

Ten Warning Signs of Financial Distress

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Today's Outline

- Identify 10 warning signs of financial distress
- What is fraud?
- Types of fraud
- Internal Controls
- Case studies

10 Warning signs of Distress

1. Unexpected deficits
2. Unexplained/unexpected variances between budgeted and actual amounts
3. Significant internal control issues reported by external auditors
4. Depleted reserves
5. No one with financial expertise

10 Warning signs of Distress

6. Infrequent or late financial reports
7. Financial process not transparent, insufficient financial information
8. Appearance of personnel living beyond their means
9. Complaints from taxpayers
10. Shortages of cash, missing inventory and fixed assets

How to Identify and Monitor Financial Distress

- ▶ Causes of financial distress:
 - Tough economic times
 - Poor management
 - Fraud
- ▶ Checklist to identify current level of financial stress
- ▶ Fraud can be a major cause of financial distress

What is Fraud?

- What is fraud?
- The Free Dictionary defines it as "a deception deliberately practiced in order to secure unfair or unlawful gain".
- Fraud is a crime and a civil tort. Definitions are set by law.

What is Fraud?

- Occupational fraud – occurs in the workplace
 - Use of one's occupation for personal gain through deliberate misuse or misapplication of the organization's resources or assets.
 - Three common categories according to the Association of Certified Fraud Examiners
 - Asset misappropriation
 - Corruption schemes
 - Financial statement fraud

Types of Fraud

- **Asset Misappropriation** – employee steals or misuses the organizations resources
- **Corruption Schemes** – employee misuses influence in a business transaction that violates duty to employer in order to gain a direct or indirect benefit (bribery, conflict of interest)
- **Financial Statement Fraud** – employee intentionally causes misstatement or omission of material information in the organization's financial reports (fictitious revenue, understated expense)

Types of Fraud

- Asset Misappropriation:
 - Theft of cash receipts
 - Skimming – cash stolen before it is recorded
 - Accept payment from taxpayer but do not record
 - Billing permits, sewer tap fees
 - Larceny – cash stolen after it has been recorded, also called kiting
 - Record payment but steal it before it is deposited
 - Water and sewer payments

Types of Fraud

- Asset misappropriation (continued):
 - Fraudulent disbursement of cash:
 - Billing – invoices for fictitious goods or services, inflated prices, personal purchases, fictitious vendors
 - Expense reimbursements – overstate expense, overstate mileage, submit false receipts
 - Check tampering – steal blank checks and make payable to self, steal outgoing checks and deposit into own account

Types of Fraud

- Asset misappropriation (continued):
 - Fraudulent disbursement of cash (continued)
 - Payroll – Employee causes payment to be issued by making false claims such as claiming overtime for hours not worked, setting up ghost employees, issuing extra check
 - Cash register disbursements – Employee makes false entries on a cash register by voiding sales and stealing cash.

Types of Fraud

- Asset misappropriation (continued):
 - Other Schemes
 - Misappropriation of cash on hand – steal cash from vault, steal petty cash
 - Non-cash misappropriation – steal inventory from warehouse, non-authorized use of assets, steal or misuse taxpayer information

Why Does Fraud Occur

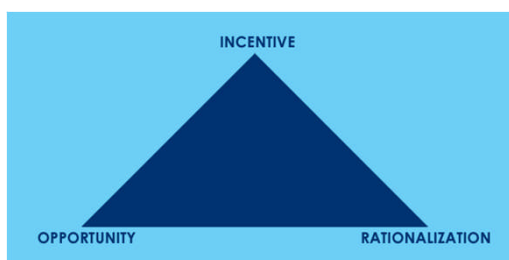
- Today's employee environment:
 - Effects of recession on employees
 - Rising personal debt
 - Home foreclosures
 - Unemployment of spouse
 - Rising food and gas prices
 - Raises do not keep up with increase in cost of living
 - Rising cost of health care
 - Reductions in staffing

Why Does Fraud Occur

- Today's business environment:
 - Organizations have less resources – pressure to do more with less
 - Organized and professional fraud rings are becoming more prevalent and more sophisticated
 - Cyber-crime advances make it possible to compromise large quantities of data
 - Desktop publishing makes counterfeiting checks and other documents relatively cheap and easy.

Why Does Fraud Occur

▶ Fraud Triangle



Why Does Fraud Occur

- ▶ **Incentive** – what drives an employee to commit fraud
- ▶ **Opportunity** – this is created from too much trust, poor internal controls, lack of supervision, and no financial audit by independent CPAs
- ▶ **Rationalization** – perpetrators of fraud convince themselves that they are not stealing

Who Commits Fraud

- Internal Perpetrators:
 - Disgruntled or stressed out employees
 - Employees with excessive control issues
 - Employees who live above their means
 - Employees who never take a vacation
 - Employees experiencing financial difficulties
 - Employees with drug, gambling or other addictions
 - Otherwise honest and responsible citizens

Who Commits Fraud

- External Perpetrators:
 - Vendors who intentionally double or over bill
 - Vendors who provide substandard good or services
 - Fraud rings that target identity theft
 - Fraud rings that target various businesses
 - Vendors that provide kick-backs to employees

Facts About Fraud

- Overwhelmingly happens in small operations
 - Less effective internal controls
 - Harder to have adequate segregation of duties
- External auditors rarely identify fraudulent activity
 - According to the ACFE 2012 Report to the Nations over 43% of frauds were discovered because of a tip, about 14.5% each by management review and internal audit and 7% by accident. Only 3% discovered by external auditors.

Facts About Fraud

- ▶ According to the 2012 Report to the Nations:
 - Typical organization loses 5% or revenue per year to fraud
 - Governmental fraud accounted for 10.3% of reported fraud, second only to the banking and finance industry
 - The medium loss for governmental fraud was \$100,000 per incident
 - There is a correlation between the position, age and length of employment of the person committing fraud and the size of the fraud.

Why are Municipalities Vulnerable?

- Lack of resources to ensure adequate segregation of duties
- Lack of individual with adequate financial oversight
- Political environment – don't want to rock the boat
- Budget constraints
- Decentralized departments and systems

Fraud Hot Spots

- Points of cash collections
- Departments with independent systems
- Unsecured checks
- Sensitive information not safeguarded
- Passwords and safe combinations not safeguarded
- Too many bank accounts
- Reliance on part-time employees
- Inadequate IT systems

How to Deter Fraud

- Good system of internal controls that is documented, implemented and tested
- Fraud awareness training for employees and managers
- Tone at the top

Internal Control

- Objectives of internal control
 - Safeguarding of assets
 - Compliance with policies, procedures, laws and regulations
 - Accomplishment of organizational objectives
 - Reliability and integrity of information for financial reporting
 - Economical and efficient use of resources

COSO Framwork

This is a continuous, integrated process.



COSO Key Concepts

- Internal control is a *process*. It is a means to an end, not the end in itself.
- Internal control is effected by *people*. It's not merely policy manuals and forms, but people at every level of an organization.

Types of Internal Control

- ▶ Two major types of internal controls:
 - Active – seek to prevent fraud from occurring by taking specific actions
 - Passive – seek to deter fraud by significantly increasing the risk of detection

Active Internal Controls

- Active Internal Controls Include:
 - Segregation of duties
 - Separation of functions
 - Physical control of assets
 - Physical restraints
 - Document matching
 - Signatures, PINs

Segregation of Duties

- ▶ Ensures one person does not have responsibility for entire receipt or disbursement activity
- ▶ Can be challenging for smaller governments
- ▶ Most fraud is committed by individuals rather than collusion
- ▶ Segregation of duties can be very effective
- ▶ Examples of duties that should be segregated

Separation of Functions

- ▶ Divides transaction processing or functions in such a way that different organizational units are involved; helps reduce risk of fraud.
- ▶ For example, an administrative assistant or other person not involved in accounting opens the mail, lists all receipts then distributes the receipts to the accounting department.

Physical Asset Control

- ▶ Identify and keep a record of assets
 - Fixed assets over a certain threshold
 - Sensitive assets such as cameras, cell phones and other items that are susceptible to theft
- ▶ Procedures for signing out assets
- ▶ Periodic inventories by independent personnel
- ▶ Procedures for asset use

Physical Restraints

- ▶ Physical restraints include:
 - Locked filing cabinets
 - Limited access to certain departments like payroll
 - Fences and padlocks to protect inventory
 - Vaults or safes to store money, check stock
 - Firewalls to prevent hacking

Document Matching

- ▶ Document matching can help restrict introduction of non-authorized forms and to help assure receipt & processing of all forms in the sequence issued.
 - Matching invoices to approved, pre-numbered purchase orders and accounting for all purchase orders
 - Matching deposits to list of receipts
 - Using pre-numbered receipts and matching receipts to deposits and accounting for all receipts.

Signatures and PIN's

- ▶ Authorized signatures for purchases and disbursements
- ▶ Procedures for establishing and safeguarding passwords and PINS
- ▶ Security questions

Passive Internal Controls

- Passive internal controls include:
 - Audit trails – record changes to records
 - Review processes and procedures
 - Focused audits / Surprise audits – narrow in scope, can be conducted internally
 - Surveillance of key activities – use of cameras, one-way mirrors
 - Rotation of key personnel – mandatory vacations, cross-training, substitution of duties without notice

Roles and Responsibilities in an Internal Control System

- ▶ Everyone in a local government has responsibility for internal control
- ▶ Controls only work if they are monitored and evaluated on a periodic basis
- ▶ All personnel should be responsible for communicating problems upward including:
 - Problems in operations
 - Policy violations and illegal acts
 - Suspicious activity
 - Sense or suspicion that something just doesn't feel right

Fraud Awareness Training

- ▶ Tips are the most common way fraud is discovered
- ▶ Need to encourage employees to be actively aware of fraud and to report it
- ▶ Provide training to management and staff
 - make them aware of what constitutes fraud
 - discuss how fraud hurts the organization
 - provide information on warning signs of fraud (employees living beyond means, excessive control issues etc)
 - provide information on how to report questionable activity

Whistleblower Policy

- ▶ Do you have a whistleblower policy?
- ▶ Do you have a fraud hotline?
- ▶ Is there effective follow through?
- ▶ Do employees feel comfortable reporting suspicious activity?

Tone at the Top

- ▶ Management should set a good example
- ▶ City Council should provide government and oversight
 - This includes insuring that personnel they are responsible for are competent and have adequate training and knowledge for position
 - Can identify problems and intervene if management overrides controls

Steps to Take to Prevent Employee Dishonesty

- ▶ Secure IT System
 - Passwords and encryption
 - Policy related to laptops and cell phones
 - Clean desk policy
 - Centralized system
 - Firewalls
- ▶ Good Internal Control System
- ▶ Effective Whistle-Blowing System
- ▶ Good Tone at the Top

Steps to Take to Prevent Employee Dishonesty

- ▶ Alert Vendors and Install Strict Controls
 - Master vendor file
 - Review addresses and relationships
 - Physical verification
 - Statistical analysis
- ▶ Secure Physical Assets

Case Studies

- ▶ Five case studies
 - Billing, dummy vendor
 - Kiting scheme with accounts receivable
 - False expense reimbursements
 - Payroll fraud
 - Non-cash misappropriation

Conclusion

▶ Questions and Answers

▶ Contact Information:

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