

# Fraud & Internal Controls

FGFOA SCHOOL OF GOVERNMENTAL FINANCE  
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# Fraud & Internal Controls



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# Agenda

- Fraud
  - Headlines!
  - Statistics
  - Top 10 Fraud Red Flags
- Internal Controls
  - COSO Framework
  - Segregation of Duties
  - Internal Controls for Small Organizations
  - Incorporating Compensating Controls



# Fraud

LOS ANGELES

## Ex-Placentia Employee Accused Of Embezzlement Charged With 89 More Felonies

KCAL NEWS

June 17, 2016 / 12:54 PM PDT / KCAL News

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**PLACENTIA (CBSLA.com)** – Prosecutors filed 89 more felony charges Friday against a former Placentia finance services manager accused of embezzling nearly \$5.2 million from the city.



# Fraud

PRESS RELEASE

## Former Spring Lake Public Official Sentenced to Four Years in Prison for Embezzlement

Wednesday, December 14, 2022

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For Immediate Release

U.S. Attorney's Office, Eastern District of North Carolina

ELIZABETH CITY, N.C. – Gay Cameron Tucker, 64, was sentenced today to two consecutive 24-month sentences in prison for embezzling more than \$500,000 from the Town of Spring Lake. Tucker is the former finance director and account technician for the Town. On September 21, 2022, she pleaded guilty to one count of Embezzlement from a Local Government Receiving Federal Funds, and one count of Aggravated Identity Theft.



Fraud

PRESS RELEASE

# Municipal Employee Pleads Guilty to Wire Fraud Conspiracy

Thursday, February 2, 2023

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For Immediate Release

Office of Public Affairs

First Guilty Plea in Ongoing Investigation of Excess Vehicle Auctions at the Metropolitan Transportation Authority

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# Fraud

PRESS RELEASE

## Former Dixon Comptroller Rita Crundwell Sentenced To Nearly 20 Years In Federal Prison For \$53.7 Million Theft From City

Thursday, February 14, 2013

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**For Immediate Release**  
U.S. Attorney's Office, Northern District of Illinois

ROCKFORD — The former comptroller of the City of Dixon, Ill., RITA A. CRUNDWELL, was sentenced today to 19 years and 7 months, nearly the 20-year maximum, in federal prison for stealing \$53.7 million from the city over two decades. Crundwell was taken into custody to immediately begin her sentence, which was imposed by U.S. District Judge Philip G. Reinhard in Federal Court in Rockford.

Crundwell, 60, formerly of Dixon, pleaded guilty on Nov. 14, 2012, to wire fraud, and agreed she also engaged in money laundering, in connection with stealing more than \$53 million from the city since 1990 and using the proceeds to finance her quarter horse farming business and life of luxury. It is believed to be the largest theft of public funds in state history.



## Fraud

### What do the following municipalities have in common?

1. Atlanta, GA
2. New Orleans, LA
3. San Francisco, CA
4. Chicago, IL
5. Philadelphia, PA
6. Dallas, TX
7. State of South Carolina
8. San Jose, CA
9. Austin, TX
10. Baltimore, MD
11. Detroit, MI
12. Pittsburgh, PA
13. Cincinnati, OH
14. Columbus, OH
15. Cleveland, OH
16. Akron, OH
17. Dayton, OH

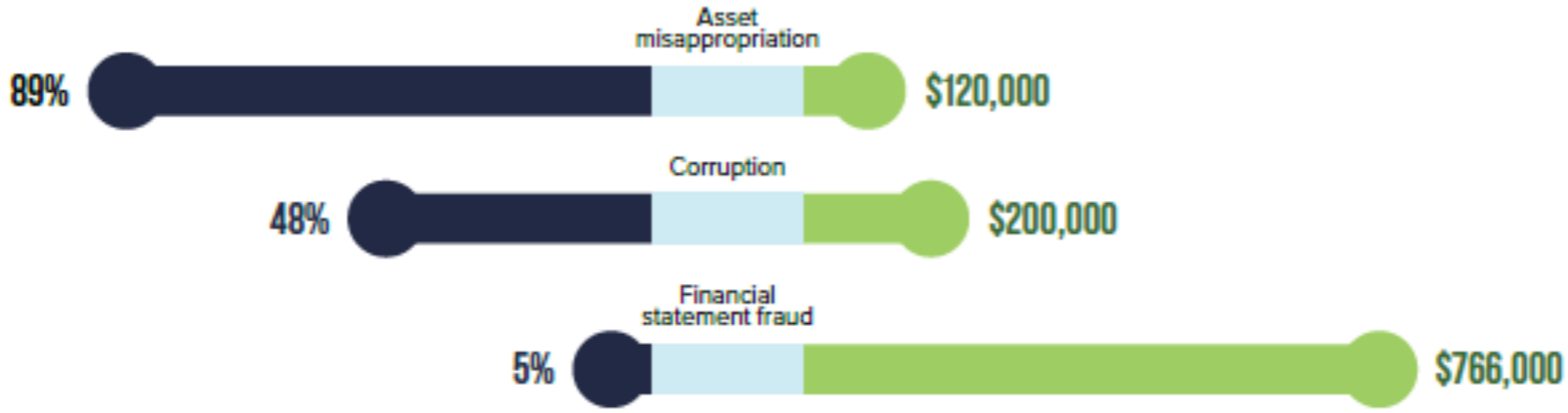




# Fraud Statistics

- According to the ACFE's 2024 Report to the Nations:

FIG. 2 HOW IS OCCUPATIONAL FRAUD COMMITTED?



● Median loss  
● Percent of cases

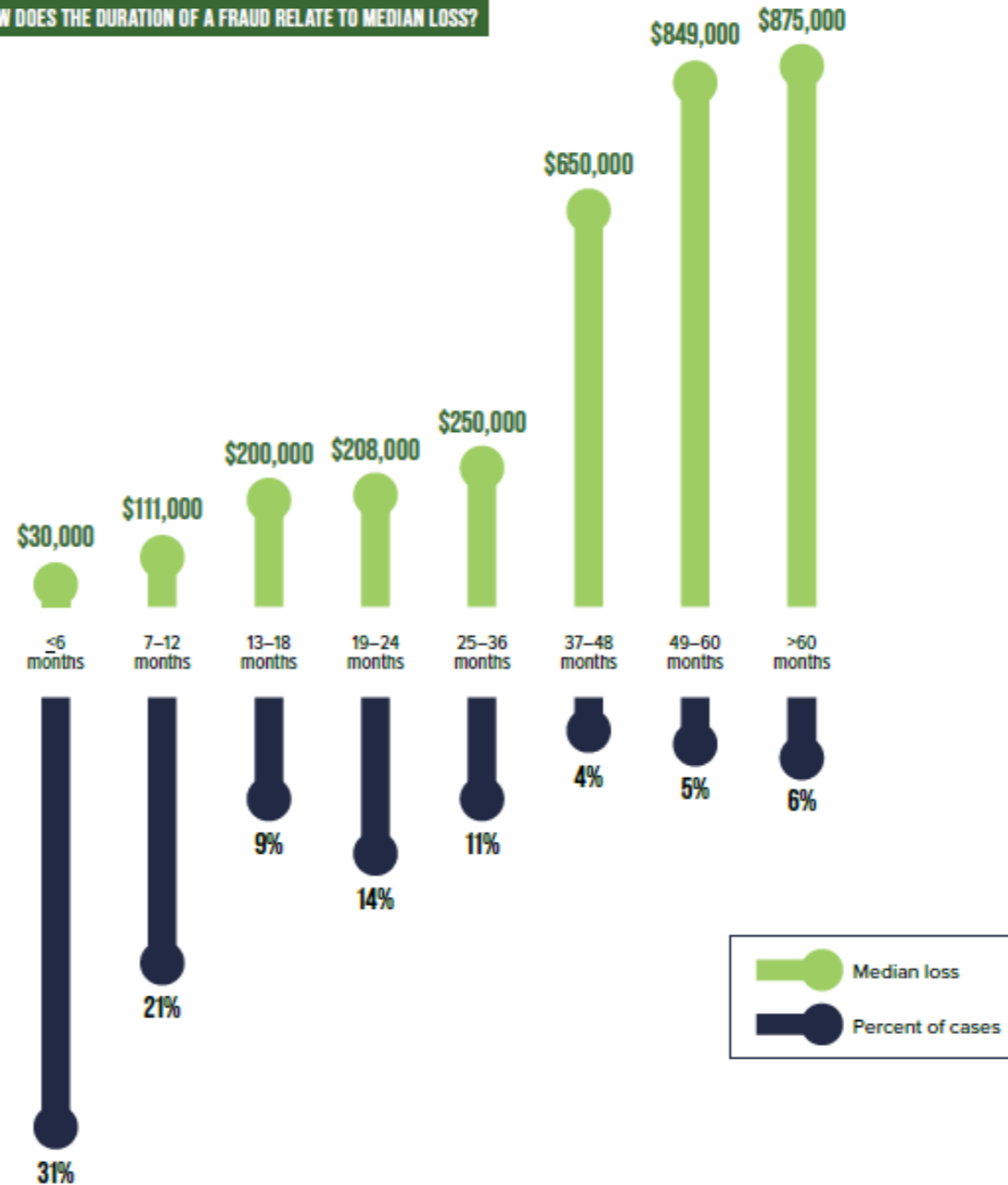
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# Fraud Statistics

- According to the
- ACFE's 2024 Report
- to the Nations:

FIG. 7 HOW DOES THE DURATION OF A FRAUD RELATE TO MEDIAN LOSS?



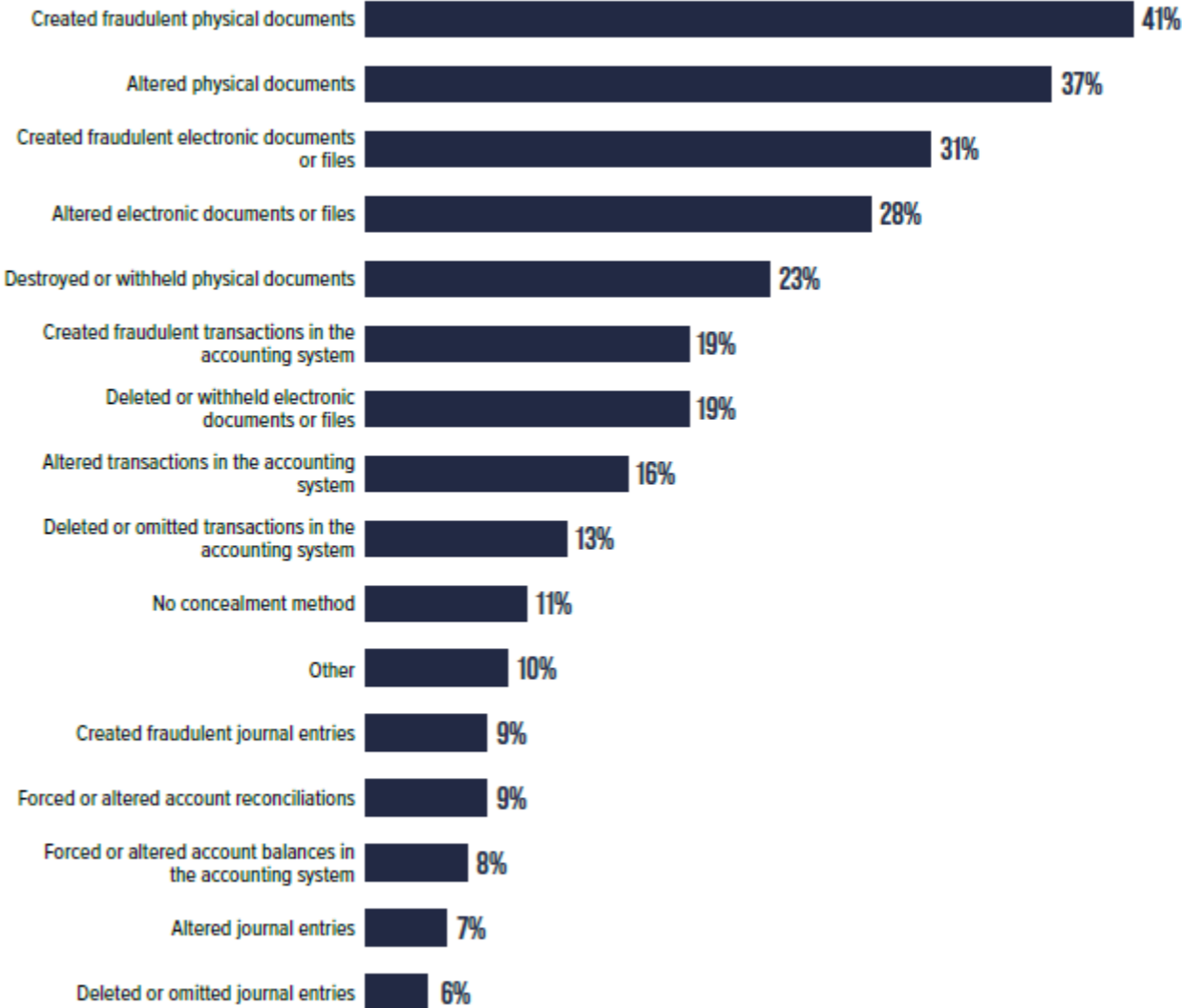
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# Fraud Statistics

- According to the
- ACFE’s 2024 Report
- to the Nations:

FIG. 10 HOW DO OCCUPATIONAL FRAUDSTERS CONCEAL THEIR SCHEMES?



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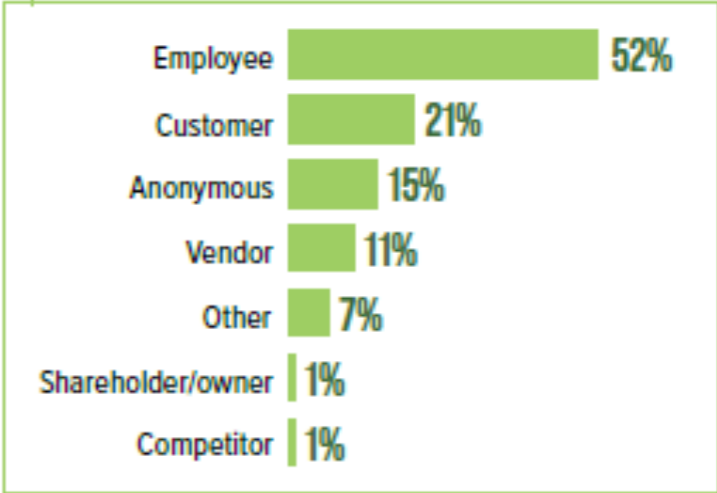
# Fraud Statistics

- According to the
- ACFE’s 2024 Report
- to the Nations:

FIG. 13 HOW IS OCCUPATIONAL FRAUD INITIALLY DETECTED?



FIG. 14 WHO REPORTS OCCUPATIONAL FRAUD?



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# What is my auditor's responsibility for detecting fraud?

- Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to error or **fraud**. *Reasonable assurance* is a high level of assurance but is not absolute assurance. **The risk of not detecting a material misstatement resulting from fraud is higher than one from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.**
- The financial statement audit is not designed to detect fraud



# Fraud Statistics

- According to the
- ACFE's 2024 Report
- to the Nations:

FIG. 20 WHAT TYPES OF ORGANIZATIONS ARE VICTIMIZED BY OCCUPATIONAL FRAUD?

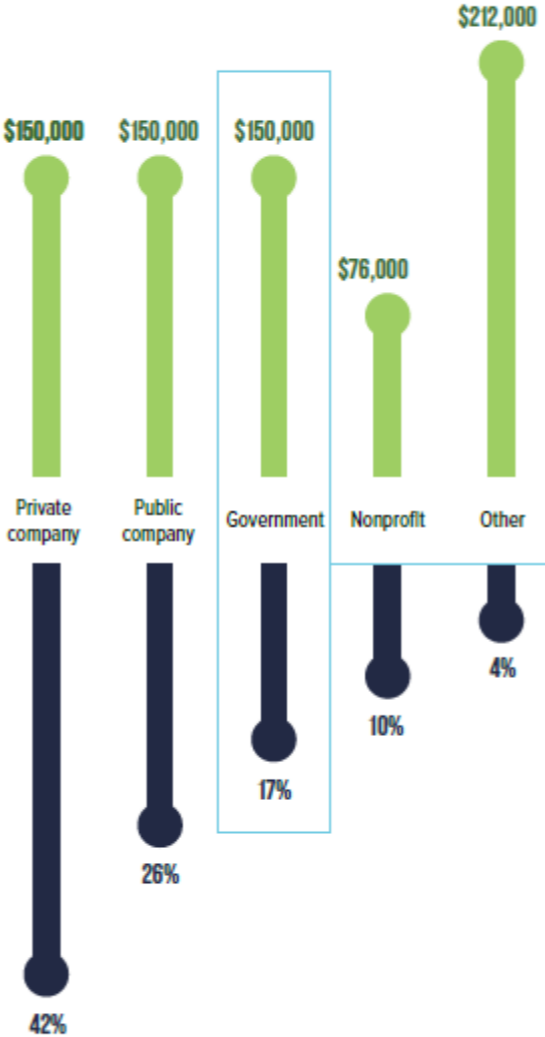
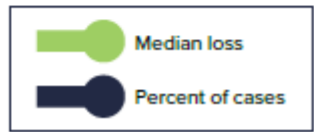
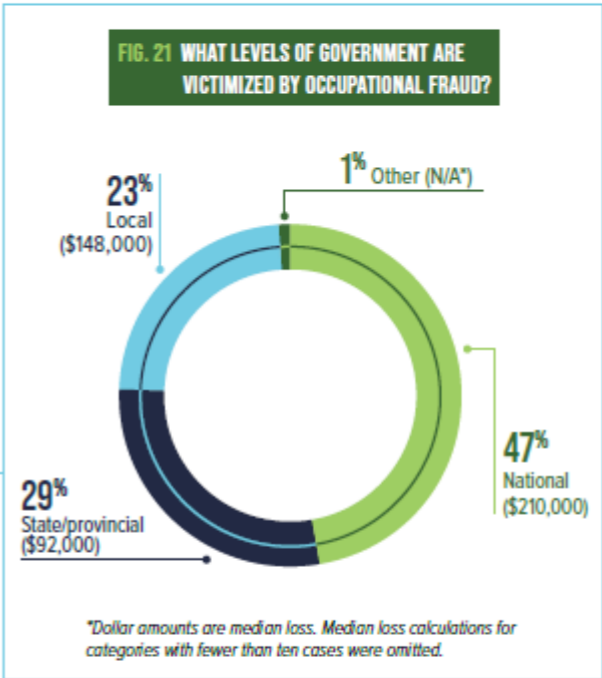


FIG. 21 WHAT LEVELS OF GOVERNMENT ARE VICTIMIZED BY OCCUPATIONAL FRAUD?



## Why Governments are Targets

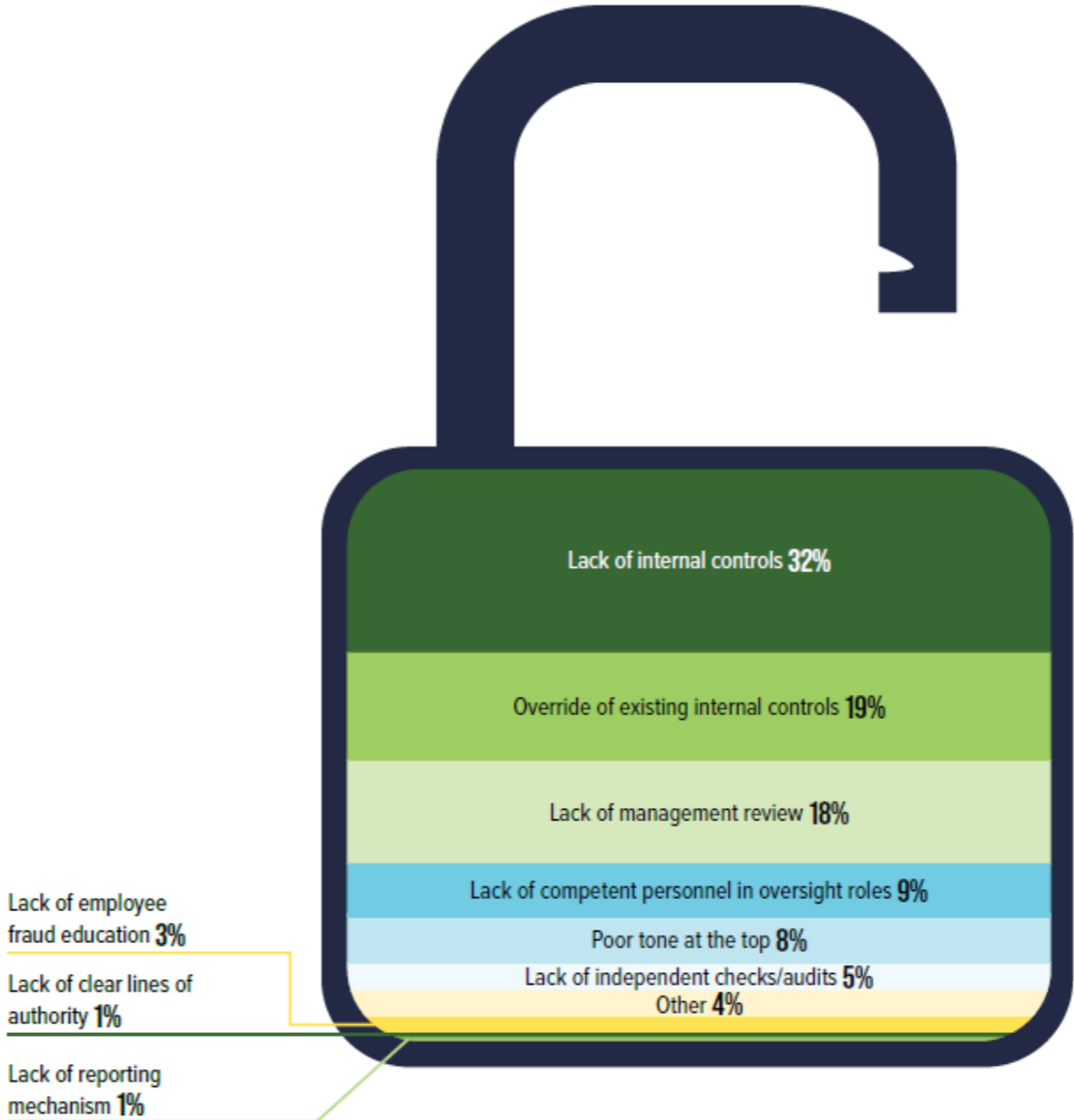
- Large amounts of cash collected and distributed
- Significant employers in local areas
- Relative lack of resources to combat fraud
- Volume of personnel with purchasing authority



# Fraud Statistics

- According to the
- ACFE’s 2024 Report
- to the Nations:

FIG. 37 WHAT ARE THE PRIMARY INTERNAL CONTROL WEAKNESSES THAT CONTRIBUTE TO OCCUPATIONAL FRAUD?



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# Fraud Triangle



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## Fraud Triangle - Pressure

Typical pressures:

- Meet budget or other performance goals
- Personal issues



## Fraud Triangle - Rationalization

Rationalization (convincing yourself its okay):

- “They don’t pay me enough for what I do.”
- “I’ll pay it back when I get back on my feet.”
- “The City has plenty of money.”
- “Everyone does it”
- “The City is wasting the money on xyz.”



# Fraud Triangle - Opportunity

Opportunity includes:

- Access to bank accounts
- Access to cash
- Access to inventory
- Ability to process transactions (ex. Error corrections, customer account adjustments, etc.)



## KNOWLEDGE CHECK

### What key factor was attributed to the largest percentage of occupational fraud?

1. Lack of competent personnel in oversight roles
2. Poor tone at the top
3. Lack of internal controls



## Top 10 Red Flags Indicating Fraud

### #10 – Employee Behavior

- Living beyond means
- Personal issues – medical, divorce, etc.
- Refusal to take vacation time
- Defensive when questioned about transactions



## Top 10 Red Flags Indicating Fraud

### #10 – Employee Behavior – What do we do?

- Pay attention to your employees and understand their personal situation
- Mandatory vacations
- Don't worry about hurting feelings while reviewing the way a transaction was handled



## Top 10 Red Flags Indicating Fraud

### #9 – Financial Results (Good and Bad)

- Revenue and Expenditure Projections very close to actual every year
- Poor financial results and/or significantly different than expected
- Bond covenants are barely met





## Top 10 Red Flags Indicating Fraud

### #9 – Financial Results (Good and Bad) – What do we do?

- Review transactions near year end for appropriate cut-off
- Thoroughly investigate budget variances
- Know how your bond covenants are calculated – don't just rely on auditor



## Top 10 Red Flags Indicating Fraud

### #8 – Related Party Transactions

- Doing business with someone related to an employee or member of governing body
- Lack of conflict of policy policies



## Top 10 Red Flags Indicating Fraud

### **#8 – Related Party Transactions – What do we do?**

- Formal conflict of interest policies
- Have employees sign a conflict of interest statement each year.
- Make sure to review the conflict of interest statements



# Top 10 Red Flags Indicating Fraud

## #7 – Credit Card Usage

- Make purchasing more convenient, but at what price?
- Manipulation of spending limits
- Too many have access
- Limits are not appropriate for employee's responsibilities



## Top 10 Red Flags Indicating Fraud

### #7 – Credit Card Usage – What do we do?

- Limit the number of people who have access
- Formal policy for limits
- Hold those approving transactions accountable
- Review in a timely manner



## Top 10 Red Flags Indicating Fraud

### #6 – Tone at the Top

- Lack of policies and procedures
- Repeats of findings and auditor suggestions
- Communication of the importance of integrity
- No open door policy or hotline to report fraud and abuse



## Top 10 Red Flags Indicating Fraud

### #6 – Tone at the Top – What do we do?

- Formal policies and procedures related to job responsibilities
- Listen to your auditors
- Make sure fraud related training is provided to all employees



## Top 10 Red Flags Indicating Fraud

### **#5 – Lack of Cross Training**

- Only 1 person knows procedures for certain types of transactions
- Resistant to change or involving other people in processes
- Not only good policy for fraud, but for efficiency in financial reporting





## Top 10 Red Flags Indicating Fraud

### #5 – Lack of Cross Training – What do we do?

- Proactively identify job responsibilities which are only known by one person
- Schedule rotation of changes so you're more likely to stick to it



# Top 10 Red Flags Indicating Fraud

## #4 – Rumors

- Keeping our eyes and ears open to what other employees and members of the community are saying
- Most fraud isn't uncovered by audits



## Top 10 Red Flags Indicating Fraud

### #4 – Rumors – What do we do?

- Be open minded. Even someone with a grudge may be telling the truth
- Always follow up



## Top 10 Red Flags Indicating Fraud

### #3 – Access

- Access (both physical and access to software) should be restricted to those people whose job necessitates them having access
- Former employee access should be of concern
- Risk of outside hacking should be a consideration for everyone



## Top 10 Red Flags Indicating Fraud

### #3 – Access – What do we do?

- Formal IT policies regarding access and termination procedures
- Disaster recovery plan
- Regular re-appraisal of necessity of access and adequacy of controls



# Top 10 Red Flags Indicating Fraud

## #2 – Potpourri

- Unexplained budget variances
- Excessive overtime for certain employees
- Untimely preparation and review of bank reconciliations
- Undocumented journal entries



# Top 10 Red Flags Indicating Fraud

## #2 – Potpourri – What do we do?

- Review budget to actual reports on a regular basis
- Inspect payroll for individuals with excessive overtime
- Reconcile bank accounts on a monthly basis
- Require approval for all journal entries



## Top 10 Red Flags Indicating Fraud

### #1 – Lack of Adequate Segregation of Duties

- An effective internal control structure must have an appropriate segregation of duties, especially for key areas
- When motivated, people will find the cracks in the system





## Top 10 Red Flags Indicating Fraud

### **#1 – Lack of Adequate Segregation of Duties – What do we do?**

- Internal control questionnaires are a good way to evaluate your controls
- Consider including non-accounting employees as part of the financial reporting process when staff sizes are limited





# Internal Controls

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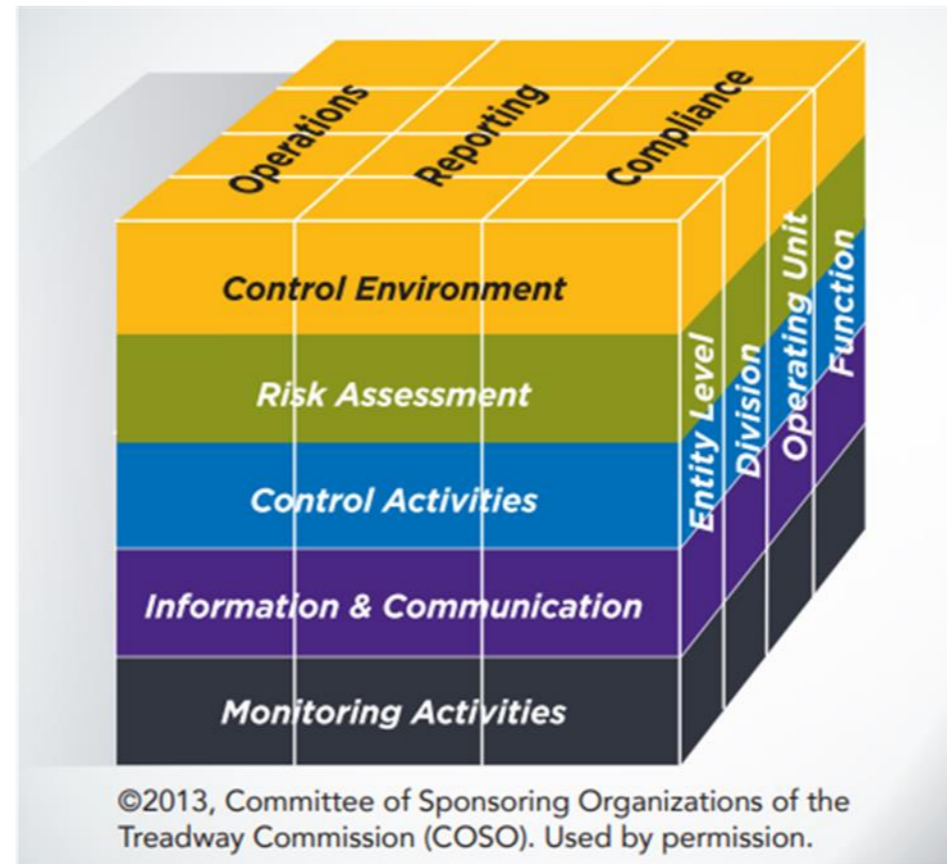


## Internal Controls

- The process to provide reasonable assurance of:
  - Reliability of Financial Reporting
  - Effectiveness / Efficiency of Operations
  - Compliance



# Committee of Sponsoring Organizations of the Treadway Commission (COSO)



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# Committee of Sponsoring Organizations of the Treadway Commission (COSO)

Control Environment	Risk Assessment	Control Activities	Information and Communication	Monitoring Activities
<ol style="list-style-type: none"> <li>1. Demonstrates commitment to integrity and ethical values.</li> <li>2. Exercises oversight responsibility.</li> <li>3. Establishes structure, authority, and responsibility.</li> <li>4. Demonstrates commitment to competence.</li> <li>5. Enforces accountability.</li> </ol>	<ol style="list-style-type: none"> <li>6. Specifies suitable objectives.</li> <li>7. Identifies and analyzes risk.</li> <li>8. Assesses fraud risk.</li> <li>9. Identifies and analyzes significant change.</li> </ol>	<ol style="list-style-type: none"> <li>10. Selects and develops control activities.</li> <li>11. Selects and develops general controls over technology.</li> <li>12. Deploys through policies and procedures.</li> </ol>	<ol style="list-style-type: none"> <li>13. Uses relevant information.</li> <li>14. Communicates internally.</li> <li>15. Communicates externally.</li> </ol>	<ol style="list-style-type: none"> <li>16. Conducts ongoing and/or separate evaluations.</li> <li>17. Evaluates and communicates deficiencies.</li> </ol>



## Segregation of Duties

- No financial transaction is handled by one person from beginning to end!
- The more negotiable the asset, the greater the need for proper segregation of duties.



## Segregation of Duties

### Which duties should be segregated?

- Authorization of transactions
- Custody of assets
- Recordkeeping
- Reconciliation



## Segregation of Duties

### Authorization of Transactions

- The process of reviewing and approving transactions or operations
  - Approving purchase requisitions or purchase orders;
  - Approving timesheets, payroll certifications, leave requests and cumulative leave records;
  - Approving change orders, computer system design or programming changes
- Do we now have individuals working remotely now? If so, we may need to re-evaluate who should be performing these functions.





## Segregation of Duties

### Custody of Assets

- The process of having access to, or control over, any physical asset such as cash, checks, equipment, supplies, or materials
  - Access to any funds through the collection of funds or processing of payments;
  - Access to safes, lock boxes, file cabinets or other places where money, checks or other assets are stored;
  - Custodian of a petty cash or change fund
- When less people are in the office, how are we ensuring that we are safeguarding physical assets?
- Do we have a policy for what is allowed off premises?



## Segregation of Duties

### Recordkeeping

- The process of creating and maintaining records of revenues, expenditures, inventories, and personnel transactions. These may be manual records or records maintained in automated computer systems
  - Preparing purchase requisitions, payroll certifications and leave records
  - Entering charges or posting payments to accounts receivable
  - Maintaining inventory records
- How are we maintaining our records? Do we have the resources to do this adequately?



## Segregation of Duties

### Reconciliation

- Verifying the processing or recording of transactions to ensure that all transactions are valid, properly authorized and properly recorded on a timely basis. This includes following up on any differences or discrepancies identified.
- How are reconciliations prepared, who maintains them, how are they reviewed, how are we documenting who prepared and who reviewed?



## Example Finance Department

- Finance Director – Bobby
- Accountant II – Andrea
- Accountant I – Laura
- Other
  - City Manager/Mayor
  - Police Officer
  - Secretary
  - Department heads



## Disbursement Controls

- Purchasing:
  - Approved vendor list
  - Periodic review of changes to the vendor list
  - POs are reviewed to ensure the expenditure is within budget
  - POs are prenumbered
  - Sequence accounted for regularly
  - Unissued forms are controlled
  - Retain voided documents
- Segregation of Duties:
  - Purchase requisition is entered by department head and approved by City Manager. PO signed by the Finance Director.
  - If the Finance Director receives invoices from departments and approves, then Accountant I enters bills for payment.
  - Accountant I does not have access to approved vendor listing.



# Disbursement Controls

- General Controls:
  - Bank accounts are authorized by the governing board or appropriate level of management
  - Individual(s) responsible for signing checks is/are authorized by the governing board.
  - Mechanical check signers and signature plates are safeguarded
  - Dual signatures for checks over a certain amount or on all checks
  - Review and approval of all check registers
  - Prohibit checks payable to cash
  - Use positive pay
- Segregation of Duties:
  - Checks require two signatures with the options of the Mayor, Finance Director and/or City Manager.
  - Review of canceled checks by an authorized signer



# Disbursement Controls

- Check processing:
  - Prepared after proper matching to support documentation
  - Support documentation is appropriately marked/canceled with the check number
  - Signed by authorized signer
  - Dual signatures obtained, if required
  - Check for clerical accuracy, pricing, quantities received, brand name, etc. to the vendor invoice.
  - Check signer reviews all supporting documents
  - Promptly recorded to the general ledger
- Segregation of Duties:
  - Checks require two signatures with the options of the Mayor, Finance Director and/or City Manager.
  - Review of bank statement prior to reconciliation
  - Review of bank reconciliations



## KNOWLEDGE CHECK

**What percentage of victim organizations modified their anti-fraud controls following a fraudulent event?**

1. 43%
2. 56%
3. 81%
4. 96%





## Disbursement Controls

- Individuals responsible for the following should be separate:
  - Initiator of purchases – Department Head
  - Approver of purchases – City Manager
  - Receiving goods/services – Departments
  - Preparation of checks – Accountant II (not a signer)
  - Signer of checks – Two of three
  - Accounts payable – Accountant I



## Electronic Disbursement to Vendors

- Strong internal and information technology controls
- Written agreements with banks and third parties
- Dual controls authorizing non repetitive transactions
- Dual controls for establishment of repetitive transactions
- Establishment of dollar limits for authorized personnel
- Use of passwords / pin numbers
- Call-back verification
- Fraud Risk:
  - Vendor email compromised
  - Phishing email sent to government
  - Wire payment initiated to fraudulent account



## Electronic Disbursement to Vendors

- Purchase Card –Segregation of Duties
  - Credit Card Statements distributed to appropriate individuals - Accountant I
  - Card Holder - Submits credit card statement with attached receipts to Dept Head.
  - Dept Head – Approves supporting documentation and submits to Finance Director.
  - Finance Director – pre-audits and approves for payment.
  - Accountant II- processes for payment.



## Cash Disbursements to Vendors

- Timely preparation and review of the bank reconciliation
- Reviews outside the Finance Department used to help with segregation of duties
  - Must be by appropriate level of management or governing body member.
  - Review cash disbursements listing periodically
  - Review cash disbursements to budget periodically



## KNOWLEDGE CHECK

### **Control activities can be defined as:**

1. A means to an end
2. Authorized procedures
3. The particular category in which a control is placed
4. The actions of people to help ensure that management directives necessary to address risks are carried out



## Cash Receipting Controls

- Perform daily reconciliations of cash received through walk-in traffic and mail.
- Reconciliations of cash register tape to cash drawer, daily cash receipts to postings, etc.
- Deposit cash receipts on a daily basis.
- Monthly (or even daily) reconciliation of general ledger to bank balance.
- Segregation of Duties:
  - Accountant I collects cash and enters into System.
  - Daily deposits are reconciled by Accountant II and reviewed by Finance Director. All video recorded.
  - Bank deposits are taken the next day by a finance employee (or another department) and police escort.
  - Accountant II, prepares bank reconciliations and they are reviewed by the Finance Director.



## Cash Receipting Controls

- Individuals responsible for the following should be separate:
  - Opening mail or copying checks received - Secretary
  - Posting cash receipts – Accountant I
  - Preparing deposits – Accountant I/Finance Director
  - Depositing cash receipts – Rotational with Police escort
  - Reconciling bank statements – Accountant II
  - Review bank statements – Finance Director



## Cash Receipting Controls

- All employees receiving cash should use pre-numbered receipts or a cash register
- All checks should be restrictively endorsed upon receipt
- Standard daily cash register reconciliation forms
- Cashier funds should be counted and reconciled at the end of each shift and the reconciliation should be reviewed by a supervisor





## Cash Receipting Controls

- Someone independent of accounting department should open mail and restrictively endorse checks
- Same person as above should also log each item
- Accounting department should record the checks in the accounting system and deposit funds daily
- A third person should periodically compare and contrast deposit slips to the daily log of incoming checks to ensure all receipts were deposited



## Cash Receipting Controls

- Bank drafts, electronic fund transfer (EFT), internet payments
- With electronic receipting, reports identifying individual receipts must be generated on a daily basis and reconciled to the funds deposited per the bank



## KNOWLEDGE CHECK

### What are ways to overcome a lack of segregation of duties?

1. Surprise audits
2. Management review
3. Anonymous hotline
4. All of the above





# Compensating Controls

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## Designing Compensating Controls

- Documentation – Create a formal document which clearly outlines the steps necessary to execute the compensating control.
- Approval – Ensure documentation is reviewed and approved by management regularly. Systems, access, people and functionality change so it is important to determine if the compensating control serves the purpose that was intended.
- Training – Ensure that appropriate staff are trained. They need to understand the risk, review the procedure documentation and be clear on the method and timing.
- Review – Periodically review the control to ensure that it's effective, especially when the control is new.



## Overcoming a Lack of Segregation of Duties

- Provide all bank statements to someone other than the bookkeeper
  - Mayor
  - County Manager
  - Board Member
- Surprise audits (internal or external)
  - Inspect all cleared checks for a particular time period
  - Agree all receipts to the deposit slip for a time period
  - Inspect bank reconciliations
  - Review a monthly budget to actual report
  - Request a report of all new vendors added during a time period
  - Request a report of all new employees added during a time period or changes to employee records
- Anonymous hotline
- Periodic review of journal entries and don't be afraid to ask questions



## Overcoming a Lack of Segregation of Duties

- Detailed review of balance sheet and income statement transactions or review a sample of transactions during a period.
- Exception reports -
  - Compensation change audit
  - Benefits change audit
  - Time override audit
- Prepare budget analysis and cost trends to investigate any discrepancies
- Perform analytical reviews – Identify predictable relationships and perform an analysis of unusual trends. (Look for anomalies when job assignments change or surrounding vacations)
- Reassign reconciliations to someone outside of the process
- Forced vacations and cross training
- Third party involvement in the process.



## Summary

- Fraud
  - We don't want to be a part of the Headlines
- Internal Controls
  - Follow COSO Framework
  - Limit Opportunity by Segregating Duties
  - Small Organizations likely need to include employees from other departments in internal control process and/or implement Compensating Controls
  - Document Document Document
  - Train Train Train





QUESTIONS?

# Thank You

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