Why Internal Controls Often Fail

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Trust but Verify!

- Ronald Reagan used this expression to define the U.S. position on missile systems inspection.
- The basis for trust must be independent verification of the information provided to us by another person.

Thomas Golden, PwC

What are internal controls?

A process designed to provide reasonable assurance that organizational objectives are being achieved.

The COSO Model
Internal Control Objectives

The objectives of effective internal controls are to:

1. Encourage compliance with the organization’s prescribed policies and procedures
2. Promote operational efficiency
3. Ensure accuracy and reliability of the financial reporting system
4. Safeguard company assets, especially cash

Fraud and Internal Controls

- Most internal fraud schemes exploit one or more deficiencies in basic internal controls.
- Best way to prevent internal theft: Implement and adhere to basic internal controls!

Types of internal controls

1. Preventive controls—Stop problems before they happen
2. Detective controls—Find problems after they happen
Preventive control examples
1. Physical safeguards like safes, locked rooms, and fences
2. Proper segregation of duties
3. Limited access to information system
4. Employment screening

Detective control examples
1. Variance reports
2. Reconciliations
3. Periodic audits
4. Examining check images

Why Internal Controls Fail
1. Not enforced or monitored
2. Poorly designed
3. Circumvented by dishonest employees
Not enforced or monitored

Problem:
Organizational failure to enforce/monitor compliance with controls

Solution: Actively monitor compliance with controls

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P-card fraud

- Employees authorized to use company credit cards are high fraud risks.
- P-card purchases must be carefully monitored.

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Example: Donna Gamble

- Georgia Tech employee charged more than 3,800 personal items to her state-issued P-card
- Created phony receipts and made false accounting entries to conceal the fraud.
- Loss: $317,000
Spending spree!

Example: Epic Mainstream

CFO charged purchases of furniture, carpet, home repair work, and other personal expenses to the company credit card.
Fraud loss and resolution

<table>
<thead>
<tr>
<th>Description of Charge</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Royalton Hotel (NYC) trip with girlfriend</td>
<td>$2,940</td>
</tr>
<tr>
<td>2. Delta Airlines (to NYC)</td>
<td>1,164</td>
</tr>
<tr>
<td>3. Commercial Flooring (carpet and tile)</td>
<td>20,899</td>
</tr>
<tr>
<td>4. Lighting for new house</td>
<td>2,495</td>
</tr>
<tr>
<td>5. Lowe's (washer and dryer)</td>
<td>2,873</td>
</tr>
<tr>
<td>6. Sears (refrigerator and freezer)</td>
<td>2,674</td>
</tr>
<tr>
<td>7. Home repair work for new house</td>
<td>15,742</td>
</tr>
<tr>
<td><strong>Total Personal Charges to Company Credit Card</strong></td>
<td><strong>$48,787</strong></td>
</tr>
</tbody>
</table>

Poorly designed

*Problem:* Controls are poorly designed

*Solution:* Controls should be designed such that they achieve their intended objectives

Example: Pretzelmaker

*Problem:* Poorly-designed cash register closing procedures allowed manager to steal cash receipts without being detected.

*Fraud loss:* $40,000
Cash register closing procedures

1. Manager counts cash in register and compares to data from POS program.
2. Manager leaves $200 in register and puts remainder of cash in a cigar box kept in storage room.
3. Twice per week, manager prepares deposit slip and makes bank deposit.

What are the weaknesses in the above?

Circumvented by dishonest employees

Problem: Controls are circumvented by dishonest employees

Solution:
Employment screening should ferret out dishonest applicants

Example: Archdiocese of NY

• Anita Collins embezzled more than $1 million over 7 years from the Archdiocese of New York.
• When hired she had already been twice convicted of grand larceny and was on probation.
• She stole money in all but one month of 7+ years.
Hid fraud in vendor payments

- She issued 468 checks to “KB Collins,” the initials of her son.
- After printing the check, she changed the payee on the computer to a legitimate vendor.
- She kept amounts under $2,500 to preclude supervisor approval.

Detection and Epilogue

- Annual audit raised red flags and Ms. Collins was confronted and confessed.
- The money was gone, spent on expensive dolls, clothes, furniture, etc.
- Sentenced to 4 ½ to 9 years in prison
- Archdiocese now does background checks

Effective internal control systems...

1. Establish policies and procedures to safeguard assets.
2. Monitor compliance with prescribed policies and procedures.
3. Impose meaningful consequences on those violating policies and procedures.
ACFE Fraud Survey (2016)

- Average loss per case of $2.7 million, or 5% of an organization’s total revenues.
- Median losses by type of scheme:
  - Asset misappropriations: $125,000
  - Corruption: $200,000
  - Fraudulent statements: $975,000
- Small businesses are most vulnerable to fraud.
- 4% of schemes detected during external audits, 6% detected by accident.

Fraud complaints increasing

Fraud complaints reported by consumers to the FTC

Global Economic Crime Survey 2016*

- 36% of 6,000+ respondents reported being hit by economic crime.
- Losses ranged from less than $100K to more than $100M.

* Source: PwC
A Tale of Three Fraud Schemes

1. MSX Holdings
   Ponzi scheme
2. Employment compensation fraud
3. Forensic audit of a church

Scheme #1: MSX Holdings

1. Tipsters allege that MSX Holdings is a Ponzi scheme.
2. Owners deny it.
3. An investigation is launched.

Step 1: Understand Ponzi schemes

A Ponzi scheme uses the principal investments of newer investors to pay older investors what appear to be high returns, but are in fact a return of their own principal. There is little to no legitimate business operation.
How does a Ponzi scheme work?

- *Return of investment* instead of *return on investment*
- Recruitment and escalation
- Affinity fraud
- Types of Ponzi schemes:
  - Fraud from inception
  - Evolve into frauds
  - Inevitable collapse

Step 2: Identify investment vehicle

The investment vehicle is the endeavor that the money is invested into such as stocks, bonds, real estate, or a business venture.

Step 2: MSX's investment vehicle

“A trust comprised of several extremely wealthy families (the ‘Trust’) is headquartered in London, with offices in Zurich and Luxembourg.”
Step 3: MSX’s promised returns

- “The trust owns banks in Europe and has the power to create money through fractional banking.”
- Investors lent money to the Trust and were promised a 38% annual return.

Step 4: Identify red flags

- High investment returns
- Unregistered investments
- Unregistered sellers
- Complex strategies
- Secretive strategies
- Affinity scheme

Question
Do the red flags provide sufficient evidence to prove that MSX Holdings is a Ponzi scheme?
Step 5: Examine evidence

Exhibit A: Summary of Deposits and Withdrawals
MSK Holdings, Inc. from August 2009 - December 2015

<table>
<thead>
<tr>
<th>%</th>
<th>Amount</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>External Deposits</td>
<td>88.6%</td>
<td>$29,066,960.68</td>
</tr>
<tr>
<td>Unknown</td>
<td>9.6%</td>
<td>2,789,054.84</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>1.8%</td>
<td>455,113.44</td>
</tr>
<tr>
<td>Total External Deposits</td>
<td>100.0%</td>
<td></td>
</tr>
<tr>
<td>Interbank Deposits</td>
<td>79.7%</td>
<td>29,066,960.68</td>
</tr>
<tr>
<td>Total Deposits (a)</td>
<td>79.7%</td>
<td>29,066,960.68</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>%</th>
<th>Amount</th>
<th>Totals</th>
</tr>
</thead>
<tbody>
<tr>
<td>External Withdrawals to Investors</td>
<td>79.7%</td>
<td>$16,976,210.32</td>
</tr>
<tr>
<td>Personal Expenses</td>
<td>7.8%</td>
<td>1,105,478.14</td>
</tr>
<tr>
<td>Unknown</td>
<td>9.6%</td>
<td>2,041,723.22</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>2.9%</td>
<td>616,055.21</td>
</tr>
<tr>
<td>Total External Withdrawals</td>
<td>100.0%</td>
<td></td>
</tr>
<tr>
<td>Interbank Withdrawals</td>
<td>47.6%</td>
<td>41,084,091.66</td>
</tr>
<tr>
<td>Total Withdrawals (b)</td>
<td>47.6%</td>
<td>41,084,091.66</td>
</tr>
<tr>
<td>Ending balances of bank accounts (a-b)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
MSX Holdings: Epilogue

- Owner/fraudster sentenced to 15 years in prison.
- Provided litigation support to claw back $3.1 million in winnings from 32 of 240 investors.
- Investors lost $15 million

Scheme #2: Employment compensation fraud

Dr. Christy Brown accepted a compensation package from Southern Regional Hospital that included $300,000 base salary plus additional compensation. After six years hospital paid her $0 additional compensation so she sued the hospital.

Performance evaluation

Hospital CPA produced a Performance Report (PR) showing that Dr. Brown had Net Practice Losses each of the six years, thus no incentive compensation was owed to her.
A $1.5 million sentence!

Expert CPA reviewed the Employment Agreement and found the following sentence:
“Both parties agree that Physician will have control over the expenses allocated to her practice.”

The CIMA provides the following guidance regarding controllable expenses:

1. If a manager can control the quantity and price paid for a service then the manager is responsible for all of the expenditure incurred and is fully controllable.

2. If the manager can control the quantity of the service but not the price paid then the expenditure is partially controllable.

3. If the manager cannot control either the quantity or the price paid for the services then the expenditure is uncontrollable.
The battle begins

- For each of the 30 expenses, the hospital CPA was asked via interrogatories to explain the nature of the expense and how Dr. Brown had the ability to control it.
- **Response:** Objected to each of the interrogatories on the grounds that they were not relevant to the dispute.

The battle escalates

At his deposition the hospital CPA defined a controllable expense as “an expense that is not based on individual variables of the practice. A controllable expense is going to be items that are normal and necessary for the operation.”

**Expert CPA’s response:**
“Mr. Smith’s definition of controllable expense is nonsensical and cannot be supported by anything in the professional accounting literature. Nowhere in the literature are the terms ‘normal’ and ‘necessary’ used in connection with controllable expenses.”

The battle rages

Expert CPA concluded:
“Given Mr. Smith’s complete misunderstanding of the controllability of expense concept and the fact that he had not even looked at the Employment Agreement, it would be impossible for him to correctly calculate Dr. Brown’s Net Practice Profit and resulting Incentive Compensation.”
Computing additional compensation

“Additional Compensation with respect to each Employment Year shall be determined as follows: Physician shall be entitled to 85% of Net Practice Profits above $25,000 (goal). SRPCC agrees to waive this $25,000 threshold after $400,000 has been collected by SRPCC as a result of Net Practice Profits. For the purpose of this Agreement, Net Practice Profits shall be determined by subtracting all reasonable office expenses from all Net Professional Collections, which is defined by all collections derived from the professional services performed in the practice of Christy Brown.”

Expert testified at Deposition and Arbitration Hearing. Judge awarded $1.5 Million in damages.

Scheme #3: Stealing from a church?!

Senior Minister engaged us to conduct a forensic audit of the cash receipts and disbursements in connection with recent irregularities.
Engagement mandates

1. Examine existing controls over cash receipts and disbursements and identify any deficiencies.
2. Develop and test fraud theories that would exploit those deficiencies.
3. Recommend policies and procedures that will correct those deficiencies.

Cash receipts

1. Audit team attended Sunday worship services to observe the donation collection process.
2. What is the huge deficiency in this process?

Cash receipts deficiencies

1. Member can make donations without completing a donation slip.
2. The collected contributions put into the safe on Sunday are not counted by the two security officers.
3. On Monday, Chelsea is left alone to count, process, record, and deposit the collected contributions.
Fraud theory #1

In the past, Chelsea has stolen from the anonymous cash plate offerings.

Findings:
1. Premium PeopleWise Report contained nothing to suggest that Chelsea is living an extravagant lifestyle.
2. Chelsea responded to three fraud assessment questions in a manner consistent with someone who is stealing from the church.
3. Senior Minister would not allow us to examine Chelsea’s personal bank statements.

Conclusion: High risk of fraud

Fraud assessment questions

1. How could somebody steal from the church and get away with it?
2. What punishment is appropriate for someone caught stealing from the church?
3. Do you think they should be given a second chance?

Question

➢ Do the Findings provide sufficient evidence to prove that Chelsea has been stealing?
➢ What should the next investigative step be?
Cash Disbursement deficiencies
- No Approved Vendor List
- No Purchase Order system
- Receipt of items purchased not documented
- Check requests approved/signed by person submitting them.
- Inadequate supporting documentation for check requests (e.g. no itemized receipts)
- Signed checks are returned to the person who prepared them.
- Hundreds of thousands of dollars paid to many related-party vendors.

Fraud theory #2
The Church has made payments to vendors for inflated prices or for which nothing was received.

Findings:
1. We found 19 vendor payment irregularities.
2. Lack of documentation and poor record keeping practices made it difficult to test this fraud theory.
3. Three employees responsible for approving vendor payments are under significant financial pressure and answered assessment questions suspiciously.

Conclusion: High risk of fraud

Question
- Do the Findings provide sufficient evidence to prove vendor fraud?
- What should the next investigative step be?
Church Epilogue

- The Executive Director (a CPA) and two employees were fired.
- Recommendations were implemented, except one.
- No one prosecuted.

Cleaning Up After Fraudsters

- In a perfect world all frauds would be prevented, leaving no mess to clean up.
- We don’t live in a perfect world.
- Fraud can create big messes that need cleaning up.

Some ‘messes’ needing cleaning up:

- Revise controls
- File dishonesty insurance claim
- Reach out-of-court settlement
- Provide litigation support in filing:
  - Criminal charges
  - Civil lawsuit
### The aftermath of a fraud

**Criminal action**
- Fraud examination uncovers sufficient evidence of fraud
- Investigator prepares an investigative report
- Investigator solicits written admission from fraudster
- Report is turned over to law enforcement for prosecution

**Civil action**
- Victim company suffers economic damages due to the fraud
- A breach of fiduciary duty by a third party allows the fraud to occur
- Forensic accountant provides litigation support in connection with civil lawsuit

### Written Admission Statements

- Obtained during interviews and interrogations
- Expedite insurance claims
- Facilitate prosecution, civil litigation, and out-of-court settlements
- Prevent wrongful termination and defamation lawsuits

### What is litigation support?

Forensic accountant lends his/her accounting expertise to assist in resolving a matter under dispute in a court.
What is an expert witness?

A expert witness has knowledge or expertise beyond that of the ordinary lay person enabling him/her to assist the court in resolving a matter under dispute.

Testifying vs. Consulting Expert

<table>
<thead>
<tr>
<th>Testifying Expert</th>
<th>Consulting Expert</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Review documents</td>
<td>1. Review documents</td>
</tr>
<tr>
<td>2. Express opinion</td>
<td>2. Express opinion</td>
</tr>
<tr>
<td>3. Testify</td>
<td>3. Litigation strategy</td>
</tr>
<tr>
<td>4. Subject to discovery</td>
<td>4. Exempt from discovery</td>
</tr>
</tbody>
</table>

Legal Pitfalls to Consider

Improperly resolving fraud allegations could trigger lawsuits for:
1. Wrongful termination
2. Discrimination
3. Negligent hiring
4. Expert witness liability
5. Defamation
Avoiding Lawsuits

- Winning can cost from $75K to >$100K
- Losing can cost $100K to > $1M
- Avoidance is the only intelligent strategy!

Wrongful Termination

Most states allow employers to terminate employees “at will”—meaning for any reason or for no reason.
Exceptions:
- Retaliation
- Contractual employees
- Illegal acts
- Family or medical leave
- Not following own termination procedures

Wrongful Termination: Example

- Jim Aiken was fired for “stealing a welder”—a charge unconfirmed by evidence and denied by Jim.
- Jim filed a wrongful termination lawsuit for $3.35 million
- Court awarded him $900K
Discrimination

Decisions to hire/fire or prosecute can’t be based on:
- Race
- Age
- Gender
- Religion
- Disability
- Sexual orientation
- National origin

Negligent Hiring/Retention Doctrine

Employers can be held liable for the negligent or destructive actions of an employee when due diligence would have revealed the employee’s propensity to commit such actions.

Average settlements due to negligent hiring/retention:
- Wrongful death: $2.2M
- Rape: $1.8M
- Assault: $1.2M
- Theft: $700K

Negligent Hiring/Retention: Examples

1. Two home maintenance service workers exploited their access to upscale homes and robbed and shot one homeowner. Both workers were convicted felons. Employer was sued and paid $11M in damages.
2. A woman was raped at knifepoint by the resident manager who entered her apartment with a pass key. Manager was a convicted felon. Landlord paid $100K in damages.
3. Real estate agent duped a customer out of $158K. Employer had experienced prior incidents of impropriety involving the agent and was held liable for the $158K loss plus $25K in punitive damages.
Expert witness liability

- Cannot be sued by adverse party
- Can be sued for negligence by retaining party
- Neutral experts can be sued by both sides

Defamation

Any intentional false communication, either written (libel) or spoken (slander) that harms a person’s reputation and/or decreases the respect or confidence in which a person is held.

Avoiding Employment Lawsuits

1. Set example at top
2. Know employment law
3. Don’t hire problem employees
4. Develop, implement, communicate, and consistently enforce employment policies and procedures
5. Discreetly investigate wrongful conduct, don’t ignore it!

Have professional liability insurance coverage in case you are sued.
Part 4: Obtaining Restitution and Other Resolution Options

- Reach out-of-court settlement
- File dishonesty insurance claim
- Provide litigation support in filing:
  - Civil lawsuit
  - Criminal charges

Example: St. Joseph Catholic Church

- Fraudster
  - Beth Ann Boger
- Scheme
  - Fictitious vendor
- Fraud loss
  - $364,436
- Outcome
  - Pled guilty to wire fraud and tax evasion
  - Agreed to repay the money

Who has the first question?