one's means
 - Personal financial losses or unexpected financial needs
 - Greed
 - Vices – drug, gambling, theft or spending addictions
- Other pressures
 - Organizational improvement
 - Frustration with work conditions, job dissatisfaction, fear of losing job, feeling underpaid, overlooked for promotion
 - Challenge to “beat the system”
 - Stress from others to improve lifestyle



Elements of Fraud

Rationalization: A person's ability to perceive the act of fraud as acceptable

- Belief that they are underpaid and are “deserving”
- Belief that they will re-pay any funds taken
- Personal code of conduct which allows an individual to commit dishonest acts
- Perception that the organization owes it to them
- Perception that is for a good purpose
- Belief that no one will get hurt
- Belief that something has to be sacrificed – integrity or reputation



Elements of Fraud

Opportunity: Circumstances exists where individuals perceive not only a way to commit fraud, but also the ability to conceal the fraud or not be punished for the fraud

- Poor control environment
- Lack of controls
- Ineffective controls
- Lack of independent checks which would detect fraud
- Ability for management to override or circumvent controls
- Lack of an audit trail
- Failure to discipline



Fraud Prevention

- The most cost effective way to reduce losses due to fraud is to prevent fraud
- When pressures and opportunities are high, less rationalization is needed for a person to commit fraud
- Prevention encompasses policies, procedures, training and communication that stop fraud from occurring



Fraud Prevention

Fraud prevention involves two fundamental activities

1. Creation and maintenance of a organizational culture of honesty and high ethics
2. Fraud risk assessment and development of responses to mitigate identified risks to eliminate opportunities for fraud to occur

Organizational Culture



Three critical elements

1. Tone at the top

- Communicate strong ethical expectations of employees
 - Code of conduct
 - Employee handbook
 - Provide fraud awareness and ethics training
- Act as an example and show that dishonest, questionable, or unethical behavior will not be tolerated
- Avoid at all costs, giving people the rationalization to defraud

Organizational Culture



Three critical elements (continued)

2. Hire the right kind of employees through effective hiring practices
 - Conduct background investigations
 - Verify education and prior employment
 - Check references
 - Test for honesty and other attributes
 - Training for interpreting responses to inquiries of candidates and knowing fraud symptoms

Organizational Culture



Three Critical Elements (continued)

3. Develop a positive work environment –
 - Reward good work or behavior, provide positive feedback
 - Promote equality
 - Participative management
 - Organizational loyalty
 - Reasonable expectations and pay
 - Define responsibilities
 - Open communication
 - Provide training and promotion opportunities



Fraud Prevention

The most important element in fraud prevention

Implementation of a formal process for **risk assessment** used to create policies and procedures that implement internal controls to address risks that are the most significant to your organization



Fraud Risk Assessment

Should be performed periodically and systematically to identify potential opportunities or schemes where fraud might occur

- Where could fraud occur
- Who could commit the fraud
- How could controls be overridden or circumvented
- How could the fraud be concealed



Fraud Risk Assessment

Who should perform the fraud risk assessment

- Accounting and finance personnel
- Nonfinancial operations personnel
- Risk management personnel or consultant
- Legal / compliance personnel or consultant
- Internal audit personnel
- Others with expertise in standards, risk indicators, anti-fraud methodology, control activities, and detection procedures



Fraud Risk Assessment

Step 1: Identify inherent fraud risks

- Types of frauds that could occur
- Incentives
- Pressures
- Opportunities
- IT risks



Fraud Risk Assessment

Step 1 Example

It is useful to create a listing of transaction cycles to brainstorm possible fraud schemes considering each group of individuals that could commit fraud

Revenue Recognition

Employees – misstated due to misappropriation of assets

Management –

- Inflate revenues by keeping books open
- Inflate revenues by recognizing conditional promises to give or pledges not legally receivable



Fraud Risk Assessment

Step 2: Assess the likelihood and significance of risks identified

- How likely is the fraud to occur
- What could be the potential cost to the organization



Fraud Risk Assessment

Step 3: Respond to reasonably likely and significant risks

- Perform cost / benefit analysis of adopting procedures that include internal controls that would defer and detect fraud

Internal Control Best Practices



- Internal controls should be designed in a manner that address the fraud risks that are most likely and most significant.
- An area susceptible to fraud for essentially all companies is cash.
- Duties should be segregated so that individuals which record transactions are never in custody of cash. Likewise, those that are charged with the responsibility of handling cash should not have the ability to enter data into the accounting records unless that access is limited to read only.
- The goal is to eliminate the opportunity for those with access to cash to cover up any misappropriations.

Internal Control Best Practices



- Individuals who are check signers should not have access to check stock or enter data into the accounting records.
- Duties within a function should be separated so that one person does not perform processing from the beginning to the end of any process. For example, the mail should be opened and a receipt log prepared by an employee who is not involved with entering cash receipt data into the accounting records and both functions should be segregated from the employee who prepares the deposit ticket.
- Policies and procedures incorporating internal controls should be in writing.



Fraud Detection

- Focuses on activities and techniques that promptly recognize timely whether fraud has occurred or is occurring
- One of the strongest fraud deterrents is the awareness that effective detection controls are in place
- Anti-fraud controls help reduce cost and duration of fraud schemes
- May be more cost beneficial to implement detection controls where it is not feasible to rely on preventive controls, such as segregation of duties
 - Lack of or weakness in preventive controls increases need for detection controls



Fraud Detection

Whistleblower Hotlines

- Studies show that anonymous tips are the most likely means of detecting fraud
- Anonymity is key
- Promoted through educational materials / training provided to employees
- Should be reported to others beside senior management to ensure all reports are followed up on. Best is board or audit committee



Fraud Detection

Process Controls

- Specifically designed to detect fraudulent activity and errors
- Include
 - Reconciliations
 - High level, independent reviews
 - Physical inspections/counts
 - Analyses (flux analysis, reasonableness)
 - Audits (surprise audits)



Fraud Detection

Be Observant: Fraudsters exhibit warning signs of their misdeeds

- Living beyond their means
- Experiencing financial difficulties
- Exhibiting control issues
- Never taking vacations
- Working odd hours
- Disgruntled

Train managers and employees to recognize warning signs



Fraud Detection

Don't rely on financial statement audits to detect fraud

- Audits are important and have a strong preventative effect of fraudulent behavior, but they should not be considered as part of the organization's fraud detection controls



Examples of Fraud

New CFO at Capital Area United Way starts her position with an internal review of the organization's records. Finds that dozens of check copies were missing. The new CFO requested copies from the bank which indicated that each of the checks had been made out to the former VP of Finance who had forged the names of two officers. The checks totaled \$2 million dollars.

- An independent, high level review could have detected the scheme.



Examples of Fraud

Former Treasurer of the Episcopal Church embezzled \$2.2 million over five years

- Went on for years because the Treasurer had ultimate and absolute control over auditing and accounting.
- Resume claimed other positions at churches and said she graduated from prominent university. Other church officials and university officials had no records of employment or attendance.
- The Treasurer probably would not have been hired if screening procedures had been in place.



Examples of Fraud

An internal auditor noticed that, as compared to other locations, the organization was reporting considerably less vending machine income. The internal auditor called the vendor and learned that revenues were in fact much higher than reported. He requested copies of the fronts and backs of the checks from vending machine revenue and discovered that the bookkeeper had been stealing cash receipts and using the vending machine income to satisfy the balances of the customer's money she was stealing. In addition, vending machine income was only recorded quarterly instead of monthly.

- Independent high level review of bank statements and check copies could have detected this fraud.
- High level analytical procedures could also have detected foul play.

ADDITIONAL RESOURCES

- www.acfe.com/documents/managing-business-risk.pdf
- <http://www.acfe.com/resources/fraud-tools.asp>
- <http://www.acfe.com/resources/publications.asp>

QUESTIONS





Serving you in two locations

*1990 Main Street, Suite 801
Sarasota, FL 34236*

*6320 Venture Drive, Suite 203
Lakewood Ranch, FL 34202*

www.kbgrp.com





Thank You!

