

# Internal Controls

## Practical Applications to Small Businesses



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# Internal Controls

- Defined (COSO): *Internal control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objective in the effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations.*



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# Internal Controls (cont'd)

- Essentially – processes in place to prevent or detect significant misstatements, misappropriations, etc.
  - Reconciliations of balance sheet accounts (not just rollforwards)
  - Review of bank statements, credit card statements
  - Review of P&L trends, margin analysis, etc
  - Physical counts of inventory assets
  - Etc...



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# Small Business' Concerns

- Cost vs benefit
- Segregation of duties
- Lack of understanding of accounting/focus on cash in bank
- Trust factor, family relationships
- No time



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# Main business cycles

- Revenue, A/R
- Expenses, A/P
- Payroll
- Inventory



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# Revenue

- #1 area of misstatement
- Revenue – when is it recordable
  - Sufficient evidence a contract exists
  - Title transferred, performance occurred
  - Fee fixed or determinable
  - Collectibility is reasonably assured



# Revenue – internal controls

- Signed contract or p.o.?
- Internet considerations
- Invoices cannot be processed before shipment date
- Segregation of duties
- Accounting dep't knowledge of GAAP



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# A/R – internal controls

- Brainstorming – examples



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# A/R – skimming & lapping

- Lapping schemes – stealing cash, then substituting it with another customer's receipt (usually check).
  - Example: Sally steals \$75 in cash from the register. She takes a \$77.50 check received in the mail that day and deposits it instead – without recording it in the a/r subledger. Next day – takes another check received in the mail and substitutes it for the \$77.50 (recording it this time). Etc.



## A/R Fraud (cont'd)

- Lapping schemes are usually caught when 1) the fraudster unexpectedly misses work due to illness or 2) customer complaints (“Hey, we paid that invoice!”) reach management’s ears instead of the fraudster’s.
- Fraudsters typically write off balances in response to complaints
- Surprise cash deposit analysis – banks keep records!!



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# Lapping – recent case

- Diane Thistle, former hospital secretary, charged in July 2010 with stealing \$200K. Allegedly:
  - Stole cash from hospital cafeteria
  - Deposited checks paid by hospital for catering into hospital cafeteria's acct, sometimes paid the difference with her own personal checks
  - Used her computer access to change cafeteria's accounting records to alter cash intake amount to match deposit



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# Lapping case study (cont'd)

- Cafeteria's operations had been outsourced & hospital canceled contracts
- Open catering invoices paid with hospital checks intended for other invoices
- Vendor had many thousands of \$ in unpaid catering invoices – audit time!



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# A/R fraud - skimming

- Skimming – theft of cash/checks before they're recorded
  - Lapping is a type of skimming scheme
  - Another example: company settles a \$20,000 receivable for \$12,000. Bookkeeper collects the \$12,000 check, deposits into a bank account w/similar name as her employer, and writes off the entire \$20,000.



## Skimming (cont'd)

- Example – company collects an unexpected security deposit refund from a utility company. The bookkeeper washes the check, deposits in his account, and doesn't record anything in the ledger. Auditors like consistency – “same as last year” works well for security deposit accounts.



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# A/R – suggested controls

- Management review of delinquents
- Credit memos/write offs
- Independent verification – amounts billed over certain threshold
- Invoices agree to sales orders, shipping docs...
- Forced vacations/job duties rotated
- Segregate duties (next slide!)



# A/R – segregation of duties

- Billing vs opening mail/custody of collections/posting cash receipts
- Billing vs customer service complaints
- Billing vs write offs/credit memos
- Reconciliation of a/r subledger
- Management review of delinquent accounts/adjustments/write offs



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# Payables – internal controls

- Brainstorming - examples



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# Payables – types of schemes

- Fraudulent disbursements
  - Forging checks
  - Electronic transfers
  - Submission of false invoices
  - Improper use of credit cards
  - Falsified receipts on T&E reports (avg loss \$33K)
  - Check tampering (avg loss \$131K)
  - Phony vendors – usually deviation of true vendor w/po box



# Fraudulent disbursements (cont'd)

- Pass-through scheme (fraudster's company sells at inflated prices)
- Nonaccomplice scheme (fraudster overpays vendor or orders merch not needed, requests & pockets refunds)



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# Payables – examples of controls

- Segregation of duties - examples
  - Independent person adding/changing vendor records in accounting system
  - Separate people key in invoices & approve check registers
  - Separate people print checks & sign checks
  - Separate person mails checks
    - Ex. Person A (i.e. receptionist) can add/change vendor records and mail checks. Person B (i.e. A/P clerk) can key in invoices and print checks. Person C (i.e. owner) signs checks.



# Payables – examples (cont'd)

- Signed blank checks
- Custody of blank checks
- Review of bank statements, copies of cleared checks if provided
- No use of rubber stamps
- Review of company credit card statements
- Surprise audits (i.e. get vendor statement, compare to records)



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# Payables – recent cases

- Joan Shaw, bookkeeper, arrested 10/21/10 & charged with stealing appx \$120K. Allegedly:
  - Wrote checks for personal expenses
  - Used company credit cards
- Michele Kirk, bookkeeper, arrested 10/21/10 & charged with stealing appx \$37K over 4 years. Allegedly:
  - Wrote checks to herself
  - Didn't pay federal withholding taxes



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# High Value Fraud

- Constance Bexley Iwanski, 56, was sent to jail in February of 2011 for embezzling more than \$659,000. Sentence: 27 months plus full restitution
  - 30 year employee
  - Restructuring in 1994 left her as the only employee responsible for tracking cash for 17 years.
  - Wrote more than 100 checks to herself



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# More High Value Fraud

- Victoria Monfore, printing company bookkeeper, arrested and convicted of stealing \$1.56 million from 2003 to 2009
  - Wrote 234 checks to herself
  - Also reconciled bank statements
  - Claimed “gambling sickness”
  - Bankrupted company
  - 24 year sentence



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# Even More High Value Fraud

- Cecilia Chang, an ex-Dean at St. John's University in Queens, NY, was arrested 9/15/10 & charged with stealing over \$1 million. Allegedly:
  - Personal items, including her son's tuition at St. John's, on expense reports
  - Did not submit receipts



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# Koss Corporation

- Sujata Sachdeva, VP finance, charged with stealing more than \$31 million over a 5-year period. Allegedly:
  - Bought so much she had to rent office space
  - Frequently left purchases at retail stores to pick up later
  - Amex bills over \$2 million a month toward the end of her employment
  - Amex tipped off FBI – corp wires \$10+MM



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## Koss (cont'd)

- Also allegedly used 500+ cashier's checks from company accts (\$15+ million)
- Allegedly colluded with Sr Acct Julie Mulvaney (both charged by SEC)
- Mulvaney may have purchased items below market value
- Koss reported sales of \$38 million in 2009 and theft losses of \$10.2 million in 2010 (2 quarters)



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# Lessons learned

- Owner/management review – bank statements & cleared checks (if avail)
- T&E reports – receipts
- Segregation of duties – check signing
- Careful review of P&L
- Balance sheet recons, surprise audits
- Review credit card statements
- Fraud lifestyle indicators
- Surprise petty cash counts



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# Payroll – internal controls

- Brainstorming



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# Payroll schemes examples – average loss \$72K per ACFE

- Falsified time cards
- Falsified salary/hours
- Ghost employees



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# Payroll – recent cases

- Cynthia Jo Lark, former clerk of Northumberland Sewer Authority – sentenced in August 2010 to 1-3 years prison plus 4 years probation plus \$475K restitution.
  - Stole appx \$475k by forging checks
  - Created fake audited financials
  - Began stealing – unable to pay bills
  - Never took time off, even when sick
  - Sudden hospitalization



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# Overtime theft case

- Commander & lieutenant in Porterville Development Center (CA) arrested in February 2010 for alleged overtime theft
  - Appx \$121K in 2008
  - 18 month investigation
  - Collusion involved
  - Detailed review of P&L – noticed overtime hours way over budget



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# Ghost Employees

- P/R clerk sets up nonexistent employee, keeps checks/direct deposits
- P/R clerk leaves terminated employee on payroll, keeps checks/direct deposits



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# Ghosts – recent case

- Patricia Midell & Bonnie Vital were charged in connection with alleged thefts of over \$144K from the City of Houston in 2007 and 2008
  - Former employee received a W2 for 2008
  - Complained to Ms. Vital, then to City Controller's office
  - Allegedly created false employee records, deposited checks into their own accounts, and used payroll debit cards



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# Ghost Employees – controls

- Report of employees w/no deductions
- Verify employees still employed
- Segregation of duties - examples
  - Payroll clerk cannot add or term employees – or 2<sup>nd</sup> authorization needed
  - Payroll clerk has no custody of pay checks
  - Returned pay checks held/investigated by independent person
  - Payroll clerk cannot make entries to ledger or reconcile bank statements



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# Ghost controls (cont'd)

- Surprise audits of time sheets, HR files
- Surprise handouts of checks, investigate ones not claimed
- Direct deposits going into same account
- Look for employees with p.o. box addresses
- Look for unexplained high turnover
- Job rotation/forced vacations



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# Payroll controls - examples

- Payroll tax filings done/paid outside of payroll clerk's control
- Same for insurance, other payments
- Mandatory vacations
- Job rotation
- Owner reviews payroll register
- Reconcile pay checks & direct deposits back to payroll register
- No signed blank checks, no stamps, restricted manual checks



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# Payroll – segregation of duties - examples

- Owner reviews pay register
- Payroll vs general ledger functions
- Payroll vs bank reconciliation functions
- Payroll vs paying garnishments, health insurance, other invoices
- Payroll vs handling of physical checks
- Payroll clerk can't add or term – or 2<sup>nd</sup> authorization needed
- Payroll clerk has no access to HR files



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# Inventory Controls

- Inventory – brainstorming controls



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# Types of inventory schemes

- Purchasing schemes
- False sales
- Inventory records



# Purchasing Schemes

- Theft of inventory that never hits books
- Employee orders & collects inventory
- Paperwork not sent to receiving
- Employee approves invoice for payment



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# False sales schemes

- Theft of inventory after it is on the books
  - Record credit sale where debt is never collected OR
  - Recording only reduction in inventory records
  - Uses false sales documentation
  - Inventory records reduced
  - Manufacturing – WIP can be manipulated instead of recording as a sale



# Inventory records schemes

- Manipulation of inventory records directly
  - False write offs – as damaged/obsolete
  - False stock counts
  - Adjusting on-hand quantities



# Inventory controls - examples

- Blind counts
- Surprise counts
- Management – write offs
- Physical security/cameras
- Invoices show proof of goods received, match approved purchase order
- Review of margins
- Review of p.o.s over certain \$ amount



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# Inventory – examples (cont'd)

- Segregation of duties
  - Counts vs input quantities
  - Independent checks on valuation
  - Check sales docs against items being pulled
  - Custody of inventory/access
  - Only management may write off inventory
  - Purchasing, receiving, and A/P duties separate



# Inventory – case examples

- Phar-Mor
  - Management embezzled & covered tracks through inventory adjustments at retail locations they knew would not be counted by auditors
  - \$500MM accounting fraud
  - Phar-Mor declared bankruptcy in 1992
  - Former CFO pled guilty to fraud, money laundering, & false tax returns
  - All levels of management/collusion



# Inventory – case example

- Thomas Gillespie, 37, was sentenced to 9-23 months in prison plus 5 years probation, plus restitution
  - Set up fake company w/bank account
  - Purchased inventory for this fake company and had his employer pay for it
  - Sold the same inventory to his employer at a profit, sometimes double what he paid
  - Fraud amounted to appx \$77K



# Inventory - case example

- Bruce Weiss, former pharmacy tech, 35, was sentenced to 1 year in prison + 3 years probation, + restitution of \$60K
  - Physically stole prescription drugs, hidden under his jacket
  - Security cameras involved after informant tip
  - Sold drugs to other pharmacies
  - Total amount of loss unknown. Audit \$500K of drugs missing



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# Inventory - case example

- Anthony Robert D'amico, 34, arrested for grand theft in March 2010
  - Allegedly stole auto parts from employer & sold to friends, used some personally, & sold online
  - Manager of parts department
  - Able to purchase parts on behalf of the company outside of the normal protocol
  - Employer noticed questionable purchases/billings – audit time!



# Overall Controls - examples

- Management integrity, expectations
- Background checks – limited impact
- Management/owner review
  - Financial statements
  - Bank statements (very important)
  - Balance sheet account reconciliations
  - Profit & loss, margin trends
  - Write offs/adjustments – restrictions
  - Can be delegated to independent person



# Overall controls (cont'd)

- Forced vacations/rotations of job duties
- Dun & Bradstreet, LexisNexis
  - D&B "Business Information" report \$119 – includes judgments, liens, lawsuits, bankruptcies, UCC filings...
  - UCC filings critical – loans may not know about
  - LexisNexis has a similar report for \$20



# ACFE's Report to the Nations - 2010

- Free resource, internationally known and respected
- See [www.acfe.com](http://www.acfe.com)
- Source for statistics shown



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# ACFE – Profiling Perps – U.S.

- Median loss – male \$167K, female \$82K
- At employee level: losses caused by males 36% higher
- At management level: 67% higher
- At executive level: 325% higher
- More than half of losses in survey results age group 31 to 45 years old
- About half of fraudsters' tenure 5+ years. Rest – 1 to 5 years



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# More Profiling

- Some college or degreed – 71%
- Median loss for high school grad \$100K
- Median loss range – college \$136K to \$300K
- Only 7% previously convicted for fraud



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# Accounting Department's Top 9

- Check tampering – 33%
- Billing - 31%
- Skimming - 18%
- Cash larceny - 16%
- Payroll - 16%
- Petty cash - 13%
- Expense reimbursement - 11%
- Corruption (i.e. kickbacks) -10%
- Other



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# Executive Department's Top 9

- Corruption – 49%
- Billing – 41%
- Noncash/Financial stmt fraud – 32%
- Expense reimbursement – 30%
- Petty cash/cash larceny – 24%
- Payroll – 16%
- Check tampering – 14%
- Skimming – 14%
- Other



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# Behavioral Red Flags

- Living beyond means – 43% of cases
- Financial difficulties – 36%
- Control issues/no sharing – 23%
- Unusually close association w/vendor/customer - 22%
- Wheeler-dealer attitude – 19%
- Divorce/family problems – 18%
- Irritable/defensive/suspicious – 14%
- Addiction problems – 12%



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# Behavioral Red Flags (cont'd)

- Refusal to take vacations – 10%
- Past employment-related problems – 9%
- Complaints about inadequate pay – 8%
- Excessive pressure from mgmt – 8%
- Other



# Employee-level specific flags

- Living beyond means – 41%
- Financial difficulties – 48%
- Divorce/family issues – 19%
- Control issues/no sharing – 15%
- Unusually close association – 12%
- Addiction issues – 12%
- Refusal to take vacations – 12%
- Other



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# Additional Resources

- [www.acfe.com](http://www.acfe.com)
- ACFE's GA Chapter – [www.gacfe.org](http://www.gacfe.org)
- [www.aicpa.org](http://www.aicpa.org)
- Dun & Bradstreet
- LexisNexis
- Tools – i.e. Idea, Audit My Books, Excel



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# About the presenter

- Jennifer W. Birtz, CPA, CIA, CFE has over 17 years experience in public and industry accounting in Atlanta. She specializes in compiling and reviewing financial statements and has a special interest in fraud and internal controls. She may be reached at 770-353-5093 or [Jennifer.Birtz@hawcpa.com](mailto:Jennifer.Birtz@hawcpa.com).



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