



**REAL World: Fraud and Internal Controls**

2016 MASBO Fall Conference – September 15 1:15 – 2:15 pm

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Chief Financial Officer

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Cautionary Tale Pulled From **REAL** Life...



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**Fraud Information**

In 1996, Dr. Joseph T. Wells, CFE, CPA, founder and Chairman of the Association of Certified Fraud Examiners, directed the publication of the first Report to the Nation on Occupational Fraud and Abuse.

The study analyzed actual case information provided by Certified Fraud Examiners, the report presented statistical data on the cost of occupational fraud, the perpetrators, the victims, and the various methods used to commit these crimes.

This was the first study of its kind, and the findings in the 1996 report serve as the foundation for much of what is known about how occupational fraud and abuse affects organizations.

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### Fraud Statistics

Source: REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE

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| 5% of revenues lost to employee fraud & abuse, annually  | \$652 billion annually                                 | Median loss \$159,000  | Nearly one in four caused losses in excess of \$1 Million   |
| Men perpetrate 61% of fraud                              | Men cause losses more than twice those caused by women | Median loss from fraud by employees making \$50,000/year or less is \$75,000   | Median loss from fraud by employees making \$500,000/year or more is \$8 Million                                |
| Median losses caused by those 25 or younger are \$25,000 | Median losses caused by those over 60 are \$713,000    | Perpetrators with post-graduate degrees cause losses more than twice those of perpetrators with only undergraduate degrees | Multiple perpetrators cause median losses of \$485,000; nearly five times higher than perpetrators acting alone |

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### Fraud Statistics

Source: REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE

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|--|--|--|---|
| Government victims<br>Federal (\$194,000)<br>State (\$100,000)<br>Local (\$80,000) | The median loss suffered by small organizations (those with fewer than 100 employees) was the same as that incurred by the largest organizations (those with more than 10,000 employees). However, this type of loss is likely to have a much greater impact on smaller organizations. | Organizations of different sizes tend to have different fraud risks. Corruption was more prevalent in larger organizations, while check tampering, skimming, payroll, and cash larceny schemes were twice as common in small organizations as in larger organizations. | Whistleblowers were most likely to report fraud to their direct supervisors (20.6% of cases) or company executives (18%). |
| Largest - Asset misappropriation, 83% smallest average loss, \$125,000.            | Lowest - Financial statement fraud >10% Average loss, \$975,000.   | Corruption cases, 35.4% Average loss, \$200,000.   | Billing schemes and check tampering schemes posed greatest risk based on their relative frequency and median loss.        |
| In 94.5% of the cases, perpetrator took some efforts to conceal the fraud.         | The most common concealment methods were creating and altering physical documents.   | Most common detection method was tips hotlines (39.1% of cases).   | Most prominent weakness cited was a lack of internal controls & overrides of existing internal controls.                  |

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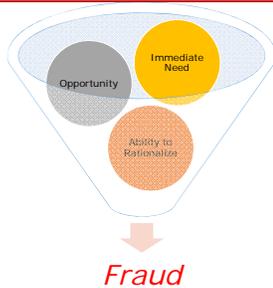
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### Why Fraud Happens




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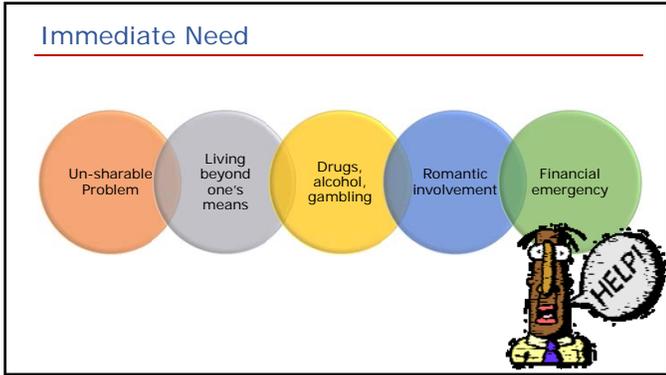
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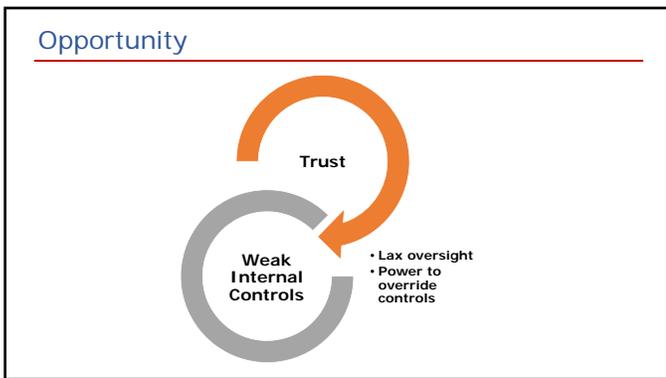
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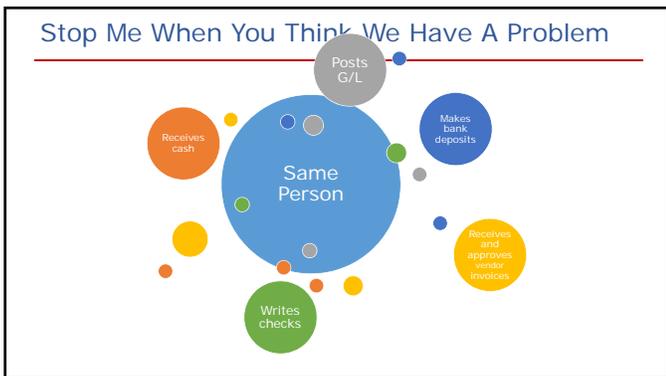
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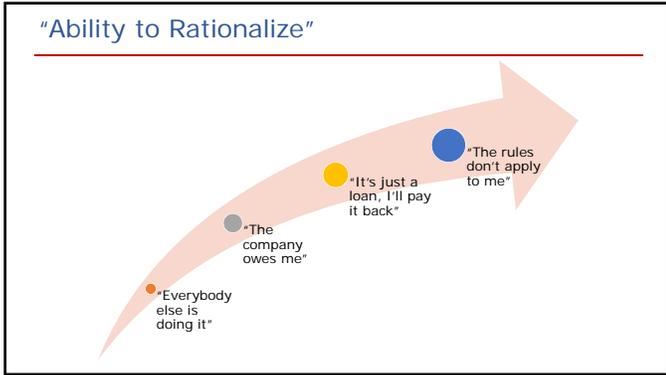
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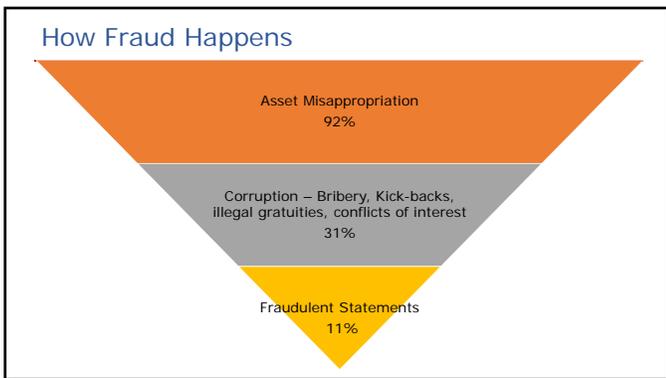
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What Happened?



Stole \$81,000; possibly \$100,000 more

Delayed Audits

Cash receipts

Caught in routine audit

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Headmaster embezzles...



Jones County Circuit Court

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What Happened?



Stole between \$25,000 to \$58,000

Accepted cash receipts

Controlled Deposits

Controlled mail

Overrode internal controls

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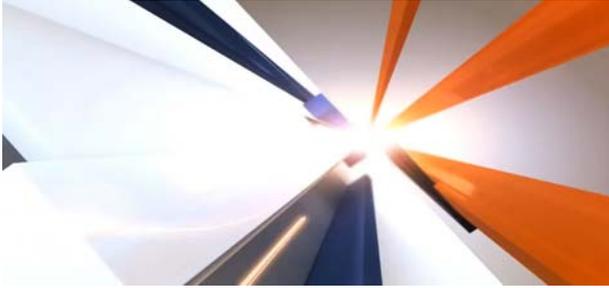
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### Golden High School financial secretary charged embezzlement



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### What Happened?



Stole \$156,000 in cash from school events (Homecoming, Prom and other school activities)

Arrested on unrelated charges

Revealed by auditors

Falsified reports

Lied to Auditors

Lack of transparency

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### A Wake Up call...



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### What Happened?



Stole more than \$3.5 million over 7 years

500 checks written to herself and family

Delayed audits

In charge of controls

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### How it was concealed?

Fraudulent journal entries

Altered bank deposits

Altered credit card statements

Bank reconciliations

- Manipulated outstanding checks
- Altered bank statements

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### Internal Controls...What's That? (DIAB)

Systems of policies and procedure designed to prevent fraud, waste and misappropriation.

Protect the assets of an organization.

Create reliable financial reporting.

Promote compliance with laws and regulations.

The work is subdivided so that no single employee performs a complete cycle of operations. (Separation of Duties)

Achieve effective and efficient operations.

#### Audit Standards

- ❑ Statement on Auditing Standards 112 (SAS 112)
- ❑ Audit Requirement – auditor to gather more evidential documentation on internal control deficiencies and include additional findings in annual audit report.
- ❑ Effective December 2006 for Non-Profits in the wake of Sarbanes-Oxley Act.

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### Who is responsible?

While everyone in the school is responsible for the internal controls, the board of education and the administration are ultimately responsible.



School districts that seek excellence in their financial management and operations must establish and maintain a strong internal control system that is effectively communicated to all.

- Principals & Teachers
- Support Administrators and their departments
- Vendors & Subcontractors
- Volunteers

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### Why do you need good internal controls?



Fraud, abuse, theft and misappropriations of funds can come from a variety of perpetrators including but not limited to employees, officers, volunteers and vendors.

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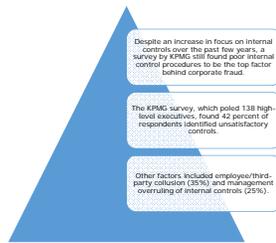
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### Why do you need good internal controls?



Source: Pennsylvania CPA Journal, Spring 2008

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## What is the risk of poor internal controls?

Risk assessment is identification and analysis of relevant risks to organizational objectives, for the purpose of determining how those risks should be managed.

Assessment begins determination objectives, followed by identification of obstacles that could prevent objectives from being attained. In other words, it's an analysis of what could go wrong.

Not all risks are equal. Some are more likely than others to occur, and some will have a greater impact if they occur. Once risks are identified, their probability and significance must be assessed.

Finally, having identified and assessed risk, management must decide how to deal with it.

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## Internal Control Elements



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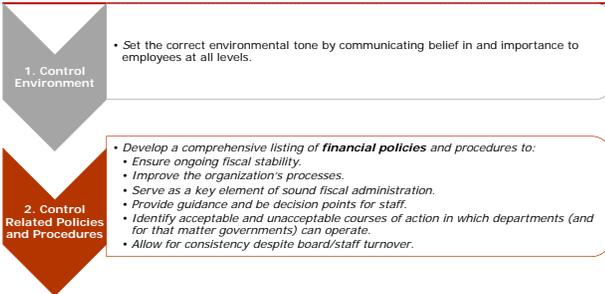
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## Internal Control Elements



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### Why have financial policies?

When financial policies are effective and enforced – they preserve and even enhance fiscal health.

By contrast, weak financial policies promote fiscal instability, cause internal control violations, invite fraud and reduce the trust and confidence citizens have in our government.

The Government Finance Officers Association (GFOA) has identified policies as a recommended practice.

Your external auditor's love them.

Take a step back and think about it – doesn't it make sense to have written financial policies?

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### Formal vs. Informal Financial Policies

**Formal financial policies** are those written into an authoritative document.

**Informal financial policies** are those that evolve over time based on past practice.

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### Formal vs. Informal Financial Policies

**Informal financial policies** may be important for short-term decisions and the beginning of a more formal structure but there are disadvantages of relying on them:

- They can be vague and result in inconsistent application.
- They might not stand the test of time.
- Past practices may not adequately assist in addressing new situations that arise.
- Staff turnover could affect the interpretation of an informal policy.
- They may or may not have the support of management and could be abandoned during times of financial stress.

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### Formal vs. Informal Financial Policies

**Formal financial policies** have many advantages over informal polices:

Increase efficiency by standardizing operations - *don't* have to reinvent responses to circumstances.

These polices most likely outlive their originator which promote stability and continuity - provides a common set of rules for all to follow.

Bond rating agencies love them - rating agencies look favorably on formal policies such as a debt policy as they render their bond rating.

*They Educate Officials* - they provide a roadmap to help inform public officials of sound financial practice making it more likely these practices will be followed.

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### PTA President...



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### What Happened?



Stole more than \$20,000 in 2 months

Cash withdrawals

Gambling

Override of internal controls

Failure to comply with policy

Discovered by internal audit

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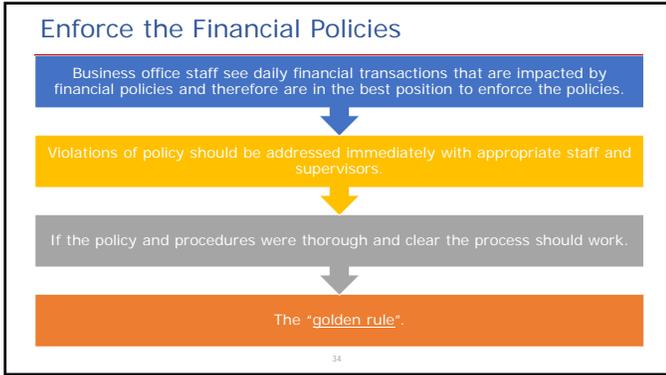
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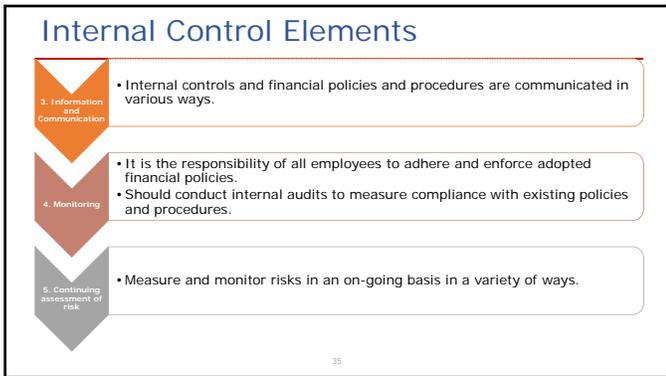
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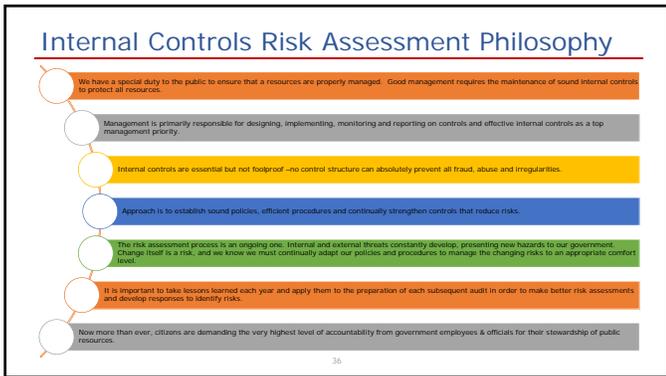
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### Non-Profit CEO and Principal Embezzle ...



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### What Happened?



Stole more than \$100,000 over 5 years

Payments made for services not provided

Money used to fund vacations, dining, jewelry and new cars

Collusion between two parties

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### Comptroller and Director of Finance Conspire and Embezzle ...



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What Happened?



Stole more than \$2.5 million over 2 years

13 Fraudulent wire transfers

Checks written between colluding parties

Override of internal controls

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Auditors are not Magicians...



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"Red Flags of Fraud"



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### "Red Flags" of Fraud

- Poor accounting records
- Missing documents
- Photocopies
- Excessive adjustments
- Increased write-offs
- Customer/employee complaints
- Related party transactions
- General ledger doesn't balance



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### Lifestyle Indicators



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### Tools and Techniques To Minimize Fraud Risk

**what do YOU expect?**  
Expect Fraud - It cannot be eliminated; only managed!

**Know Your Business**  
Know Your Business

**Know Your Employees**  
Over 30% of resumes contain false statements

**Look for Fraud**

**Recognize Limitations of Internal Controls**  
• Controls break down  
• Circumstances change

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### Contact

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Website: [Welcome to Business Services](#)

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