



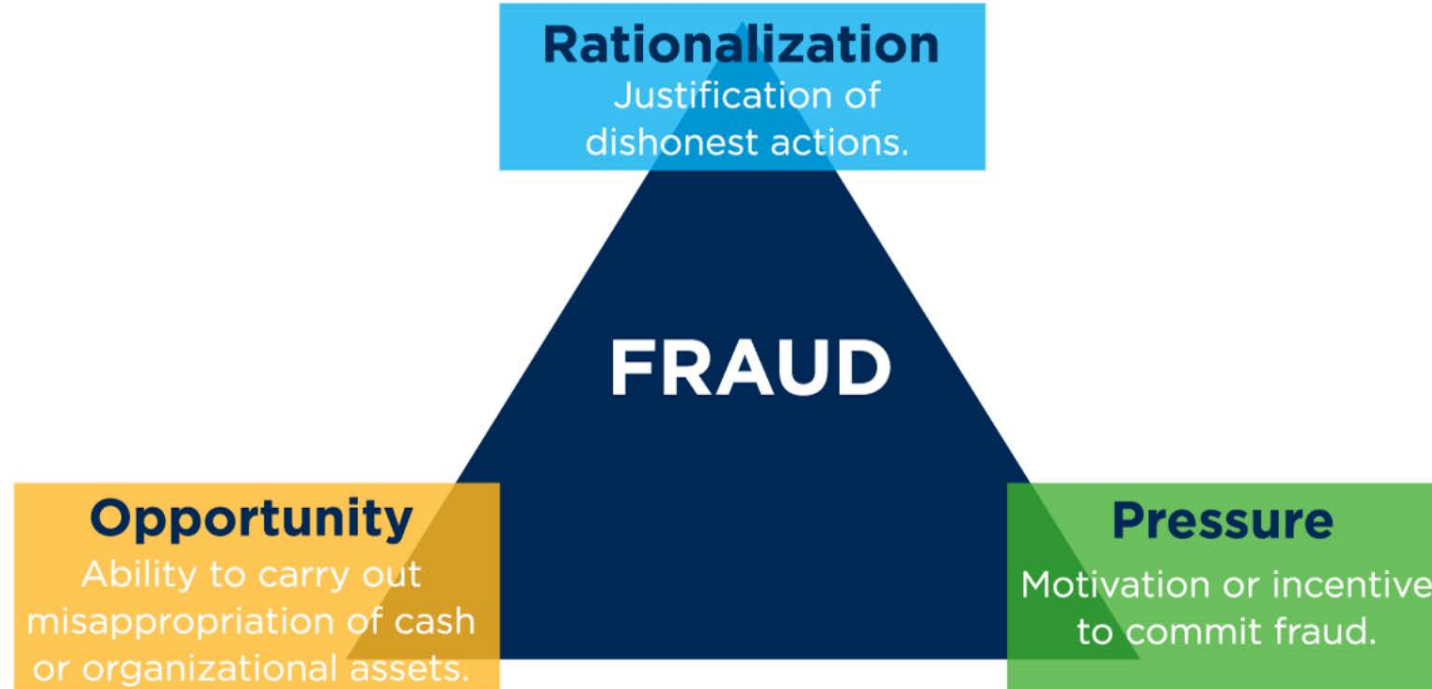
# Fraud Risks and Why Internal Controls are Important

PRESENTED BY  
Amy Buben, CPA, CFE

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# The Fraud Triangle



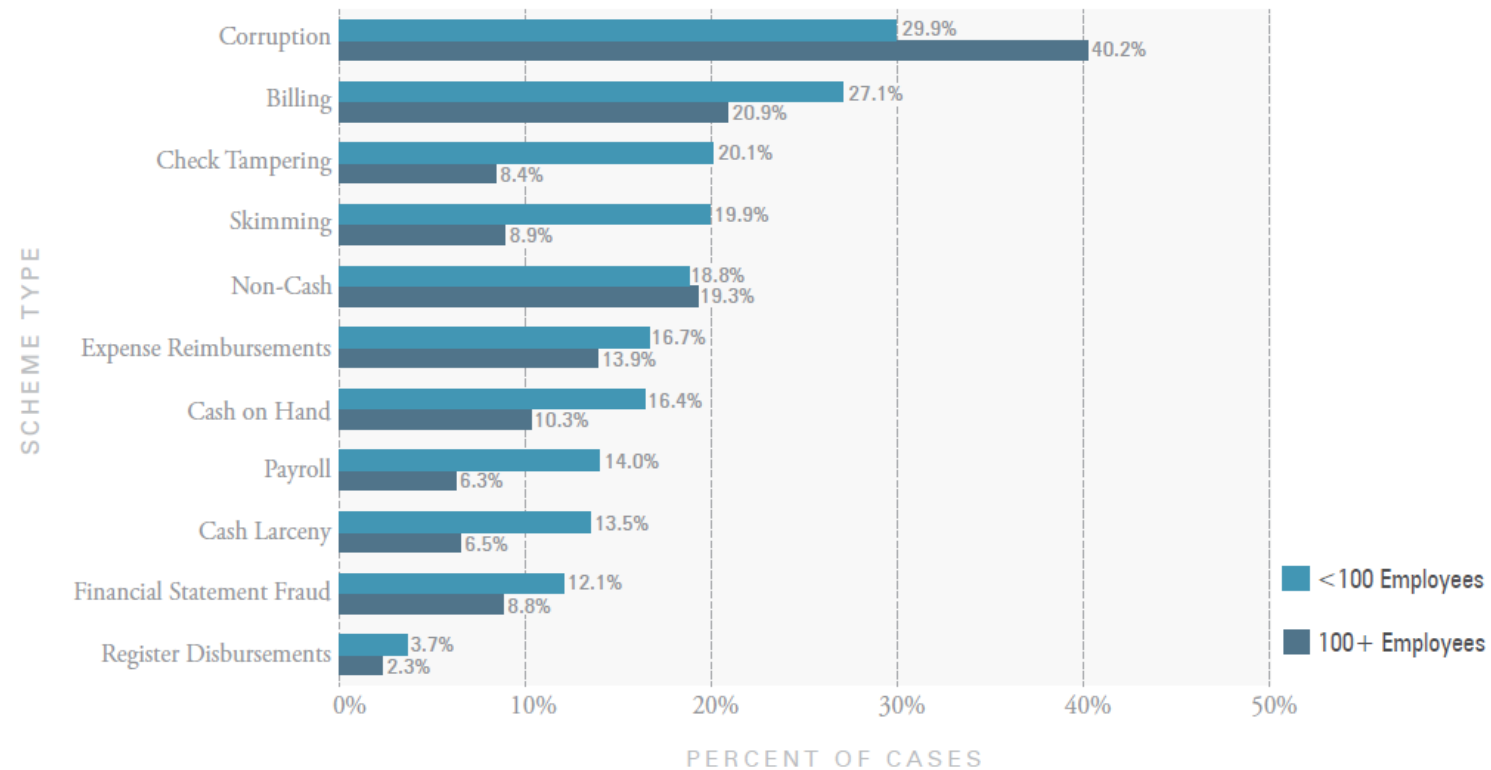
- Poor internal control can create opportunity
- It can permit, or even promote, fraud

# Methods of Fraud in Small Businesses

## Methods of Fraud in Small Businesses

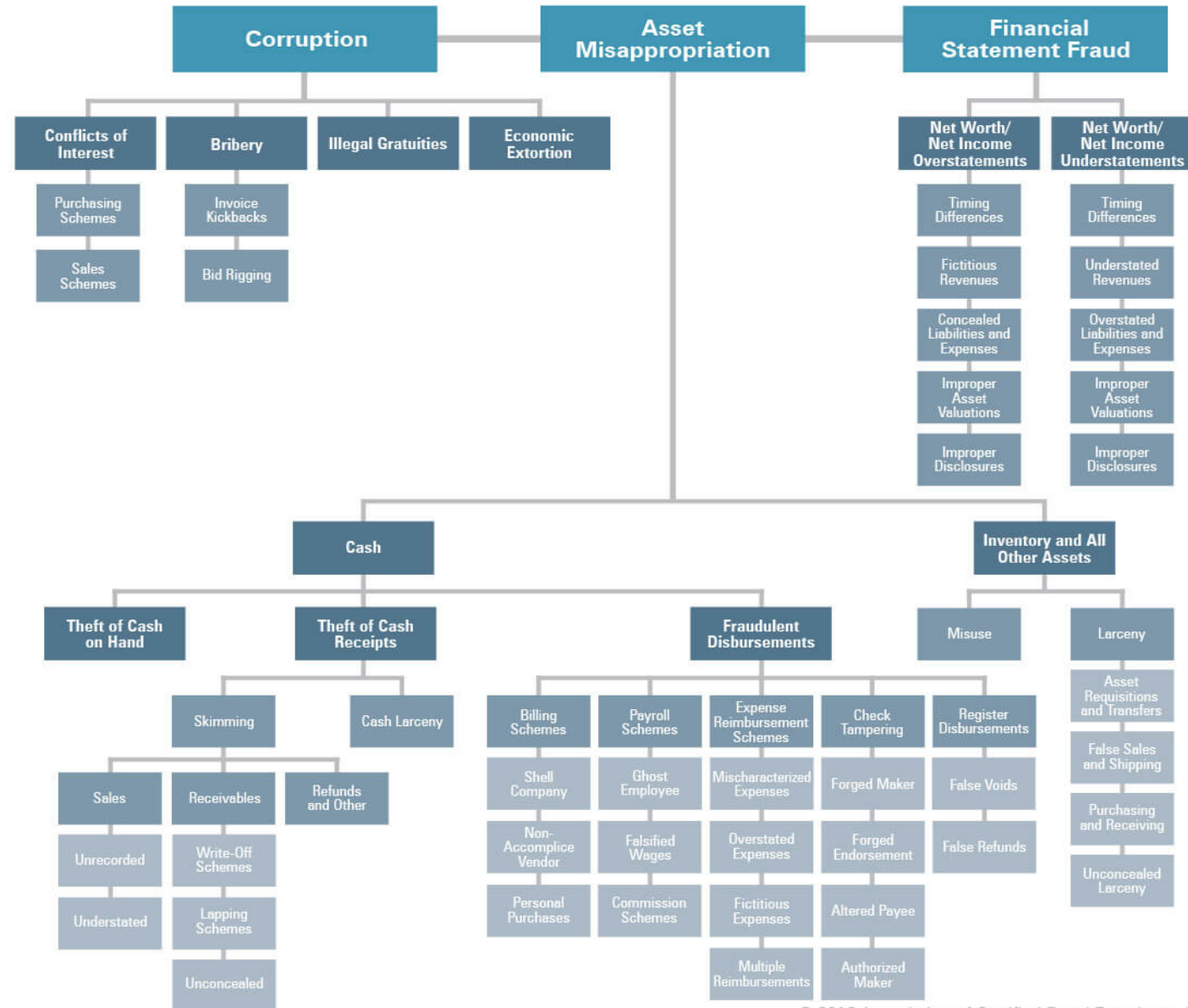
Figure 42 illustrates which fraud schemes small businesses were most susceptible to and which schemes occurred more often in larger organizations. Corruption was more prevalent in larger organizations (40.2% of cases) than in small businesses (29.9% of cases). In contrast, check tampering, skimming, payroll, and cash larceny schemes all occurred over twice as frequently in small businesses as in larger organizations.

**Figure 42:** Scheme Type by Size of Victim Organization



# THE FRAUD TREE

OCCUPATIONAL FRAUD AND ABUSE CLASSIFICATION SYSTEM

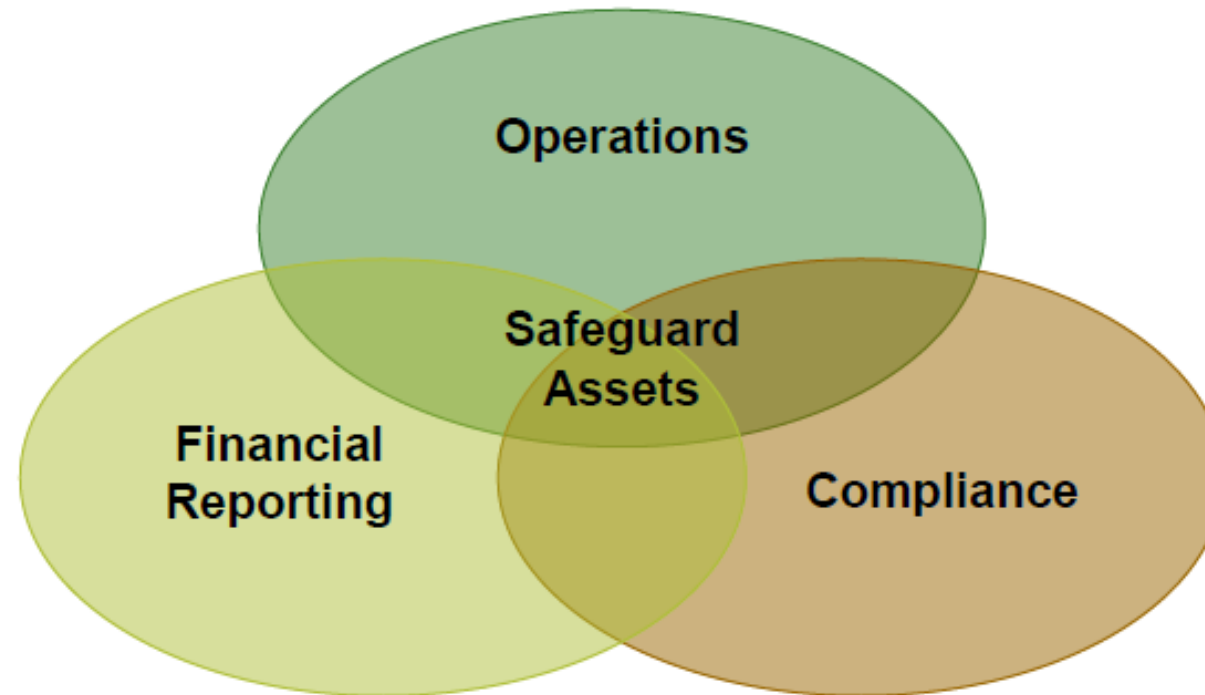


# Principles of Internal Control

- Is a process
- Is achieved by people
- Gives reasonable assurance
- Benefits the company
- Is tailored to the environment
- Is built in
- Must be cost-effective



# Internal Control



Is a process by management designed to provide reasonable assurance of:

- 1) Effectiveness and efficiency of operations
- 2) Reliability of financial reporting
- 3) Compliance with applicable laws and procedures

These combine to help safeguard assets



# Internal Control Framework

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring



# Control Environment

- Sets the tone of the organization
- Influences the effectiveness of internal controls
- Is intangible and pervasive
- Is the foundation for all other components
- Provides discipline and structure
- Encompasses technical competence and ethical commitment





# Example of Control Environment

- Management's attitude about internal control
- Integrity and ethical values
- Commitment to competence
- Human resource policies and practices
- Philosophy and operating style
- Assignment of responsibility and authority
- Design of the Organizational Structure
- Direction and attention of governing body



# Risk Assessment

- Assists management in identifying where and how fraud may occur and who may be in a position to commit fraud
- What information is critical to the organization's operations?
- Which areas are most susceptible to fraud?
- Are assets properly protected?



# Risk Assessment Results

- Identify the potential inherent fraud risks.
- Assess the likelihood and significance of occurrence of the identified fraud risks.
- Evaluate which people and departments are most likely to commit fraud and identify the methods they are likely to use.
- Identify and map existing preventive and detective controls to the relevant fraud risks.
- Evaluate whether the identified controls are operating effectively and efficiently.
- Identify and evaluate residual fraud risks resulting from ineffective or nonexistent controls.
- Respond to residual fraud risk.



# Control Activities

- Policies and procedures that help ensure risk responses are carried out
- Help reduce the likelihood or impact of risks
- Occur throughout the organization
- Address risks identified during risk assessment
- Include approvals, authorizations, reconciliations, etc.
- Bank reconciliations – a primary control procedure for cash accounts



# Principles of Control Activities

- Establish Responsibility – limit access
- Segregation of Duties – different individuals are responsible for related activities
- Documentation Procedures – source documents, pre-numbered documents
- Physical Controls – Safes, time clocks, video
- Independent Internal Verification - reconciliations
- Human Resource Controls – background checks



# Limitations to Internal Control

- Human judgment
- Control breakdowns
- Management override
- Collusion
- Cost vs. benefits
- Lack of resources



# Fraud Case Examples

## Billing & Skimming examples (A/R):

- Staff person taking cash received from customers, covering up by entering credits to their accounts. Missing controls since the same person received cash, entered into system, deposited into bank and reconciled bank account.
- Staff member taking cash from deposits before they were taken to the bank, covering with a journal entry adjustment. Had controls in place that the same person that received funds didn't deposit them or reconcile bank account, however the bank bag wasn't locked so this person was able to remove.
- Cash taken from the deposit by management, transferring fund balances to the activities to cover up the missing cash.
- Management suspecting cash was taken but having hand written or incomplete records so couldn't be proved. Lacking internal controls and procedures.



# Fraud Case Examples

## Check Tampering & Expense Reimbursement (A/P):

- A/P payments made without adequate documentation, not adequate review by management.
- A/P checks where the authorized signature was being stamped by the A/P clerk with no review by management.
- Contracts for expenditures and large expenses from vendors that are “friends” of the approving party.
- Petty cash checks cut for more than the valid expenses, the same person took to the bank and the excess cash pocketed once the check was cashed.





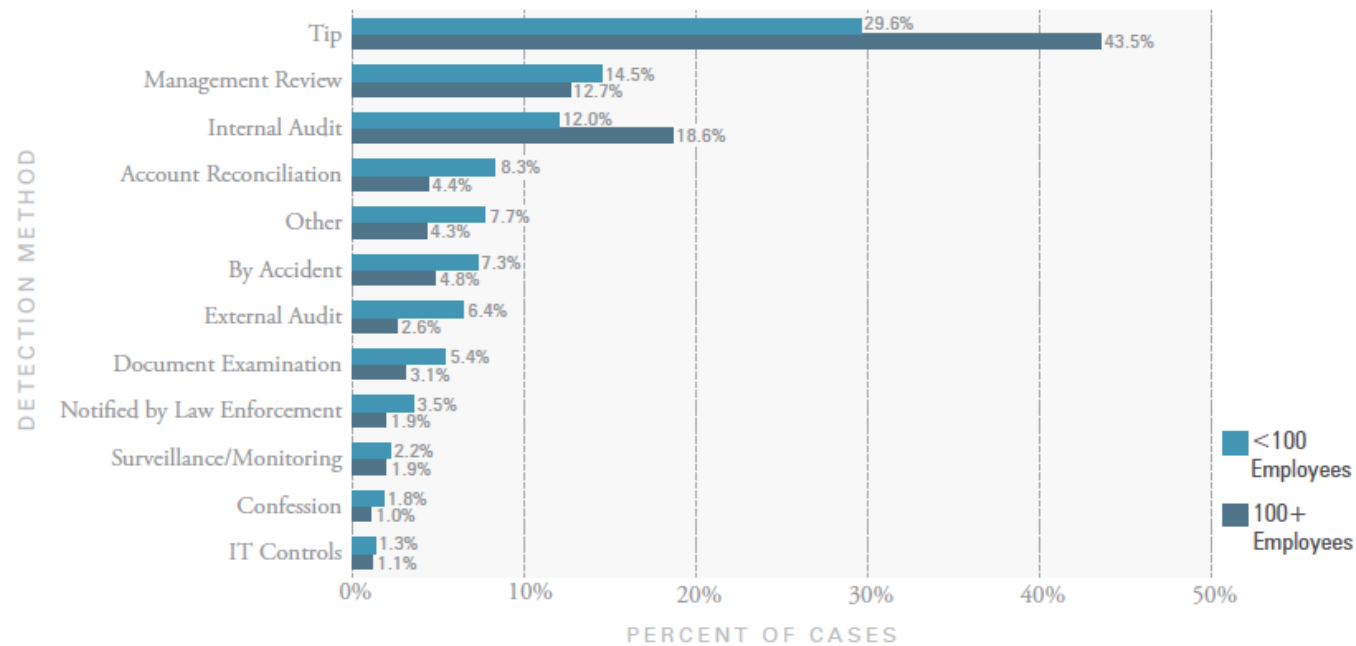
# Detecting Fraud in Small Businesses

## Initial Detection of Frauds in Small Organizations

Our data shows that detection methods varied substantially between small organizations (i.e., those with fewer than 100 employees) and larger organizations. The starkest variation occurred with tips; small and larger organizations detected fraud via tip in 29.6% and 43.5% of cases, respectively. Similarly, internal audit was the detection method for 12% of cases at small organizations but 18.6% at larger organizations.

One possible explanation for these disparities is that the controls and procedures an organization has in place affect how fraud schemes are caught. [Figure 48 on page 39](#) shows that most small organizations do not have a reporting hotline (25.7%), while the majority of larger organizations do (74.1%). Internal audit departments are also less likely to exist at smaller organizations than at larger ones (38.6% and 88.3%, respectively). In place of tips, small organizations tend to detect more frauds through management review, account reconciliation, accident, external audit, and document examination.

**Figure 22:** Detection Method by Size of Victim Organization



# Possible Warning Signs of Illicit Fraudulent Activity

- Living beyond their means
- Experiencing financial difficulties
- Unwillingness to share workplace duties
- Unusually close relationship with vendor/customer
- Refusal to take vacations
- Disorganized records



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Thank you!



Amy Buben, CPA, CFE  
[amybub@yeoandyeo.com](mailto:amybub@yeoandyeo.com)  
(989) 793-9830