

# Auditing For Fraud

or

## What Does Fraud Look Like

Presented by:

**Dennis F. Dycus, CPA, CFE, CGFM**

**NSAA/NASC Joint Middle Management Conference**

**Nashville, TN**

**April 21, 2009**

## RED FLAG



➤ *A set of circumstances that are unusual in nature or vary from the “normal activity”*

## CAUTION

- ❖ Do not ignore a red flag
  - Conduct inquiry to determine reason for abnormal circumstances
- ❖ Sometimes an error is just an error
  - Is there *intent*?



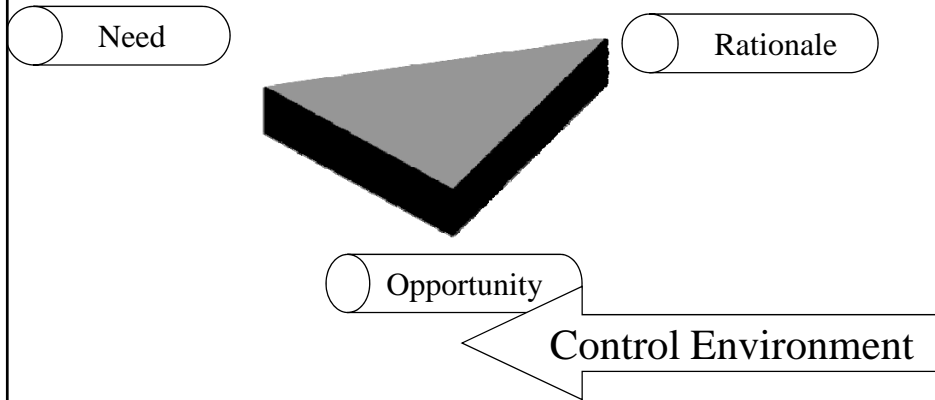
3

## Quote of the Day

**Fraud and Stupid  
Often Look  
Exactly the Same**

4

# Fraud Triangle



5

# Controlling Opportunity

**Prevent**



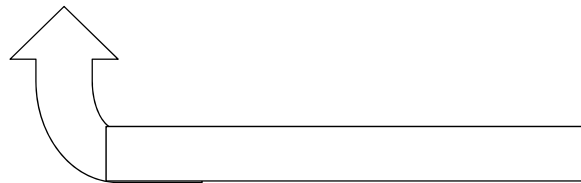
**Control**



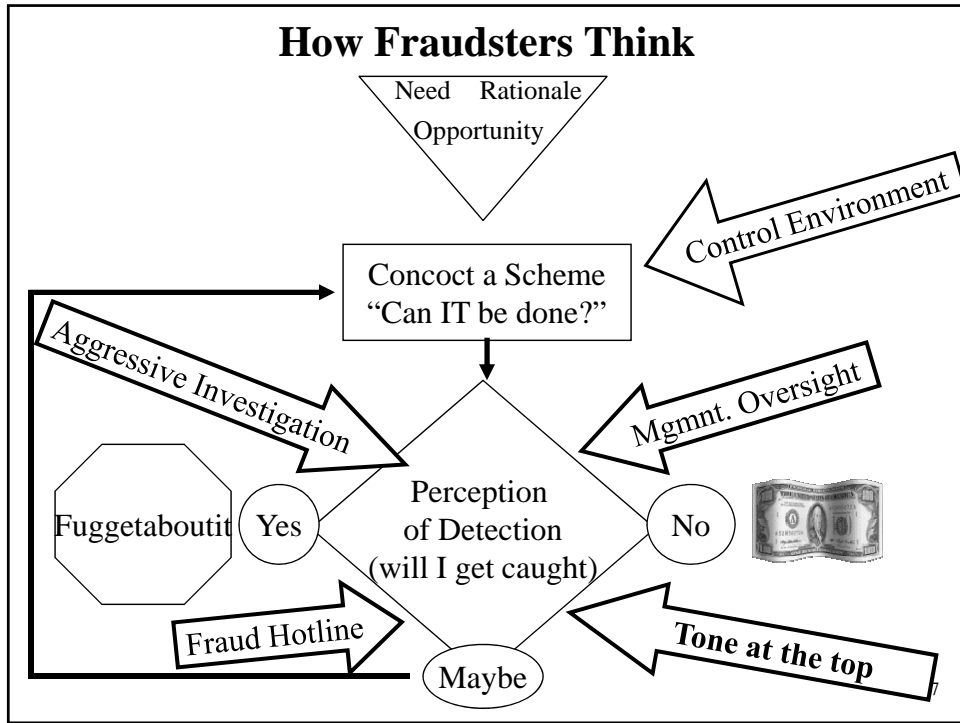
**Monitor**



**Deter**



6



Corruption Schemes and Fraud in  
Compliance Programs

**# 1 Reason Fraud  
Occurs**

**Blind Trust**

8

## EMPLOYEE RED FLAGS



- ❖ Lifestyles changes
- ❖ Significant personal debt and credit problems
- ❖ Behavioral changes
  - Drug or alcohol related
  - Gambling
  - Fear of losing job
- ❖ High employee turnover
- ❖ Refusal to take vacation or sick leave
- ❖ Lack of segregation of duties

9

## EMPLOYEE RED FLAGS



- ❖ Low or inadequate salary
- ❖ Difficulty in obtaining audit evidence
- ❖ Severe disciplinary actions
- ❖ Lack of respect or appreciation by superiors
- ❖ Open-ended contracts
- ❖ Resentment for not being treated fairly

10

## What Does Fraud Look Like

- ❖ Remember that employees will circumvent internal controls not for the purpose of committing fraud, but because .....
- ❖ It makes their job easier
- ❖ But by doing so, an *opportunity* is provided

11

## What Does Fraud Look Like

- ❖ Sooner or latter, an employee will have a need
- ❖ They only need to be able to rationalize in order to take advantage of the *opportunity*

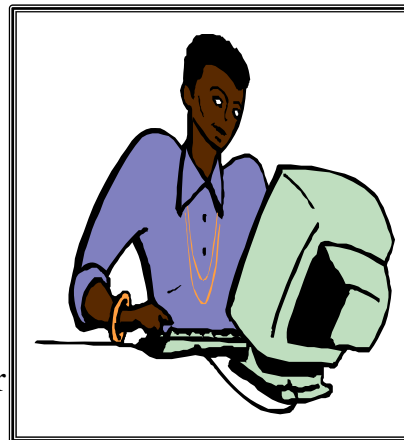
12

# **DANGER!**

## **BEWARE OF BLACK HOLES AHEAD**

### **MANAGEMENT RED FLAGS**

- ❶ Reluctance to provide information to auditors
- ❷ Excessive number of checking accounts
- ❸ Frequent changes in banking accounts
- ❹ Frequent changes in external auditors
- ❺ Company assets sold under market value

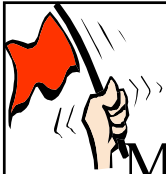




## MANAGEMENT RED FLAGS

1. Significant downsizing in a healthy market
2. Continuous rollover of loans
3. Excessive number of year-end transactions
4. High employee turnover rate
5. Unexpected overdrafts or declines in cash balance

15



## MANAGEMENT RED FLAGS

6. Refusal by company or division to use serial numbered documents
7. Compensation program out of proportion with its profits
8. Any transaction that does not make sense
9. Photocopied or missing documents

16



## RED FLAGS IN CASH/ ACCOUNTS RECEIVABLES



- ❖ Excessive number of voids, discounts and returns
- ❖ Unauthorized bank accounts in company name
- ❖ Sudden activity in dormant banking accounts
- ❖ Customers receiving late notices on accounts where payments have been made

17



## RED FLAGS IN CASH/ ACCOUNTS RECEIVABLE

- ❖ Discrepancies between bank deposits and posting to the account
- ❖ Abnormal number of expense items or supplies reimbursement by employees
- ❖ Presence of employee checks in petty cash for the employee who is responsible for petty cash
- ❖ Unjustified cash transactions
- ❖ Large number of written-off accounts
- ❖ Bank accounts that are not reconciled on a timely basis

18

## RED FLAGS IN CASH R/D ACCOUNTS RECEIVABLE


- ❖ Unusual checks
- ❖ Any check for an even amount in excess of \$50
- ❖ Any deposit of currency in a large amount
- ❖ Any non-payroll or expense reimbursement check made payable to an employee
- ❖ Excessive use of clearing accounts
- ❖ Excessive purchases of small tools
- ❖ Bids/High-Low/Same Ones/Splitting

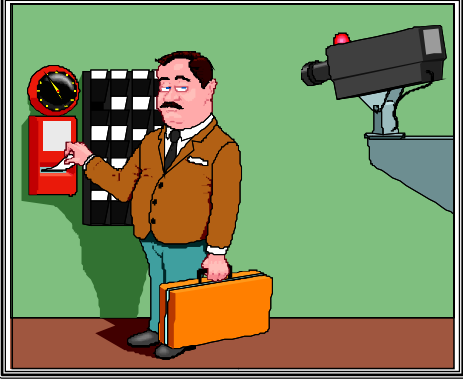
19

## RED FLAGS IN CASH R/D ACCOUNTS RECEIVABLE

- ❖ Large and frequent change orders
- ❖ High level approval of a low level transaction
- ❖ Odd purchases
- ❖ Copies of invoices rather than originals


20

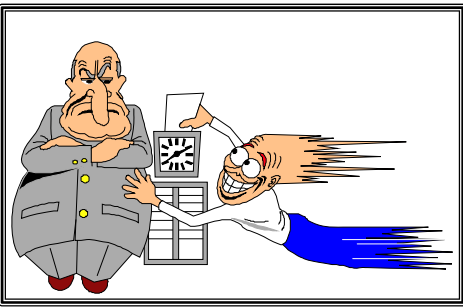
 **RED FLAGS IN PAYROLL**



- ❖ Inconsistent overtime hours for a cost center
- ❖ Overtime charged during a slack period
- ❖ Overtime charged for employees who normally would not have overtime pay
- ❖ Budget variations for payroll by cost center

21

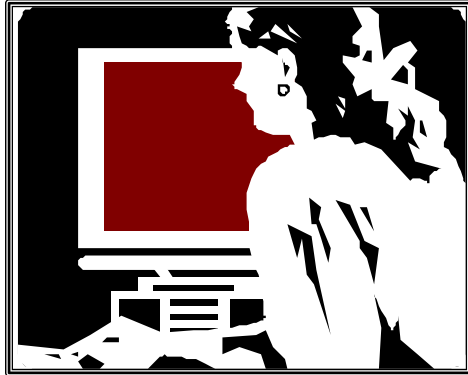
 **RED FLAGS IN PAYROLL**



- ❖ Employees with:
  - Duplicate Social Security numbers
  - Same names
  - Same addresses
- ❖ Employees with few or no payroll deductions

22

## RED FLAGS IN PURCHASING/INVENTORY



- ❖ Increasing number of complaints about products or service
- ❖ Increase in purchasing inventory but no increase in sales
- ❖ Abnormal inventory shrinkage

23



## Red Flags in Purchasing/ Inventory

- ❖ Increase in scrap materials and then reorders for the same items
- ❖ Lack of physical security over assets/inventory
- ❖ Sales without shipping documents
- ❖ Payments to vendors who aren't on an approved list
- ❖ High volume of purchases from new vendors

24



## Red Flags in Purchasing/ Inventory

- ❖ Purchases that bypass the normal procedures
- ❖ Vendors without physical addresses
- ❖ Vendor addresses that match employee addresses
- ❖ Excessive inventory and inventory slow to turnover
- ❖ Purchasing agents that pick up vendor payments

25

## Reasons Auditors Fail To Detect Fraud

- ❖ We mechanically “tick and turn,” and we are darn good at it!
- ❖ We don’t perform the basic, traditional audit tests and procedures
- ❖ Lack of substantive testing
- ❖ We avoid those “high risk” areas, especially if immaterial in amount
- ❖ Inadequate time budgets

26

## **Reasons Auditors Fail To Detect Fraud**

- ❖ Lack of training to recognize fraud indicators (But we sure can follow that audit program!)
- ❖ We don't have adequate training in order to recognize basic internal control weaknesses and what can happen as a result of such
- ❖ We just don't want to find fraud

27

## **Reasons Auditors Fail To Detect Fraud**

- ❖ We tend to accept any "Reasonable" auditee explanation for an audit exception. (Sounds good to me!)
- ❖ We ASSUME!

28

## ANALYZING RED FLAGS

❖ Recognizing the red flag is not sufficient

- Action must be taken to determine the cause and possible effect

❖ Evaluate by

- Financial analysis
- Observation
- Techniques which will mitigate the apparent weakness



29

## ANALYZING RED FLAGS

❖ Determine the effect on the business

- Red flags are most likely a warning that something is wrong
- If can not be explained, the next step is to conduct an examination

❖ Financial analysis is conducted to establish workable leads



30

## ANALYZING RED FLAGS

### Computer Analysis

- ❖ Listing of discounts, voids and refunds by employee
- ❖ Actual vs budgeted reimbursements by employee
- ❖ Unusual payment by vendor
- ❖ Duplicate or fake SS No. by employee/vendor



31

## ANALYZING RED FLAGS

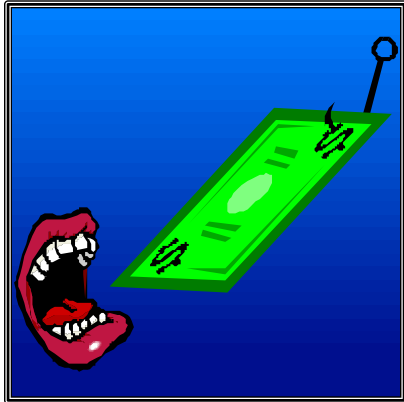
### Computer Analysis

- ❖ Customer complaints
- ❖ Unusual patterns in overtime payments



32

## ANALYZING RED FLAGS



- ❖ Observation
- ❖ Correct the situation
- ❖ Educate the responsible area

33

## ANALYZING RED FLAGS CONCLUSION

- ❖ Red Flags are “Warnings”
- ❖ Do not ignore (They will be waiting for you!)
- ❖ There are no “Little Frauds”

34

**Hope You All  
Sleep Well Tonight!**  
(Sweet Dreams – Or Night Mares)

35

# **When Leadership Fails**

**Presented by:  
Dennis F. Dycus, CPA, CFE, CGFM**

**NSAA/NASC Joint Middle Management Conference  
Nashville, TN  
April 21, 2009**

## **When Leadership Fails**

By statute, the members of a governing body of a political subdivision of the State of Tennessee, be it a county, city, town, utility district, or a local board of education are responsible for the entity's operations.

As President Harry Truman once said....

**The Buck Stops Here**

2

## **When Leadership Fails**

The members of the governing body (board) are responsible for establishing the policies and procedures (P&P) the governmental entity operates under

- The board is also responsible for seeing that the entity is operated in accordance with such P&P

3

## **When Leadership Fails**

- The board may delegate such responsibility, but in the end, they are responsible
- When the board either:
  - ✓ Fails to adopt adequate P&P
  - ✓ Adopts inadequate P&P
  - ✓ Adopts P&P but fails to see that they are compiled with

4

**When Leadership Fails**

**BAD THINGS**

**CAN HAPPEN**

**AND OFTEN DO**

5

**When Leadership Fails**

**SUCH AS**

- Inefficient operation of the entity
- Failure to adequately maintain the entity's infrastructure
- Misappropriation of the entity's assets

6

## **When Leadership Fails**

This presentation will focus on frauds/problems that have occurred in such entity's because the members of the governing board failed to carry out their oversight responsibilities

7

## **When Leadership Fails**

### **How Does It Happen**

- Most frauds are committed by “Honest People”

8

## **When Leadership Fails**

In order for an “Honest Person” to commit fraud, three things **must** always be present:

9

## **When Leadership Fails**

**NEED**

**RATIONALIZATION**

**OPPORTUNITY**

10

## When Leadership Fails

Of the three things that must be present, which one does the board members **ALWAYS** provide?

**OPPORTUNITY**

11

## When Leadership Fails

That's why that members of the board often try to keep the fraud *quiet* – because they share in the responsibility in that they either:

- Had no P&P
- Had inadequate P&P
- Did not see that the P&P were complied with

12

## When Leadership Fails

The best laid plan (P&P) is worthless unless it is put into operation and monitored

From time to time (once a month would be good) at least one member of the BOC should look at the records to make sure that:

- Adequate collection records are being created and retained;

13

## When Leadership Fails

- Adequate supporting documentation for disbursements is being obtained and retained

If there is a documentation problem, it should not be discovered when the BOC reads their annual audit report

- The poorest response to such a finding is *we were not aware of this*

14

## When Leadership Fails

- It's your job to be aware of it because you are the leader and the buck stops with you
- The members of the board should be familiar with the functioning of the office staff
- The members of the board should bring issues to the attention of the auditor, not the other way around

15

## When Leadership Fails

- Documentation deficiencies identified during the periodic reviews should not be tolerated
  - ✓ Such deficiencies may very well provide an *opportunity*
- There should not be any excuses for inadequate records

16

## When Leadership Fails

- If discrepancies are blamed on *computer software glitches*, have the software vendor come out immediately and determine if the problems are with the software
- If reports are not printed because of *printer problems*, investigate the problem, and if necessary replace the printer

17

## When Leadership Fails

- If discrepancies are blamed on a *bank error*, contact the banker and get the issue straightened out immediately
- Noncompliance with district P&P should not be tolerated
  - ✓ One warning, and then they are gone

18

## When Leadership Fails

- Do not allow an employee to entrench themselves with certain tasks
  - ✓ Resistance to giving up a task should be viewed with suspicion
  - ✓ So should resistance to change in procedures; especially in strengthening internal controls

19

## When Leadership Fails

- Be suspicious of procedures that serve no purpose other than, *we've always done it this way*

The above suggestions may appear to be a lot of extra work; but which is worse, the extra work or the embarrassment of a fraud occurring on your watch

20

## **When Leadership Fails**

Now let's talk about some of the *opportunities* Municipal Audit staff have noted either as a result of disclosures in the district's annual audit or through investigations they conducted

21

## **When Leadership Fails**

- Always No. 1 on the list of *OPPORTUNITIES* – Lack of the proper segregation of duties;
- Cash receipts not deposited on a timely basis;
- A member of the board was involved in a conflict of interest with the UD

22

## When Leadership Fails

- Failure to observe bid requirements
- Failure to maintain capital asset records
  - ✓ If you don't know what you have, you also don't know what you're missing
- Failure to either itemize or make deposits intact
- Using cash to make small purchases

23

## When Leadership Fails

- No approval of billing adjustments or such approval made by the billing clerk
- Failure to stamp *Date Paid* on billing stubs
- Failure to reconcile the bank account or failure to reconcile on a *timely* basis

24

## **When Leadership Fails**

- Failure to reconcile A/R subsidiary records to the general ledger
- The water utility has a water loss rate in excess of 20%
- Allowing the individual who opens the mail to make the bank deposits

25

## **When Leadership Fails**

- Cashing personal checks through either the petty cash fund or daily receipts
- Allowing more than one employee access to the same cash drawer
- Allowing the individual who collects receipts to also post those receipts

26

## **When Leadership Fails**

- Failure to run a background check on employees, especially those responsible for handling cash
- Failure of the members of the board to comply with the district's P&P
- Failure by the designated individual to properly review invoices prior to payment

27

## **When Leadership Fails**

- Presigning checks
- Failure to review credit card/gas card charges/payments
- Failure to have an adequate travel reimbursement policy
- Allowing personal use of district assets

28

## **When Leadership Fails**

- Failure to bill members of the board or district employees for services provided by the utility (monthly water bill or tap fee)

29

## **When Leadership Fails**

Remember, as a member of the governing board, YOU are responsible for setting/carrying out the entity's P&P  
YOU set the TONE for the organization and its operations

30

# **When Leadership Fails**

**Presented by:  
Dennis F. Dycus, CPA, CFE, CGFM**

**NSAA/NASC Joint Middle Management Conference  
Nashville, TN  
April 21, 2009**