Internal Controls:
How to Stay Out of the Headlines!

Presented By:
Clay L. Pilgrim, CPA, CFE, CFF

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Outline

• Fraud in Governmental Organizations
• The Fraud Triangle
• Internal Controls and Controlling Fraud
• “Pseudo-Controls”
• Specific Examples
• Questions
ACFE 2014 Report to the Nations on Occupational Fraud and Abuse

• Estimated 15.1% of all fraud cases are in governmental organizations

• Estimated average median loss of $90,000 for governmental organizations

• Across all industries, primary internal control weakness observed by CFEs was “lack of internal controls” in 32.2% of cases reported
Fraud Triangle

Opportunity

FRAUD TRIANGLE

Need (or Greed)
PRESSURE

Rationalization
Fraud Triangle – Common Pressures

• Inability to pay one’s bills
• Drug or gambling addiction
• Desire for status symbols such as bigger house, nicer car, etc.
• Need to meet productivity targets or cover up poor performance
Fraud Triangle – Common Rationalizations

• “I was only borrowing the money.”
• “I was entitled to the money.”
• “I had to steal to provide for my family.”
• “I was underpaid; my employer cheated me.”
• “My employer is dishonest to others and deserved to be fleeced.”
• “The organization didn’t need the money or wouldn’t miss the assets.”
Fraud Triangle – Opportunity

Opportunity defines the method by which the crime can be committed. The person must see some way he/she can use (abuse) his/her position of trust to solve his/her financial problem with a low perceived risk of getting caught. It is critical that the fraud perpetrator be able to solve his/her problem in secret.
Breaking the Fraud Triangle

• Key to Fraud Deterrence = Removing one of the elements of the fraud triangle

• Which element is most able to be removed?
  – OPPORTUNITY!

• Removal of opportunity is directly affected by a system of internal controls.
Internal Controls and Controlling Fraud

- Setting the Tone at the Top
- Assessing Fraud Risk and Responses
- Financial Systems and Controls
- Non-Financial Systems and Controls
Setting the Tone at the Top

• Culture of Honesty, High Ethics, and Oversight

• Positive Workplace Environment

• Equal Treatment of Employees

• Realistic Goals
Setting the Tone at the Top

- **Code of Conduct / Code of Ethics**
  - Should be formally approved
  - Should be communicated and available to all employees
  - Should be updated when changes occur or on a schedule (once every three years)

- **Conflict of Interest Policy**
  - Same notes as Code of Conduct / Code of Ethics
Setting the Tone at the Top

• Audit Committees [http://www.gfoa.org/audit-committees](http://www.gfoa.org/audit-committees)
  
  – practical means for a governing body to provide much needed independent review and oversight of the government’s financial reporting processes, internal controls, and independent auditors
  
  – provides a forum separate from management in which auditors or others can candidly discuss concerns
  
  – should be formally established by the governing body by charter, enabling resolution, etc.
Setting the Tone at the Top

• Audit Committees (continued)
  – who should be on the committee?
  – all members should possess or obtain a basic understanding of governmental financial reporting and auditing

• Policy/Procedure Manuals [link: http://www.gfoa.com/financialpolicies]
  – formal documentation of accounting policies and procedures enhances both accountability and consistency
Setting the Tone at the Top

- Policy/Procedure Manuals (continued)
  - appropriate level of management should emphasize the importance and authority
  - Should be communicated and available to all employees
  - Should be updated when changes occur or on a schedule (annual is preferred, but once every three years at a minimum)
Assessing Fraud Risk and Responses

• Common excuses for not performing risk assessment:
  – Not even sure where to begin the process
  – External auditors perform risk assessment, why should we?
  – We have good controls in place
  – We have good, honest people who work here (The 10-80-10 Rule)
  – Even if we discover issues, we won’t be able to fix them
Assessing Fraud Risk and Responses

• Proactively Identify and Measure Fraud Risk
  – Fraud risk exposure should be assessed periodically by the government to identify specific potential schemes and events that the government needs to mitigate
  – Risk assessment team should consist of members of the governing body, management, accounting/finance personnel, department heads, legal/compliance personnel, risk management personnel, internal audit personnel (if applicable), external consultants (if necessary)
Assessing Fraud Risk and Responses

• Proactively Identify and Measure Fraud Risk (continued)
  – Brainstorming session to discuss incentives, pressures, and opportunities to commit fraud
  – Styles or techniques may include interviews, focus groups, surveys, anonymous feedback, checklists, questionnaires, etc.
  – Important to discuss the potential for management override of internal controls
  – Identified risks should then be assessed for likelihood and significance (prioritize)
Assessing Fraud Risk and Responses

• Proactively Identify and Measure Fraud Risk (continued)
Assessing Fraud Risk and Responses

• Take Steps to Mitigate Identified Risk
  – Communicate to all personnel that a fraud risk management program has been implemented
  – Design and implement financial and non-financial internal controls (preventive and detective) based on the fraud risks identified
  – Document the techniques developed and implemented to prevent and detect fraud
Assessing Fraud Risk and Responses

• Monitor Prevention and Detection Programs
  – The preventive and detective controls implemented should be routinely or continuously (if possible) monitored to confirm that the controls / processes are operating and effective
  – The monitoring process and results should be documented and updated as necessary
Financial Systems and Controls

• Segregation of Duties
  – Separating the custody, authorization, and recordkeeping duties
  – Sometimes difficult with limited staff

• Institute Job Rotation
  – Rotating jobs amongst existing staff
  – Can be costly due to training
  – Sometimes difficult with limited staff
Financial Systems and Controls

• Conduct Surprise Audits
  – Employees are less inclined to perpetrate fraud if they feel the risk of being caught is higher
  – Sometimes difficult with limited staff

• Periodic Reconciliations
  – Cash/Bank account reconciliations monthly
  – Miscellaneous A/R monthly
  – Sub-ledgers to the general ledger monthly
  – Other
Financial Systems and Controls

• Periodic Independent Review
  – General ledger adjustments (journal entries) monthly
  – Bank reconciliations monthly
  – Bank statements monthly
  – Wire transfers monthly
  – Vendor list monthly or quarterly

• Analytical Reviews and Ratio Analysis
  – Why is Water Sales Revenue down significantly?
Financial Systems and Controls

• Periodic Independent Verifications
  – Capital assets
  – Petty cash
  – Securities

• Use of Authorizations
  – Proper authorization levels
  – Advance approval requirement
  – Voids/Refunds/Deleted Transactions (Cash Rec)
  – Written documentation of approval requirement
Financial Systems and Controls

• Physical Safeguards
  – Capital assets
  – Petty cash

• Information Technology
  – Appropriate system access
  – Security and privacy policies for email, web browsing, and electronic communication
Non-Financial Systems and Controls

- Mandatory Vacations
- Background Checks
- Communicate Often with Current Employees to Monitor When Employees are Feeling Pressured
- Communicate Consequences of Fraud
- Implement an Anti-Fraud Policy
- Require Ongoing Anti-Fraud Training
- Provide a Hotline for Anonymous Tips
“Pseudo-Controls”

- Authorization / Signatures Without First Reviewing Supporting Documentation
  - $1,000 or more example, Credit Card Stmt. Example
- No Documentation of Authorization / Signatures
- Reliance on Banks for Monitoring
  - No signature example
- External Auditors
  - Sampling
Specific Examples

- **Town of Fairfield, $378,000**: The town’s former supervisor and his wife received $378,000 to which they were not entitled. The former supervisor’s signature stamp was used to sign 316 of 347 unauthorized checks. In April 2010, the former supervisor’s wife was indicted on 350 counts related to theft of these town funds.
Specific Examples

- **Village of Port Henry, $152,864**: The clerk-treasurer admitted to the town board that she stole approximately $4,000 in garbage sticker receipts. However, our auditors determined that cash in the amount of at least $152,864 was unaccounted for over a five-year period. The clerk-treasurer used various schemes to remove cash from the village office while avoiding detection by other village officials, including skimming, lapping, substituting checks for cash, and adjusting receivable accounts.
Specific Examples

- **Town of Sodus, $50,000:** The former town clerk admitted to embezzling more than $50,000 in town funds during the past eight years. She stole cash from the town’s safe at night and created fake deposit tickets to hide the losses. When collecting taxes, she took some of the cash payments and paid tax stubs and used the interest and penalties paid by others to cover the amounts taken.
Specific Examples

• **Ithaca Housing Authority, $206,834:** The former executive director misappropriated $45,000 and incurred questionable expenditures of more than $160,000. This situation occurred because the executive director could override the authority’s internal control system and process payments outside the normal flow of most transactions. The authority board had abdicated its oversight role and essentially did not monitor the authority’s financial operations.
Specific Examples

• **Hopevale Union Free School District, $108,650:** The district’s former business manager misappropriated $108,650 by issuing himself unauthorized checks, improperly increasing his own salary, and using district funds to pay for his personal tax liability. The district also inappropriately paid certain salaries, retirement incentives and other benefits totaling $55,200 to a former principal and two teachers.
Specific Examples

• **Town of Winchester Connecticut, $2.3 Million:** Town left high and dry after director is accused of siphoning funds to mistress.
Questions?

Clay Pilgrim, CPA, CFE, CFF

cpilgrim@rushtonandcompany.com

www.RushtonandCompany.com

770.287.7800