

Fraud & Internal Control

October 2, 2019

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Non-profits in the News!!!

“Two longtime officials of a federally funded Head Start program run by the Roman Catholic Archdiocese of New York siphoned more than \$800,000 from the program,...by burying additional payments to themselves...they nearly tripled their salaries,...” The New York Times, June 2, 2005

“Head Start director in Maryland...stole \$335,777...South Dakota woman on charges that she embezzled \$185,000...” The New York Times, March 18, 2005

“...mismanaged \$140,000...and collected roughly \$30,000 in bonuses...in violation of employment policies... and not reported to tax authorities.” The New York Times, July 1, 2004

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Non-profits in the News!!!

“Undercover investigators trying to enroll a handful of fictitious children in federally funded Head Start child care centers found that in about half of the cases, workers fraudulently misrepresented parents' incomes, addresses and other information to allow kids to qualify for a slot.” USA Today, May 19, 2010

“...director of food services for Open Arms of Minnesota from 2009 to 2012. He allegedly made contractual arrangements for food deliveries with at least four charity organizations and two private individuals, delivered Open Arms' food and kept the money(\$155,000) for himself.” Pioneer Press, August 6, 2012

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### Non-profits in the News!!!

“Seattle police are investigating allegations that the nonprofit's (Senior Services of Seattle-King County) employee, who was fired in March, created a fake company to bill the agency for moving and hauling services that clients never received. Senior Services estimates that \$89,000 in city money was appropriated.” The Seattle Times, September 28, 2012

“The former executive director of a southwest Florida nonprofit is accused of misappropriating more than \$900,000.” CBS, July 24, 2012

“The former CFO of a Kansas nonprofit was charged Wednesday with stealing more than \$2 million in Medicaid money. Prosecutors said Sellers diverted Medicaid funds to a shell company billing for work supposedly done by the nonexistent business.” Kansas City Business Journal, August 22, 2012

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### Non-profits in the News!!!

“...a senior program officer with the Buffett Foundation was charged with stealing \$46,000. Patel, who made \$190,000 a year, turned in false receipts for various types of expenses. Omaha World-Herald, May 22, 2012

“The Trauma Intervention Program in Vista, California prosecuted 79-year-old Judy G. for writing 181 checks to herself worth \$300,000 over a four year period. Omaha World-Herald, May 22, 2012

“The former accounting director of the Roman Catholic Archdiocese of St. Paul and Minneapolis has been accused of stealing more than \$670,000 from the church. ...Diverted archdiocese checks to pay personal credit card bills, private school tuition for children and other personal expenses.” Pioneer Press, June 15, 2012

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### Fraud Happens

“U.S. organizations lose \_\_\_\_% of their annual revenues to fraud.

“The median loss caused by occupational fraud was \$\_\_\_\_\_. More than one-quarter of the frauds involved losses of at least \$\_\_\_\_\_.

“The typical fraud lasted \_\_\_\_\_ months until the time it was caught by the victim organization.

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### Why do people commit fraud?

- “The key is to focus on prevention
- “If we prevent fraud, we avoid the losses
- “In order to prevent, we must understand why fraud occurs

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### Why do they do it?

- “Vast majority are not career criminals
- “Most are trusted employees with no criminal history
- “When 3 elements come together, the basically honest person will commit fraud...

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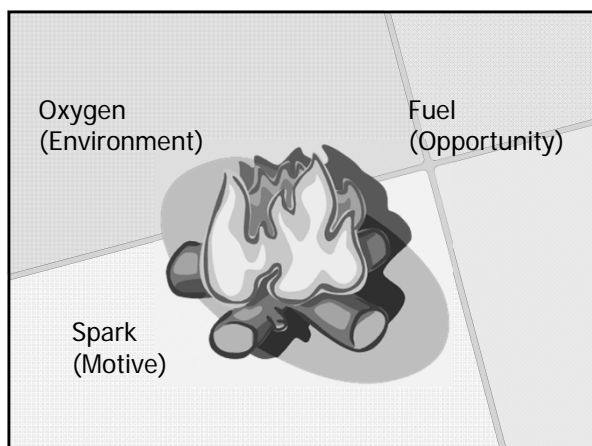
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### Elements of Fraud

Motive (Need) – Individual has some financial problem he is unable to solve through legitimate means:

- “ Inability to pay one’s bills
- “ Vice (Booze, person on the side, gambling, and/or drugs)
- “ Status – keeping up with the neighbors

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### Elements of Fraud

- “ Opportunity – The person must see a way of using his position with a low perceived risk of detection
- “ Environment – Lack of controls must be present to enable the desired action to occur.
- “ The fraudster rationalizes the crime to himself *before* he commits the crime, *after* the act takes place, rationalization no longer important.

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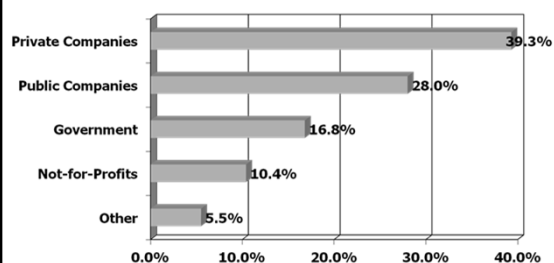
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Organization Victim of Fraud



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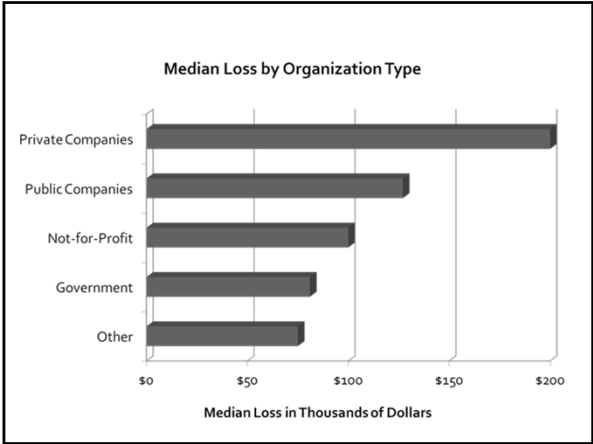
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Category	Examples	% of all Cases	Median Loss
Asset Mis-appropriation	■Fraudulent invoices ■Payroll fraud ■Skimming Revenues	86.3%	\$135,000
Corruption	■Accepting or paying bribe ■Conflict of interest	32.8%	\$250,000
Fraudulent Statements	■Fictitious sales ■Expenses in wrong period	4.8%	\$4.1 million

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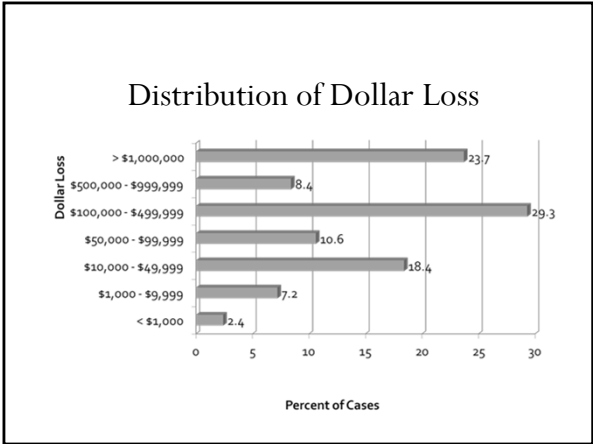
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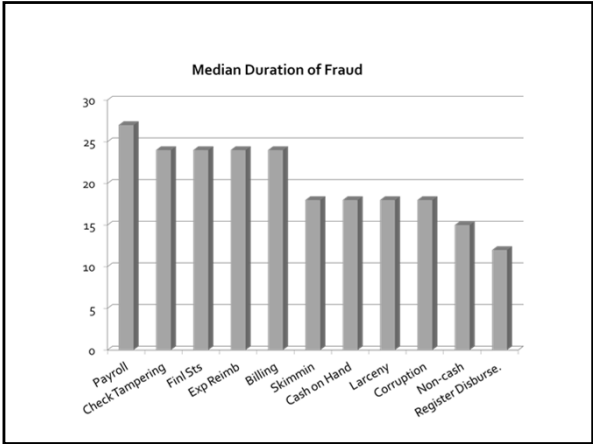
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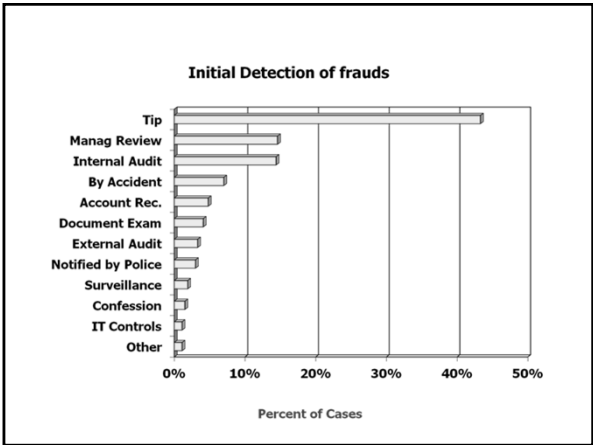
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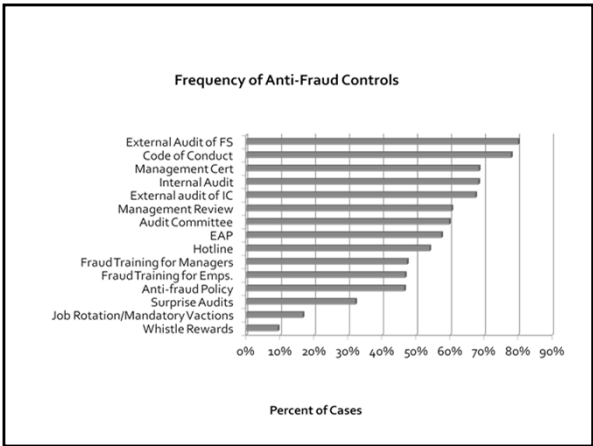
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Effectiveness of Controls				
Control	Used	Yes	No	Reduction
Management Review	60.5%	\$ 100,000	\$ 185,000	45.9%
Employee Support Programs	54.5%	100,000	180,000	44.4%
Hotline	54.0%	100,000	180,000	44.4%
Fraud Training for Managers	47.4%	100,000	158,000	36.7%
External Audit of IC	67.5%	120,000	187,000	35.8%
Fraud Training for Emps.	46.8%	100,000	155,000	35.5%
Anti-Fraud Policy	46.6%	100,000	150,000	33.3%
Formal Fraud Assessments	35.5%	100,000	150,000	33.3%
Internal Audit	68.4%	120,000	180,000	33.3%
Job Rotation/Mandatory Vac	16.7%	100,000	150,000	33.3%
Surprise Audits	32.2%	100,000	150,000	33.3%
Rewards for Whistleblowers	9.4%	100,000	145,000	31.0%
Code of Conduct	78.0%	120,000	164,000	26.8%
Independent Audit Commit	59.8%	125,000	150,000	16.7%
Management Certification of FS	68.5%	138,000	164,000	15.9%
External Audit of FS	80.1%	140,000	145,000	3.4%

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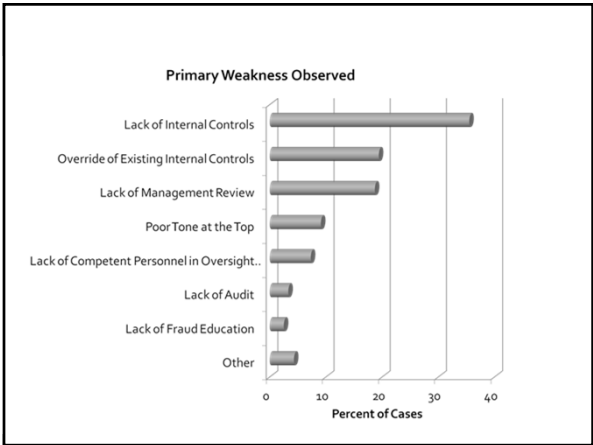
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Identify the Perp



Age:

- ☐ > 60
- ☐ 51 - 60
- ☐ 41 - 50
- ☐ 36 - 40
- ☐ 31 - 35
- ☐ 26 - 30
- ☐ < 26

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### Identify the Perp

Tenure

- ☐ < 1 Year
- ☐ 1 – 5 Years
- ☐ 6 – 10 Years
- ☐ > 10 Years

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Annual Income

- ❖ < \$50,000
- ❖ \$50,000 - \$99,999
- ❖ \$100,000 - \$149,999
- ❖ \$150,000 - \$199,999
- ❖ \$200,000 - \$499,999
- ❖ \$500,000 +



### Identify the Perp

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### Identify the Perp

Gender

- ☐ Male
- ☐ Female

Education

- Postgraduate degree
- Bachelor's degree
- Some College
- High School Grad

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## Identify the Perp

Position in Organization

- Accounting
- Operations
- Sales
- Executive/Upper Management
- Customer Service
- Purchasing
- Board of Directors
- Human Resources




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## Behavioral Red Flags

- Living beyond means
- Financial difficulties
- Unusually close association with vendor
- Control issues, unwilling to share duties
- Divorce/family problems
- Wheeler-dealer attitude
- Irritability, suspiciousness, or defensiveness
- Addiction problems
- Past legal Problems
- Past employment-related problems
- Complaining about inadequate pay
- Refusal to take vacations
- Excessive family/peer pressure for success
- Complaining about lack of authority

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## Why Internal Controls?

- ❖ Internal controls are the systems that are in place to prevent a loss from occurring
- ❖ Easier to *prevent* a loss from occurring than *discovering* it after it has occurred

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### Subpart D – Post Award Requirements

#### Internal Controls

- Establish and maintain effective internal control over Federal awards
- In compliance with:
  - “Standards for Internal Control in the Federal Government” (Comptroller General of the United States)
  - “Internal Control Integrated Framework” (COSO)
- Comply with Federal statutes, regulations and the terms and conditions of the awards
- Evaluate and monitor compliance
- Take prompt action when instances of noncompliance are identified in audit findings

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### COSO Framework

- Key Concepts:
  - Internal control is process
  - Internal control is impacted by people, not just policies and manuals
  - Internal control provides reasonable assurance, not absolute
- Definition
  - A process, effected by an entity’s board of directors, management and other staff, designed to provided reasonable assurance regarding achievement of objectives:
    - Effectiveness and efficiency of operations
    - Reliability of financial reporting
    - Compliance with applicable laws and regulations
    - Safeguarding of assets

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### Subpart D – Post Award Requirements



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INTERNAL CONTROL FRAMEWORK

➤ **Control Environment** – Organization’s culture that influences ethical behavior.

➤ **Risk Assessment** – Process of identifying risks that threaten achievement of goals.

➤ **Control Activities** – Processes and procedures to support compliance and mitigate risk.

➤ **Information and Communication** – Providing right information to the right people at the right time.

➤ **Monitoring** – Process to verify that the controls are working as intended.

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Internal Control Examples

○ **Control Environment:**

○ Integrity and Ethical Values

○ How does the organization communicate ethics, values and integrity to employees?

○ Conflict of interest policy

○ Fraud policy

○ Commitment to Competence

○ Are there job descriptions?

○ Are there annual appraisals?

○ Are there professional development opportunities?

○ Governing Board Oversight

○ Does the Board have on-going training?

○ Are there financial expert(s) on the Board?

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Internal Control Examples

■ **Risk Assessment**

■ Is a formal process conducted and documented?

■ Does management understand risks and controls?

■ Does the Board understand its role?

■ Is information technology’s role evaluated?

■ **Control Activities**

■ Are there controls over journal entries, estimates, and related party activities?

■ Are there written policies and procedures (Fiscal and HR)?

■ Is there proper segregation of duties?

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Internal Control Examples

Information and Communication

“ Are budgets and business plans prepared and communicated to staff?

“ Does the Board and upper management review financial results routinely and timely?

“ Is there an IT disaster recovery plan?

Monitoring

“ Are internal controls routinely evaluated and updates made to policies?

“ Are comments from external parties used?

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Green Book

Same 5 Components

Adds 17 principles

How does an entity use the Green Book?

Objective identified

Controls designed

Controls in place

Objective achieved

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17 Principles

Figure 3: The Five Components and 17 Principles of Internal Control

Control Environment

1. The oversight body and management should demonstrate a commitment to integrity and ethical values.

2. The oversight body should oversee the entity's internal control system.

3. Management should establish an organizational structure, assign responsibility, and delegate authority to achieve the entity's objectives.

4. Management should demonstrate a commitment to recruit, develop, and retain competent individuals.

5. Management should evaluate performance and hold individuals accountable for their internal control responsibilities.

Risk Assessment

6. Management should define objectives clearly to enable the identification of risks and define risk tolerances.

7. Management should identify, analyze, and respond to risks related to achieving the defined objectives.

8. Management should consider the potential for fraud when identifying, analyzing, and responding to risks.

9. Management should identify, analyze, and respond to significant changes that could impact the internal control system.

Control Activities

10. Management should design control activities to achieve objectives and respond to risks.

11. Management should design the entity's information system and related control activities to achieve objectives and respond to risks.

12. Management should implement control activities through policies.

Information and Communication

13. Management should use quality information to achieve the entity's objectives.

14. Management should internally communicate the necessary quality information to achieve the entity's objectives.

15. Management should externally communicate the necessary quality information to achieve the entity's objectives.

Monitoring

16. Management should establish and operate monitoring activities to monitor the internal control system and evaluate the results.

17. Management should remediate identified internal control deficiencies on a timely basis.

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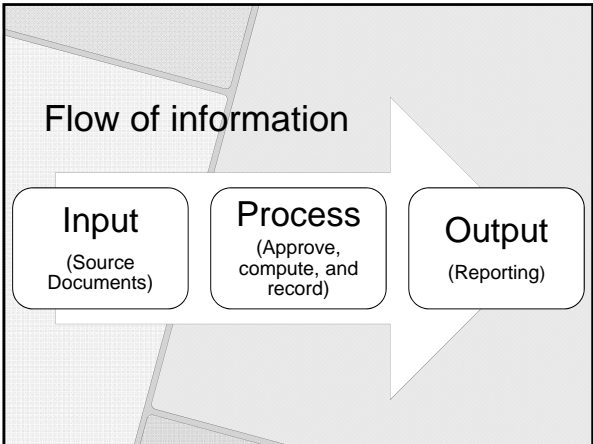
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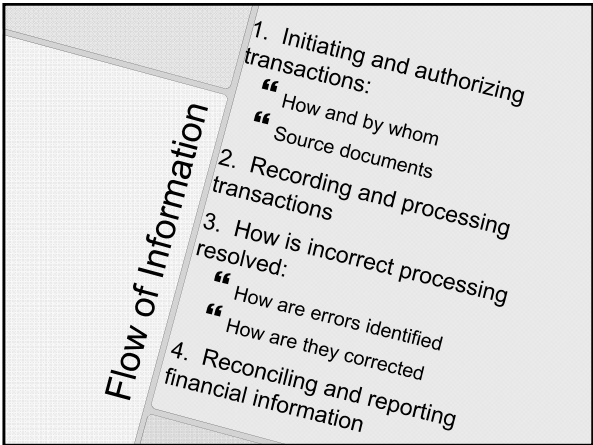
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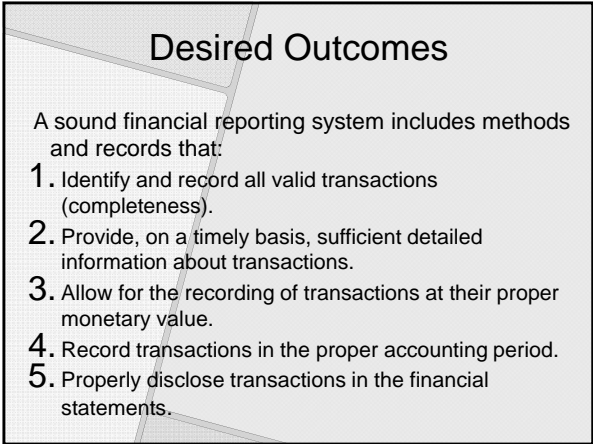
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**Practical Considerations**

**Segregation of Duties**  
 Separate the roles:

- “ Initiate
- “ Authorize
- “ Record
- “ Reconcile/Review

**Smaller organizations:**

- “ Executive Director
- “ Board members

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**Practical Considerations**

- “ Timely reconciliations
- “ Adequate documentataion
- “ Bank statements
- “ Bank reconciliations
- “ Board members
- “ Contract Accountant
- “ Program employees

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**Practical Considerations**

**JOURNAL ENTRIES**

- “ How originated?
- “ Documentation required
- “ Reviewed and approved

**FICTITIOUS**

- “ Vendors
- “ Employees



**WATCH  
OUT!**

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Must Haves

- Appropriate systems
  - Written financial policies and procedures
  - Proper segregation of duties
  - Timely reconciliations
  - Journal entry control
- Qualified and competent people
  - Written personnel policies and procedures
  - Staff development and appraisals
- Sound governance
  - Timely review of budget vs. actuals
- Audit

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Common Internal Control Deficiencies

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1. Lack of Segregation of Duties
  - “ Especially in smaller organizations
2. Lack of or outdated policies and procedures
  - “ Review every 3 years
3. Untimely information
4. Undocumented procedures
5. Lack of controls over specific exposures:
  - “ Ghost employees/Fictitious vendors/Journal entries
6. Inadequate Board or Management oversight

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Internal Control Findings

- Inadequate account reconciliations
- Unsupported adjusting journal entries
- Inadequate supervision of staff
- Staff lacking appropriate accounting skills
- Inadequate sense of ethical environment
- Lack of risk assessment
- Out of date financial policies and procedures
- Lack of financial monitoring
- Untimely financial processing

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Internal Control Findings

“Inadequate approval processes

“Undocumented cost allocation process

“Inadequate support documentation

“Reimbursement requests not reconciled to general ledger