



The Importance of Internal Controls & Professional Skepticism

Forvis Mazars

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forvis
mazars

Agenda

1. Evaluate professional standards as they relate to maintaining professional skepticism in the work we perform.
2. Discuss how certain strategically placed controls, coupled with professional skepticism, can help mitigate fraud risk.
3. Analyze what happens when these controls are missing.
4. Discuss information that links certain controls with fraud losses.
5. Identify the grey areas.
6. Fraud or not? A case example

First Questions Often Asked

How did the auditors/CFO/Controller miss this?

or...

Why didn't they tell us this was happening?

CPA's too Often Take the Blame

- “...you relied heavily, if not exclusively, upon information provided to you by _____ for information and documentation used to prepare...”
- How many of us can fall into this construct?

Thought to Ponder

The question isn't whether a person is honest, but rather in what situations & to what extent

Manipulation of Accounts Payable- Collin Street Bakery

Case 3:13-mj-00503-BH Document 1 Filed 08/12/13 Page 1 of 9 PageID 1
AO 91 (Rev. 12/10) Criminal Complaint

United States District Court
NORTHERN DISTRICT OF TEXAS

UNITED STATES OF AMERICA
V.
SANDY JENKINS

COMPLAINT
CASE NUMBER: 3-13-MJ-503-BH

U.S. DISTRICT COURT
NORTHERN DISTRICT OF TEXAS
FILED
AUG 12 2013
TEXAS
CLERK, U.S. DISTRICT COURT
By Deputy *DNCR*

- Now, Sandy considered himself a moral person. But somehow, as he sat at his desk that December day in 2004, the action he was tempted to take didn't seem wrong. He felt he was working the equivalent of three jobs at the bakery, and was he really compensated for all of it? How long was he supposed to wait to achieve his dreams?
- By January 25, when his credit card payment was due, he was ready to follow through with his plan. He drummed his fingers on his desk, sipped a Diet Coke, and glanced over to see if Scott was looking. And then, taking a breath, he set his fingers on his keyboard and typed a \$20,000 check payable to Citi Card. The software automatically signed the check "Bob McNutt." Sandy printed that check, voided it in the system, but mailed it. Then, to cover his tracks, he typed the next check payable to a legitimate bakery vendor for the same amount but never mailed it.
- See more at: <http://www.texasmonthly.com/articles/just-desserts/>

Where did the Money Go?

Source: United States District Court Exhibit – Case 3:13-mj-00503-BH

Year	Total Number of Fraudulent Checks	Total Dollar Amount
2005	76	\$2,149,137.00
2006	139	\$2,286,182.98
2007	140	\$2,483,598.09
2008	127	\$2,220,483.05
2009	106	\$1,732,994.64
2010	97	\$1,615,790.49
2011	88	\$1,866,883.43
2012	81	\$1,749,328.75
2013*	34	\$545,388.48
Grand Total	888	\$16,649,786.91
<i>*January 1, 2013 to June 21, 2013</i>		

Payee	Total Amount
American Express	\$11,120,449.92
Citi Card	\$1,941,596.39
Neiman Marcus	\$1,196,773.51
Bank of America	\$555,915.97
Capital One	\$337,957.66
BAC H/L (Home Loan) Servicing	\$125,854.30
Lexus Financial Services	\$101,303.27
Sewell (Lexus)	\$98,662.30

- On Thursday, June 20, 2013, Semetric, the relatively new hire in accounting, stopped in his doorway. She'd been going over bank statements that morning and had found a check that she didn't recognize, a check made out to Capital One. She knew the bakery didn't have any accounts or credit cards with Capital One. It was then that Sandy heard the question he had once feared: "Sandy, there's a discrepancy with this check. Can you help me understand this?"
- See more at: <http://www.texasmonthly.com/articles/just-desserts/>

AICPA Code of Professional Conduct

- Due Professional Care requires the auditor to exercise:
 - Professional skepticism
 - Is an attitude that includes:
 - a questioning mind,
 - being alert to conditions that may indicate possible misstatement due to fraud or error, and
 - a critical assessment of audit evidence
 - Considers the competency and sufficiency of the evidence
 - Neither assumes that management is dishonest nor assumes unquestioned honesty
 - Not satisfied with less than persuasive evidence because of a belief that management is honest



Polling Question #1

Which of the following represent characteristics of professional skepticism?

- A** | Questioning mind
- B** | Suspension of judgment
- C** | Search for knowledge
- D** | All of the above

Maintaining Skepticism

- Professional skepticism
 - AU-C Section 240 says
 - Ongoing questioning of whether information & evidence suggests fraud occurred
 - Consider reliability of evidence obtained
 - Do not rely on past experience with management
 - Easy to become comfortable with client
 - Be objective, no bias in our thinking



Skepticism

An Enemy of Fraud

Chapter 3

Six Characteristics of Skepticism

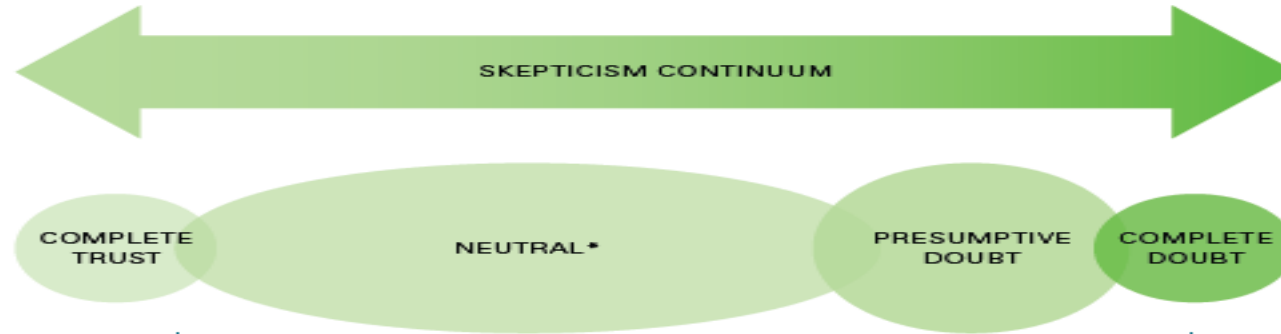
- **Questioning Mind**—A disposition to inquiry, with some sense of doubt
- **Suspension of Judgment**—Withholding judgment until appropriate evidence is obtained
- **Search for Knowledge**—A desire to investigate beyond the obvious, with a desire to corroborate
- **Interpersonal Understanding**—Recognition that people’s motivations and perceptions can lead them to provide biased or misleading information
- **Autonomy**—The self-direction, moral independence and conviction to decide for oneself, rather than accepting the claims of others
- **Self-Esteem**—The self confidence to resist persuasion and to challenge assumptions or conclusions

Summarized from R. Kathy Hurtt, “Development of a Scale to Measure Professional Skepticism,” *Auditing: A Journal of Practice and Theory*, May 2010.

Deterring and detecting financial fraud: A platform for action



Exhibit 1: The Application of Professional Skepticism



PROFESSIONAL SKEPTICISM**
"An Attitude that Includes a Questioning Mind"



- FACTORS POTENTIALLY LEADING TO LESS AUDIT EVIDENCE (after initial appropriate risk assessment procedures)**
- Lower risk and susceptibility of material misstatement
 - No indicators of fraud
 - No errors detected
 - Routine, little judgment required
 - Audit evidence consistent with initial risk assessment

- FACTORS POTENTIALLY LEADING TO MORE AUDIT EVIDENCE (after initial appropriate risk assessment procedures)**
- Higher risk and susceptibility of material misstatement
 - Fraud indicators present
 - Errors detected
 - Complex judgment
 - Audit evidence inconsistent or contrary to the initial risk assessment

* Neutral—neither assuming management dishonesty nor unquestioned honesty.
 ** Professional Skepticism does not include the area of the continuum depicted by complete trust; in the area depicted as complete doubt, the auditor will move to a forensic mindset.

The Fraud Spectrum

Affected by: Company Culture, industry, position in company, persona; spending philosophy

Good

Bad



Examples

Never taking a dollar that isn't yours, avoiding perceptions of conflicts of interest, recording accounting entries based on what is right, not what helps bottom line

Examples

First class business travel, borrowing office equipment for home projects, awarding project to a relative, "aggressive" accounting positions. These are often debated

Examples

Classic fraud schemes – e.g., fake vendors, skimming cash receipts. Normally little debate here

Company Credit Card Scenarios



Three Common Types of Credit Card Purchases



Okay:

Office supplies with receipts, approved travel for conferences



May be inappropriate:

First class travel, certain meals, fuel for personal car, gift cards

Don't give this type an automatic free pass



Clearly wrong:

Casino cash advances, home remodeling projects

Different Ways of Doing Business

- What's "ethical" in one company might be frowned upon in others
 - Spouse travel to conferences
 - First class travel
 - High-end wining & dining
 - Business in U.S. vs. Mexico vs. China, etc.



Polling Question #2

Charges on the previous slides (hotel, cash advances, meals) were

- A** | Definitely excessive
- B** | Likely embezzlement
- C** | Probably okay
- D** | It depends on the situation

Making the Right Call

- Acceptable at one company may be prohibited at another
- Does your company have a good policy?
- Is board of directors aware of the kinds of transactions that are occurring in your organization?
- Is situation ripe for turning into something worse
- Avoiding overreliance on management explanations



Policies & Tone at the Top

- How does your company communicate their way of business?
 - Policy manual/employee handbook
 - Code of conduct
- Unwritten rules
 - Tone at the top



Case Study: Fraud...or Not?

Sick & Vacation Leave Granted

September 1997:

- Top government official convinces City Council to allow him to sell (cash out) unused leave time
- Added amendment to his existing employment contract
- City Council approves each contract



Sick & Vacation Leave

Leave Activity

Leave time: June 11, 2002 contract	442 days
Leave sold back in next eight weeks	107 days
Total:	335 days

Pattern was

- City Council approved new employment contracts
- After approval: sell batches of leave time
- Each sale of leave time was documented in a memo & backed up with latest employment contract

Polling Question #3

Based on facts presented, since City Council approved, leave time granted & sold was

- A** | Likely embezzlement
- B** | Not embezzlement but unethical
- C** | Bad accounting process
- D** | Fine, if they wanted to reward him

Leave Buyback Scheme - End Result

- Seven-year period: over 2,000 days of leave sold
- Equivalent to 60 years worth of leave
- Final tally: \$675,000 in leave time cashed out
- He became bolder: other benefits added
- Convicted
- Sentenced to 51 months in federal prison



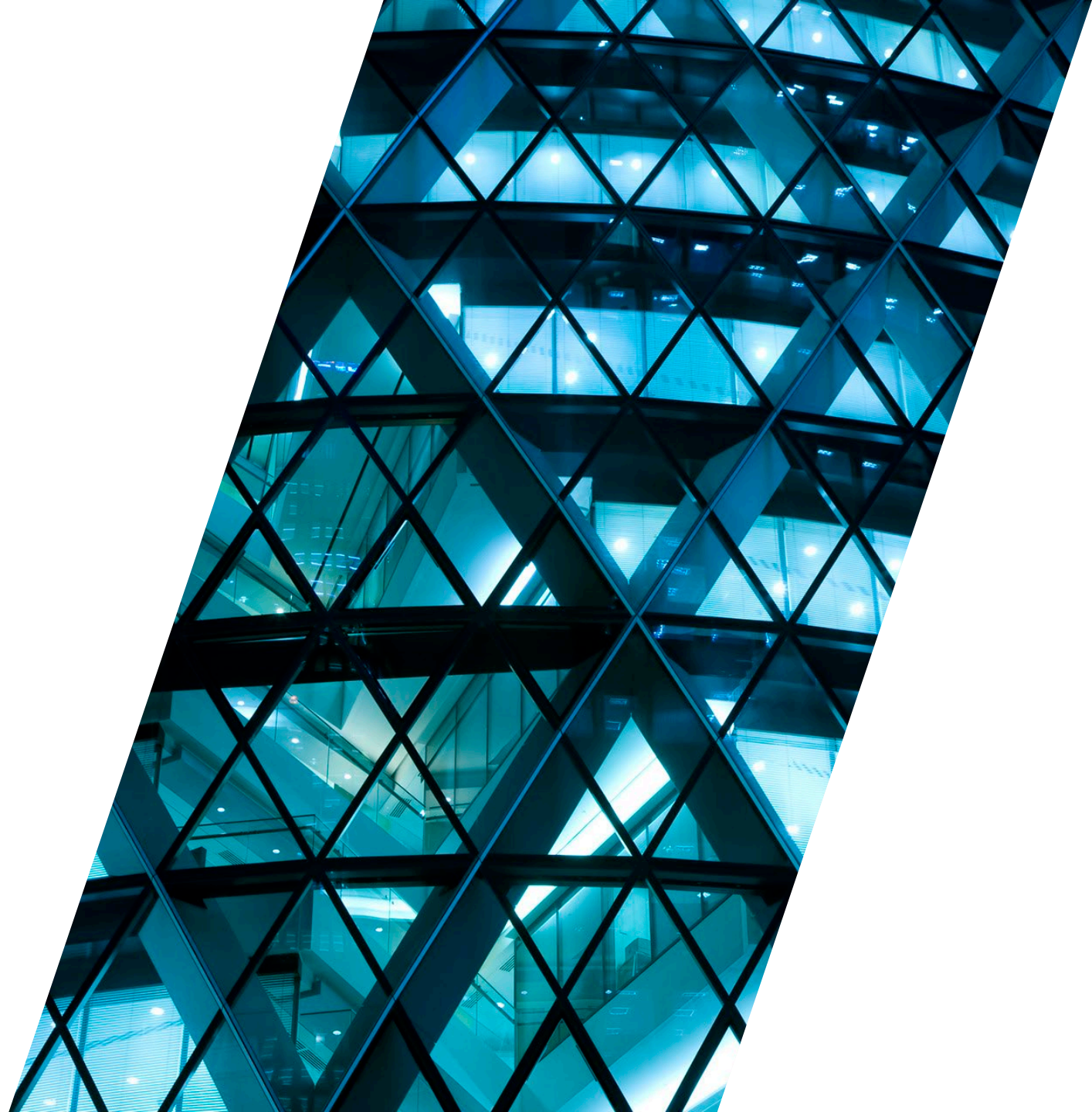
Ethical Lessons Learned

- Creativity & aggressiveness seen as positive attributes
- But where does the line get crossed?
- Some will build paper trails to cover trail
- Legal doesn't make it ethical
- Be on lookout for omissions as much as fabricated data
- Beware of vague or poorly written contracts
- Nothing written down- hard to nail down later

Warning Signs There is More to the Story

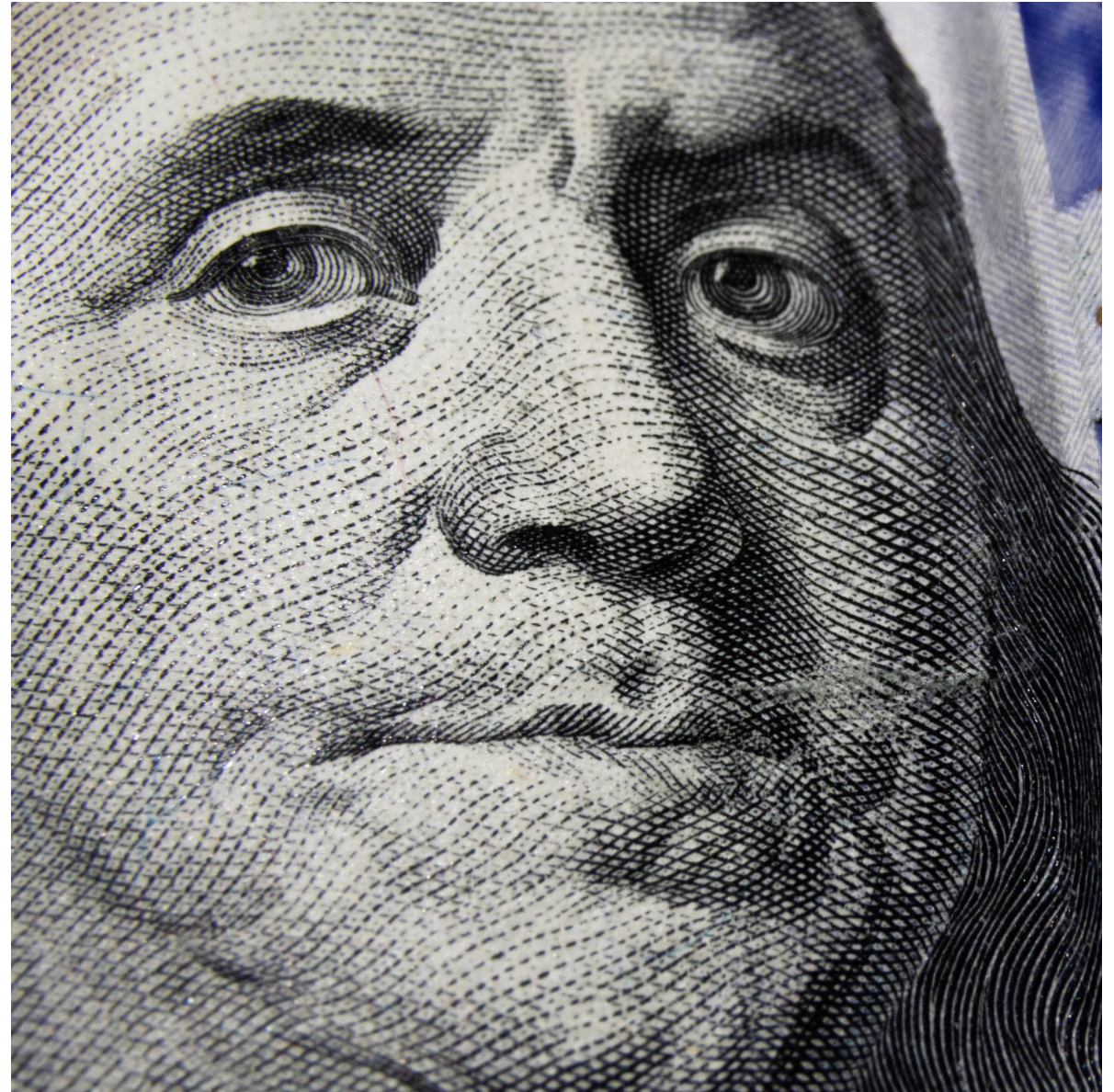
- Told you are not needed at certain meetings
- Attempts to control flow of information
- Making you feel dumb or like you don't understand
- Lots of smooth talking but still no answers

Reminders



60% Recover Nothing After Finding Fraud

Recovering Funds is Difficult



Do You Have an Insurance Policy?

Fidelity bond or employment dishonesty coverage



Polling Question #4

Does your firm have an insurance policy that covers employee dishonesty/theft?

- A** | Yes
- B** | I'm not sure; but, I am going to check
- C** | We do not
- D** | What is that?

Tips are Top Method of Detection

43% of all frauds in larger companies detected by tip



Fraud Hotlines

- Fraud hotline?
- Providing individuals a means to report suspicious activity is a critical part of an anti-fraud program
- IntegraReport



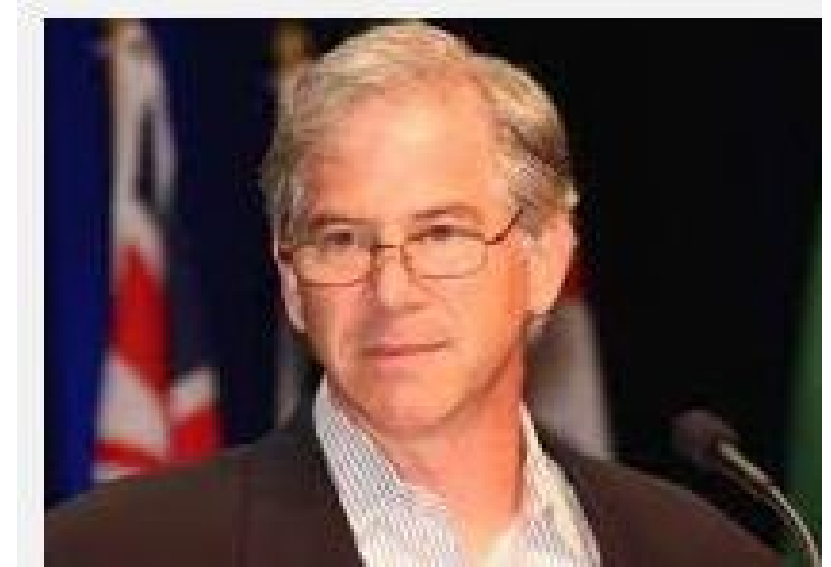
Making the Right Call

SOURCE?

“ I knew it was wrong... I knew that what I was doing was misleading. But I didn't think it was illegal. I thought: That's how the game is played. You have a complex set of rules, and the objective is to use the rules to your advantage. And that was the mistake I made.”

Andrew Fastow

Enron Chief Financial Officer



Summary

- You cannot judge who is honest
- Not every bad situation is “fraud” but is still a risk
- What starts small grows larger, almost always
- Don’t give grey areas an immediate free pass
- Avoid watering down your communication

Questions to Consider

- As a professional, do I recognize importance of public trust?
- Do I know with whom I may consult on ethics matters?
- Do I ensure that I maintain my integrity & am objective in performing the work that I do?
- Do I evaluate independence & ethics issues fully before deciding what I should do?
- Do I prepare documentation of matters in a timely fashion?





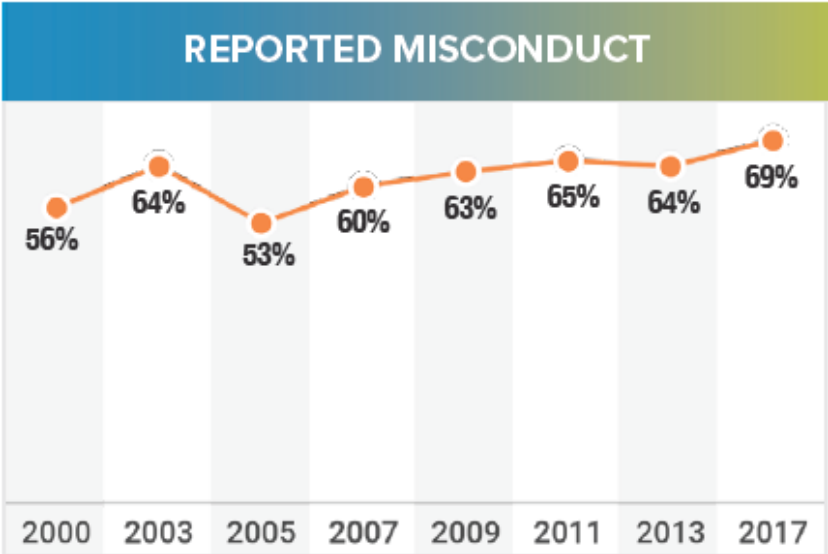
"Let the minutes show that Fenwick brought up the subject of corporate ethics."

Whistle-blowers



EMPLOYEES ARE REPORTING MISCONDUCT AT THE HIGHEST RATES EVER

Sixty-nine percent of employees said they reported the misconduct they observed. This is a 23% increase since the inception of ECI's research.

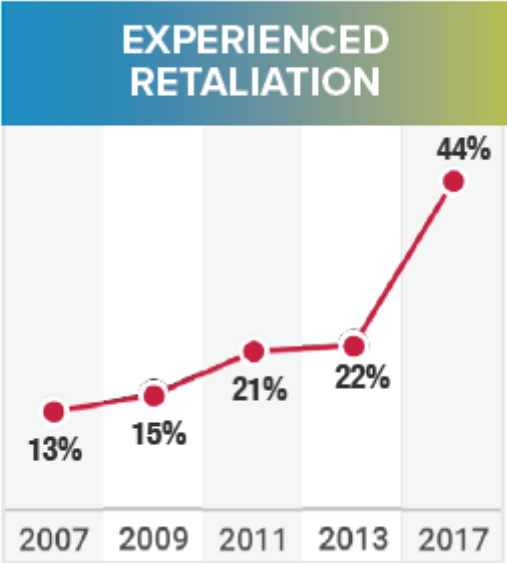


Whistleblower Retaliation



INSTANCES OF RETALIATION AGAINST EMPLOYEES DOUBLED

The rate of retaliation against employees for reporting wrongdoing doubled since 2013. While in past years of this research, ECI revealed that reporting and retaliation rise and fall together, what is most concerning is that in 2017, retaliation rose significantly higher than reporting – a 100% increase as opposed to a 7% increase in reporting.



Whistleblower Retaliation

TIME ELAPSED BETWEEN REPORT AND RETALIATION



Retaliation happens quickly: 72% of employees who experienced retaliation said that it occurred within three weeks of their initial report.

MISCONDUCT WITH HIGHEST RATES OF RETALIATION FOR REPORTING

-  **83%** Accepting Gifts/Kickbacks or Bribing Public Officials
-  **62%** Improper Political Contributions
-  **56%** Retaliation against a Reporter

Most retaliation occurs within three weeks of the initial report.



Polling Question #5

Does your firm have a hotline?

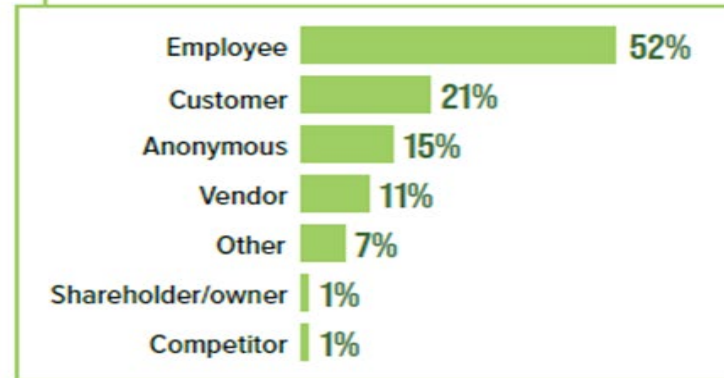
- A** | Yes
- B** | I'm not sure; but, I am going to check
- C** | We do not
- D** | What is that?

2024 ACFE Report to the Nations

FIG. 13 HOW IS OCCUPATIONAL FRAUD INITIALLY DETECTED?



FIG. 14 WHO REPORTS OCCUPATIONAL FRAUD?



2024 ACFE Report to the Nations

FIG. 15 HOW DOES DETECTION METHOD RELATE TO FRAUD LOSS AND DURATION?

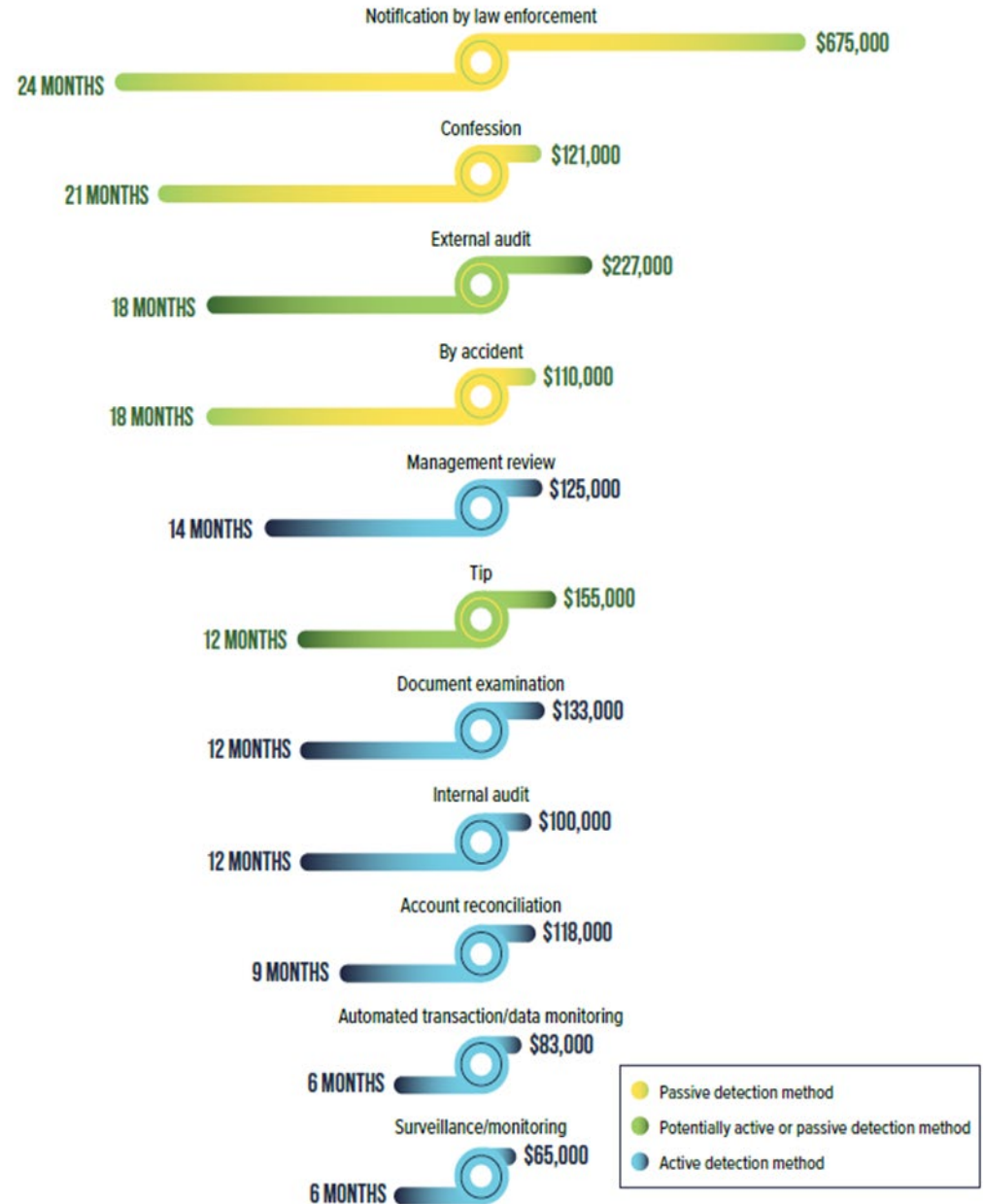
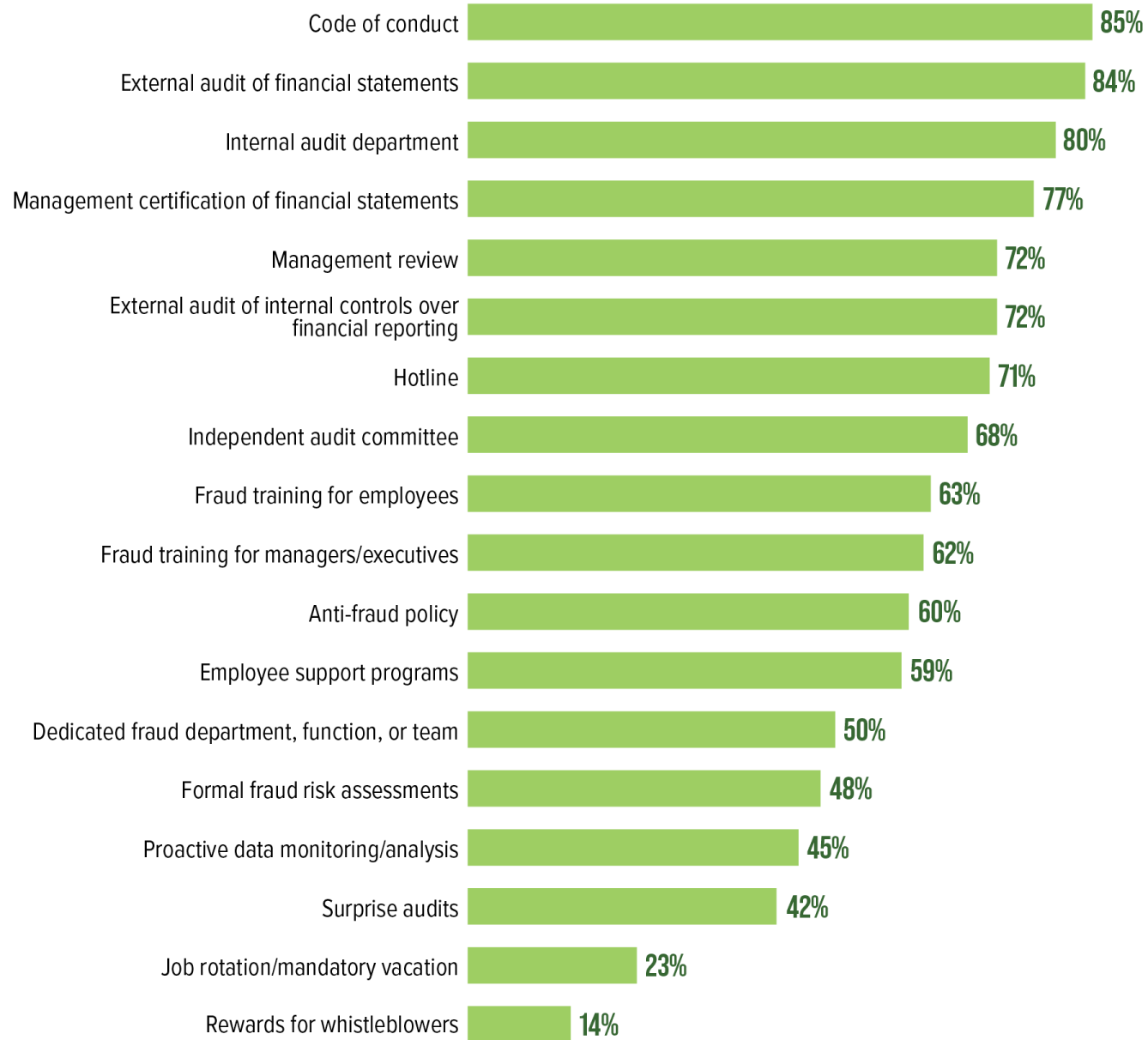
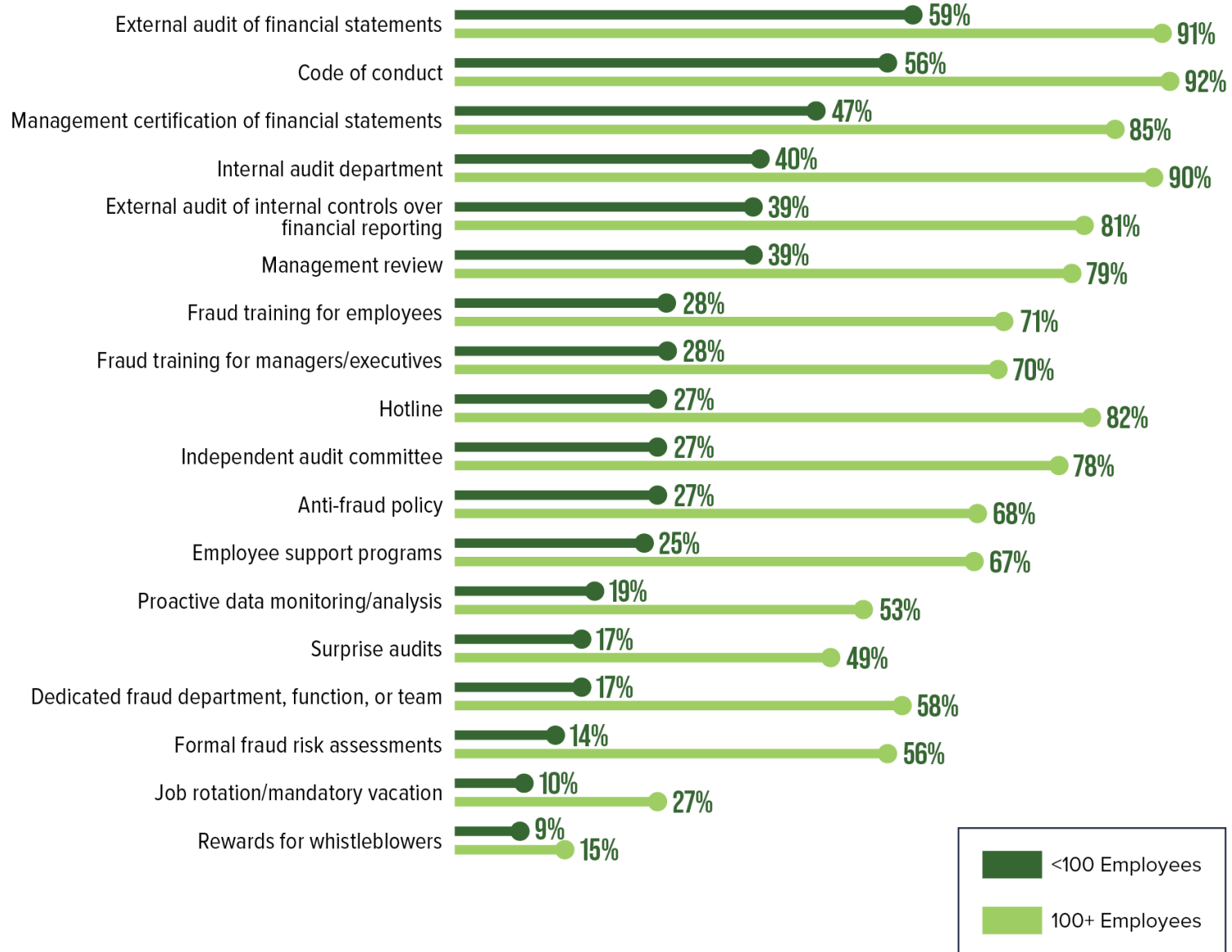


FIG. 27 WHAT ANTI-FRAUD CONTROLS ARE MOST COMMON?



Victim Organizations

FIG. 30 HOW DO ANTI-FRAUD CONTROLS VARY BY SIZE OF VICTIM ORGANIZATION?



Victim Organizations

Victim Organizations

Control	Percent of cases	Control in place	Control not in place	Percent reduction
Surprise audits	42%	\$75,000	\$200,000	63%
Management review	72%	\$100,000	\$250,000	60%
External audit of financial statements	84%	\$121,000	\$250,000	52%
Hotline	71%	\$100,000	\$200,000	50%
Fraud training for managers/executives	62%	\$100,000	\$200,000	50%
Anti-fraud policy	60%	\$100,000	\$200,000	50%
Proactive data monitoring/analysis	45%	\$100,000	\$200,000	50%
Fraud training for employees	63%	\$100,000	\$187,000	47%
Formal fraud risk assessments	48%	\$100,000	\$187,000	47%
Internal audit department	80%	\$120,000	\$210,000	43%
Dedicated fraud department, function, or team	50%	\$109,000	\$184,000	41%
Code of conduct	85%	\$121,000	\$200,000	40%
Management certification of financial statements	77%	\$120,000	\$200,000	40%
External audit of internal controls over financial reporting	72%	\$119,000	\$199,000	40%
Employee support programs	59%	\$101,000	\$150,000	33%
Independent audit committee	68%	\$120,000	\$165,000	27%
Rewards for whistleblowers	14%	\$110,000	\$145,000	24%
Job rotation/mandatory vacation	23%	\$115,000	\$150,000	23%

ACFE- Antifraud Controls

6-12 months faster!

Presence of antifraud controls is notably correlated with significant decreases in the cost & duration of occupational fraud schemes. Victim organizations that had implemented any of 18 common antifraud controls experienced considerably lower losses & time-to-detection than organizations lacking these controls.

Losses 50% less!

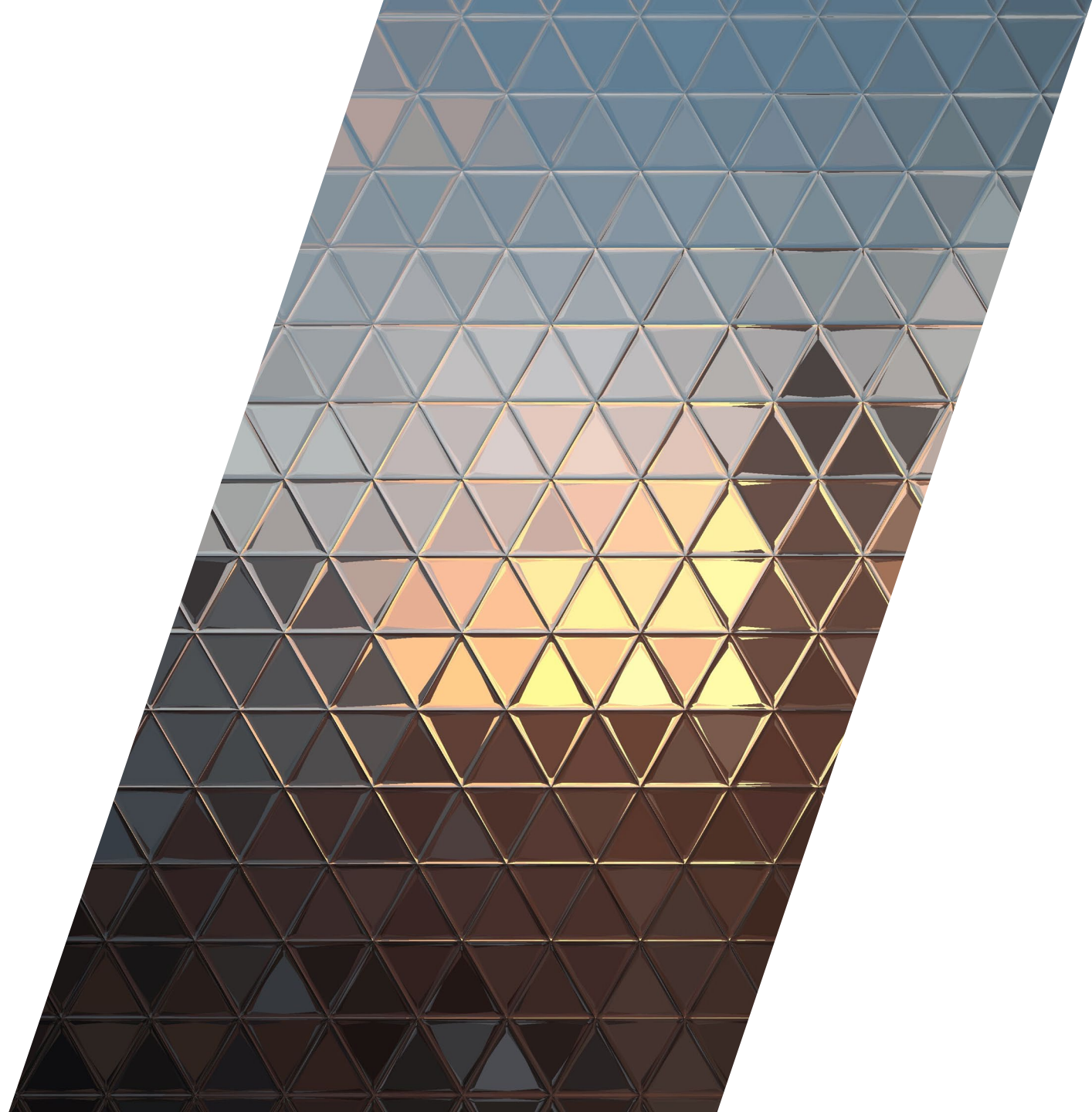
Perpetrators with higher levels of authority tend to cause much larger losses. Median loss among frauds committed by owner/executives was \$703,000, median loss caused by managers was \$173,000 & median loss caused by employees was \$65,000

Lessons Learned

- Be cognizant of your ethical obligations to public under AICPA Code of Professional Conduct
- When evaluating issues, take time to understand facts, applicable rules & regulations, available options & effect of your actions on various stakeholders
- The profession has resources in place to help you with issues & you should use them
- Don't go it alone!
- The decisions you make DO matter!



Questions



Thank You

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