

**INTERNAL FRAUD PREVENTION:
COMMON FRAUDS AND THE
“ABSOLUTES” OF INTERNAL CONTROL DESIGN**

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CFO & Controllers' Conference**



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The "Not Quite Yet" Ex-Employee

An accountant changed the direct deposit routing number and account number to three of her own bank accounts on six previously terminated employees.

No one noticed until \$250,000 and 7 months later, a former employee called asking why his W-2 reflected \$50,000 more than he was paid!

THE GENIUS

Kyle embezzled funds from his cooperative by increasing the tip amount on the customer's copy of restaurant credit card receipts by approximately \$2 to \$3 per meal.

The actual restaurant copy of the receipt represented the actual lesser amount charged to the credit card.

He would then attach the customer copy of the receipt to his expense report for reimbursement of charges to his personal credit card.

Why Prevention?

“I’m a true believer that you have a moral obligation to keep your employees honest, and that is why you have controls; so I’m never tempted or put in a position where I could do something to defraud my employer” — Frank Abagnale, Jr.



...because it is OUR responsibility!

Who is Committing Fraud?



HAVE A
NICE DAY



The Common Victim Response

**"Steve, I can't believe this happened to us...
and by him..."**

**I trusted him; he's been here forever; he's
the last person I would have suspected!"**

FRAUD?

FRAUD RULE #1

Fraud and Stupid Look Just Alike

*“Mens Rea” (the criminal state of mind)
Turns Stupid Into Fraud*

As Long As It's Paid in Full



The accountant used the cooperative credit card for personal purchases as well as for business purposes.

She paid the business purpose portion of the balance with a cooperative check and the personal portion with a personal check.

Is this fraud?

“Internal Fraud”

The Three “C”s

A criminal act has been **Committed**

The Act has been **Concealed**

The perpetrator **Converted** the results of the Act for personal gain (personal benefit)

“Internal Fraud”

Mens Rea – The Criminal State of Mind

INTENT:

A deliberate, purposeful resolve to bring about a particular result.

Circumstantial evidence is allowed as support for intent.

“Internal Fraud”

Mens Rea – The Criminal State of Mind

KNOWLEDGE:

A perpetrator’s deliberate indifference to his or her behavior that almost certainly creates a risk that results in a criminal outcome

A perpetrator is aware of the nature of his conduct and didn’t act through ignorance, mistake, or accident

“Internal Fraud”

Mens Rea – The Criminal State of Mind

RECKLESS CONDUCT:

Acting with a conscious disregard that exposes others to unjustifiable risk

A gross deviation from a standard of care that a reasonable person would take in a given situation

As Long As It's Paid in Full



The accountant used the cooperative credit card for personal purchases as well as for business purposes.

She paid the business purpose portion of the balance with a cooperative check and the personal portion with a personal check... for the most part...

...she may have misclassified \$30k, \$40k, \$50k of personal charges as business charges.

As Long As It's Paid in Full



Evidence:

- Fictitious reports to the board regarding usage
- White-out on the credit card statements to conceal true nature of the charges

Is this fraud?

CONTROL ACTIVITIES

Raising the Walls of Protection



The Development of Control Activities

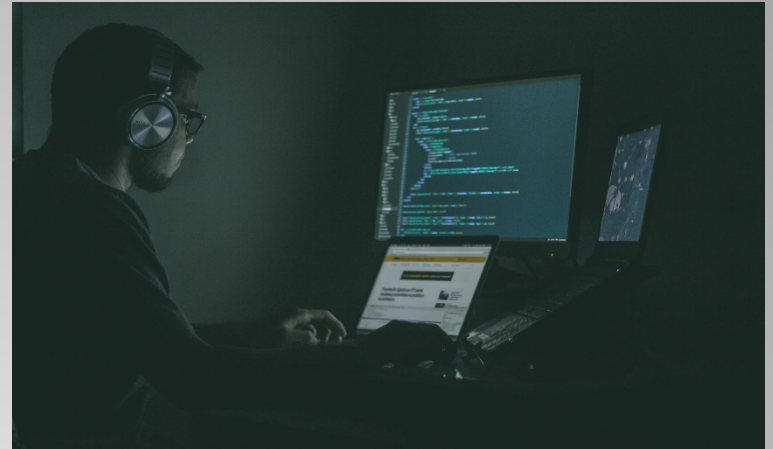
Guiding Principles of Control Activities Design...

“Design the internal control around the POSITION, never around the PERSON in that position”

“The PERCEPTION OF DETECTION is the strongest internal control that can be implemented”

The Shell Company

Kyle, the Cooperative purchasing agent, stole over \$3.8 million using a simple shell company fraud method:



- **Created a separate company,**
- **Opened a separate bank account,**
- **Subscribed to a mail drop service,**
- **Obtained an endorsement stamp,**
- **Created invoices to his cooperative for fictitious transformer purchases**

The Shell Company Fraud

New Vendor Establishment

Causing your employer to make disbursements to a company that you own, without your employer's knowledge that you own that company... for either legitimate costs or for bogus costs.

The Shell Company Fraud

New Vendor Establishment

Creation of a “fictitious” vendor or a vendor “not necessary to the business”

- **Names of the “vendors” can be similar to existing valid vendors**

ABC Company, Inc.

ABC Company

ABC Co., Inc.

ABC, Inc.

Control Considerations for New Vendor Establishment

- **New Vendor Establishment Process / Form**
- **Conflict of Interest Form**
- **Compliance Audit Procedures**

SCOTCO, Inc.
Conflict of Interest Form

To be completed annually by all employees, owners, and members of the governing body. If there are any questions as to what category a relationship should be included, select one and management shall determine any necessary reclassifications.

Name: _____
Title: _____ Signature _____

Please provide individual names, company names, and the nature of the relationships that may exist with organizations that our company does business with or that you could reasonably expect our company could potentially enter into a relationship with, as relates to:

Family Relationships:

Personal Relationships:

Business Relationships:

Financial Relationships:

SCOTCO, Inc.									
Conflict of Interest Form									
To be completed annually by all employees, owners, and members of the governing body. If there are any questions as to what category a relationship should be included, select one and management shall determine any necessary reclassifications.									
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SCOTCO, Inc.
Conflict of Interest Form

Family Relationships:

Personal Relationships:

Business Relationships:

Financial Relationships:

Your Company Name

New Vendor Establishment

Vendor Information		Validation Procedures					
		Documents or Procedures Performed					
Vendor Name:	ABC Company, Inc.	AOI	State Reg	Googled			
Taxpayer ID#:	00-0000000	W-9					
Payee Name:	ABC Company						
Duplicate Name Search:	None noted						
Primary Phone:	000-000-0000	Called - Active Number					
Fax No.:	000-000-0001	Test Fax Successful					
Website:	www.abc.aaa	Active					
<u>Physical Address:</u>		Googled - Valid	Google Earth - Valid				
Address:	1412 1st Street						
City:	City						
State:	State						
Zip Code:	11111						
<u>Mailing Address:</u>		Googled - Valid	Google Earth - Valid				
Address:	P.O. Box 9999						
City:	City						
State:	State						
Zip Code:	11111						
Duplicate Address Search:	None Noted						
Contact Person:	Jane Doe						
Contact E-mail:	jane@abc.aaa	Email to and from - Successful					
<u>Expected Transactions:</u>							
Widget Purchases OR Monthly Statement Processing Services, etc.							
<u>Vendor Relationships:</u>							
Jane Doe is John Doe's sister - John works in our marketing department							

Your Company Name

New Vendor Establishment

Vendor Information		Validation Procedures					
Vendor Information		Documents or Procedures Performed					
Vendor Name:	ABC Company, Inc.	AOI	State Reg.	Googled			
Taxpayer ID#:	00-0000000	W-9					
Payee Name:	ABC Company						
Duplicate Name Search:		None noted					
Primary Phone:	000-000-0000	Called - Active Number					
Fax No.:	000-000-0001	Test Fax Successful					
Website:	www.abc.aaa	Active					

Your Company Name

New Vendor Establishment

Vendor Information		Validation Procedures					
Vendor Information		Documents or Procedures Performed					
<u>Physical Address:</u>		Googled - Valid			Google Earth - Valid		
Address:	1412 1st Street						
City:	City						
State:	State						
Zip Code:	11111						
<u>Mailing Address:</u>		Googled - Valid			Google Earth - Valid		
Address:	P.O. Box 9999						
City:	City						
State:	State						
Zip Code:	11111						
Duplicate Address Search:		None Noted					
Contact Person:	Jane Doe						
Contact E-mail:	jane@abc.aaa	Email to and from - Successful					

Your Company Name

New Vendor Establishment

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Vendor Information	Validation Procedures
	Documents or Procedures Performed

Expected Transactions:

Widget Purchases OR Monthly Statement Processing Services, etc.

Vendor Relationships:

Jane Doe is John Doe's sister - John works in our marketing department

SCOTCO, Inc.

Anti-fraud Program

Documentation of Control Activities

Dated: September 16, 20xx

Control Activities

New Vendor Establishment Procedures

1	A Master Vendor File will be maintained and updated on a regular basis
2	A New Vendor Establishment Form will be initiated within the accounts payable department for all new vendors
3	Information to be obtained for the form will be requested from the new vendor and completed by Accounts Payable Clerk #1
4	Accounts Payable Clerk #1 will forward the information completed portion of the New Vendor Establishment form to Accounts Payable Clerk #2
	Accounts Payable Clerk #2 will then validate the information on the form. Validation and verification will include:
	Phone calls to numbers provided
5	Test email message to the email provided
	Web based search engine inquiries
	State tax base searches
	Online mapping or Google Earth searches of address provided
6	Accounts Payable Clerk #2 will forward the completed New Vendor Establishment Form to Management for approval
7	The approved New Vendor Establishment form, along with any other documentation from the vendor, will be added to the Master Vendor File
8	As a part of the formal monitoring program, compliance with the review of the supporting documentation and form completion for the Master Vendor File will be audited annually to determine the level of adherence to that control activity. The audit will be conducted by the board audit committee

Control Considerations for New Vendor Establishment

Processes MUST include the requirement for periodic Master Vendor File compliance testing to determine that vendors listed in the vendor master file have been subjected to these internal controls

The Front Counter: Accounts Receivable Lapping

Suppose the cooperative has three member customers, A, B, and C.

When A's payment is received, the perpetrator steals it instead of posting it to A's account.

The Front Counter: Accounts Receivable Lapping

Member A expects that his account will be credited with the payment he has made. If not, he will almost certainly complain.

To avoid this, the perpetrator must take some action to make it appear that the payment was posted.

The Front Counter: Accounts Receivable Lapping

When B's check arrives, the perpetrator posts this money to A's account.

Payments now appear to be up-to-date on A's account, but B's account is behind.

When C's payment is received, the perpetrator applies it to B's account.

The Front Counter: Accounts Receivable Lapping

This process continues indefinitely until one of three things happens:

- (1) someone discovers the scheme,**
- (2) restitution is made to the accounts,**
- (3) some concealing entry is made to adjust the accounts receivable balances.**

Control Considerations for Accounts Receivable Lapping

- **Segregate cash handling from cash recording**
- **Periodic verification of cash drawer, noting personal checks in the drawer**
- **Mandatory vacation**

Control Considerations for Accounts Receivable Lapping

- Stamp all checks “for deposit only”
- Control credit memos and receivable write-offs
- Periodically audit for “no mail” statements
- Establish a lock-box payment system

Control Considerations for Accounts Receivable Lapping

- **Rotate employees**
- **Periodic matching of daily deposit to accounts receivable posting**

The Front Counter: Cash Theft from Deposit

It is what it is...

Checks received = \$500

Cash received = 100

Deposit should be = \$600

Cash stolen = \$75

Deposit is actually = \$525

The Front Counter: Cash Theft from Deposit

Concealment:

- **Personal checks in the drawer... to balance**
- **Credit memos / AR Adjustments**
- **Accounts receivable write-offs**
- **Other non-standard journal entries**

Control Considerations for Cash Theft from Deposit

- **Periodic verification of cash drawer, noting personal checks in the drawer**
- **Stamp all checks “for deposit only”**
- **Control credit memos and receivable write-offs**
- **Establish a lock-box payment system**

Control Considerations for Cash Theft from Deposit

- **Rotate employees duties**
- **Match bank stamped deposit slip to copy of deposit slip as prepared**
- **Surveillance Camera**

Other Recurring Cases

**Have you been to an Office Depot lately?...
Home Depot?... Staples... Etc, Etc**

**An employee cost his cooperative \$200,000
over a 4 year period by charging personal
items to these types of accounts.**

**Payments on these accounts were
accomplished by both paper check and
online bill payment.**

Control Activities

The “Absolutes”

- **Pre-employment Background and Reference Checks**
- **Required Annual Completion of the Conflict of Interest Form**
- **Required Use of Vacation Time**
- **Required Supporting Documentation and Approval for Non-standard Journal Entries**
- **Physical Inventory Count**

Control Activities

The “Absolutes”

- **Proper Approval of Inventory Write-offs**
- **Proper Approval of Accounts Receivable / Debit Balance Accounts Payable Write-offs**
- **Proper Approval for Billing Adjustments/Credit Memos or Other “Nonpayment” Credits to Accounts Receivable**
- **Proper Disbursement Approval Procedures**
- **New Vendor Establishment Processes**

Monitoring and Routine Maintenance: The Compliance Audit Function



Monitoring and Routine Maintenance

The 2 Questions of Monitoring...

Are processes and controls working as intended?

Are there processes or activities that we need to refine, add, or delete?

Monitoring and Routine Maintenance

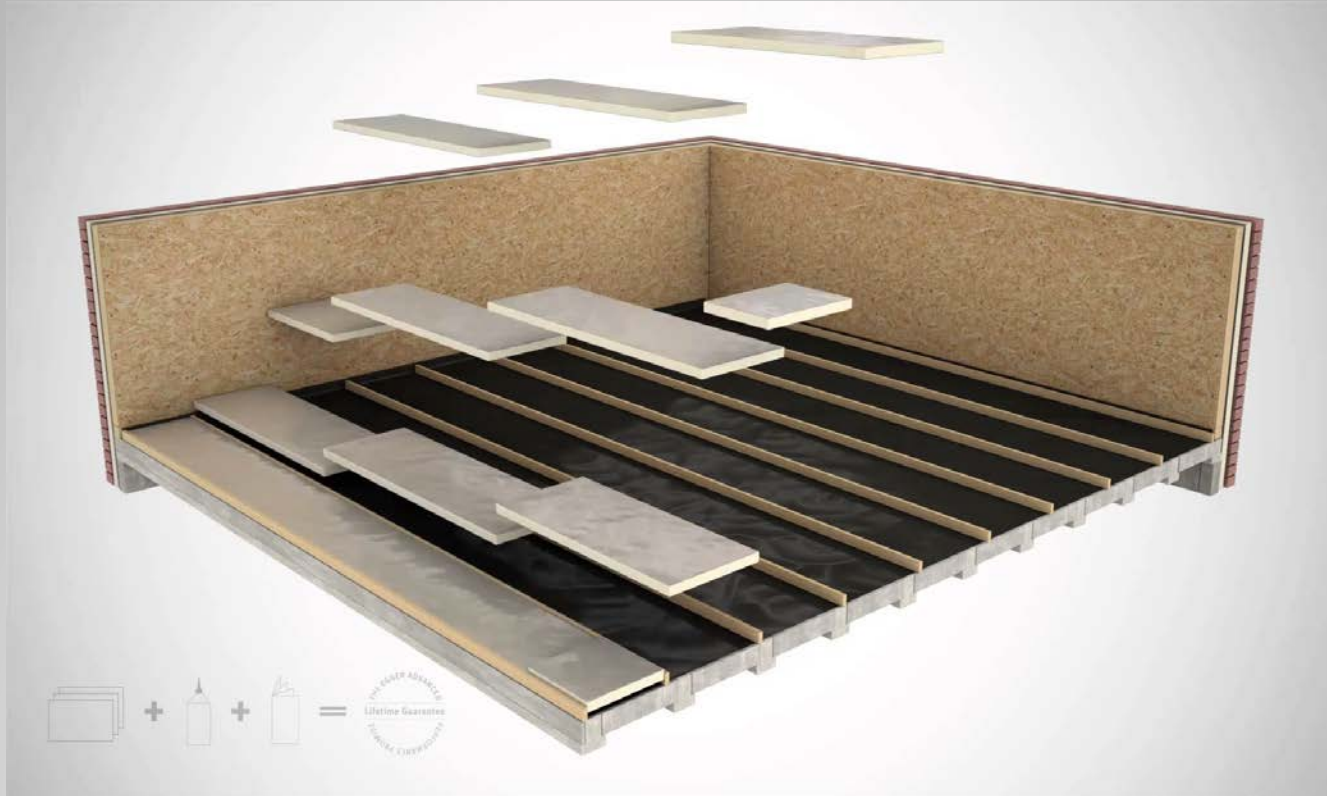
Compliance Auditing

Compliance Audits: The Absolutes...

- **Authorized check approval process**
- **Accounts receivable charge-off process**
- **Inventory write-off process**
- **Journal entry approval and documentation process**
- **Master vendor file audit**
- **Contract procurement audit**

FRAUD RISK ASSESSMENT

Laying the Ground Floor



FRAUD RISK ASSESSMENT

“The process aimed at proactively identifying and addressing the cooperative’s vulnerabilities to internal fraud”

FRAUD RISK ASSESSMENT

Goal: To Identify the Areas Vulnerable to the Risk of Fraud in Our Cooperative

The Objective is not to prevent fraud... the Objective is to determine what frauds need to be prevented.

Control activities have the objective of “preventing fraud”.

FRAUD RISK ASSESSMENT

The "Simple" Technique

Lock yourselves in a room and **BRAINSTORM!**

- Brainstorm **GENERAL** Processes
- Brainstorm **SPECIFIC** Processes

FRAUD RISK ASSESSMENT

General Processes

General Processes Are Simply Identified by:

“How money comes in”, and

“How money goes out”.

FRAUD RISK ASSESSMENT

Specific Processes

Specific Processes Are Simply Identified by:

Financial Statement Line Items

- **Cash in Bank**
- **Accounts Receivable**
- **Inventory**
- **Fixed Assets**
- **Sales**
- **Etc.**

SUMMARY

Fraud is Happening!

- **Shell Company Fraud**
- **Cash Fraud**
- **Disbursement Fraud**

Consider the Control “Absolutes”

Attempt a Risk Assessment Process
(you may be surprised at what you find)

INTERNAL FRAUD PREVENTION:
Common Frauds and the “Absolutes” of Internal Control Design

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