

# Best Practices for Internal Controls

for the  
Tri-State REMA Financial Managers Conference

*Presented by:*

**Brett Johnson**

Forensic & Valuation



# Agenda

- Background
- Internal Controls Defined
- Internal Controls and Fraud Risks
- Best Practices
- Case Examples



# Background

## ■ Firm

- Eide Bailly is a Top 25 CPA firm in United States
- Has 19 service centers in 9 states
- Headquarters: Fargo, North Dakota

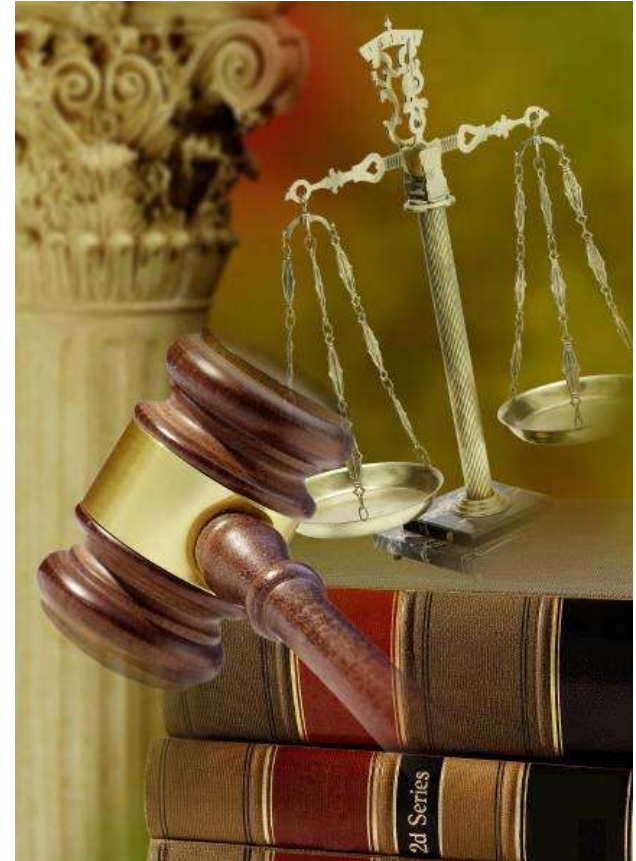
## ■ Self

- Over 8 years of forensic accounting experience
- Certified Public Accountant
- Certified Fraud Examiner
- Certified in Financial Forensics
- Certified Forensic Interviewer
- MBA in Fraud Management and Economic Crime



# Background - Forensic & Valuation

- Fraud prevention
- Fraud detection/investigation
- Business Valuation
- Computer forensics
- Internet forensics



# What Does a Forensic Accountant Do?

- **Short answer:** We are detectives of the accounting world
- **Long answer:** Organizations hire forensic accountants for fraud prevention, detection or investigation purposes
  - Need assistance in developing internal controls over assets
  - Identified suspicious financial transactions by an employee
  - Identified an instance(s) of fraud and need assistance in identifying other possible schemes (e.g., tip of the iceberg) and document for termination/litigation purposes

# Internal Control Defined

- **Internal Controls** (a/k/a checks and balances) are designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
  - reliability of financial reporting,
  - effectiveness and efficiency of operations, and
  - compliance with applicable laws and regulations.
- Should also include “Safeguarding Assets.”



# Internal Controls and Fraud Risk

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- **All** organizations are exposed to a degree of fraud risk in any process where human input is required
- The degree of risk is measured by:
  - Business/Industry
  - Effectiveness of internal controls to prevent or detect fraud
  - Honesty and integrity of people involved in the process



# Internal Controls and Fraud Risk

## ■ No. 1 Opportunity for Fraud:

- Weak or non-existent internal controls including an ineffective internal audit staff and a lack of external audits



# Internal Controls and Fraud Risk

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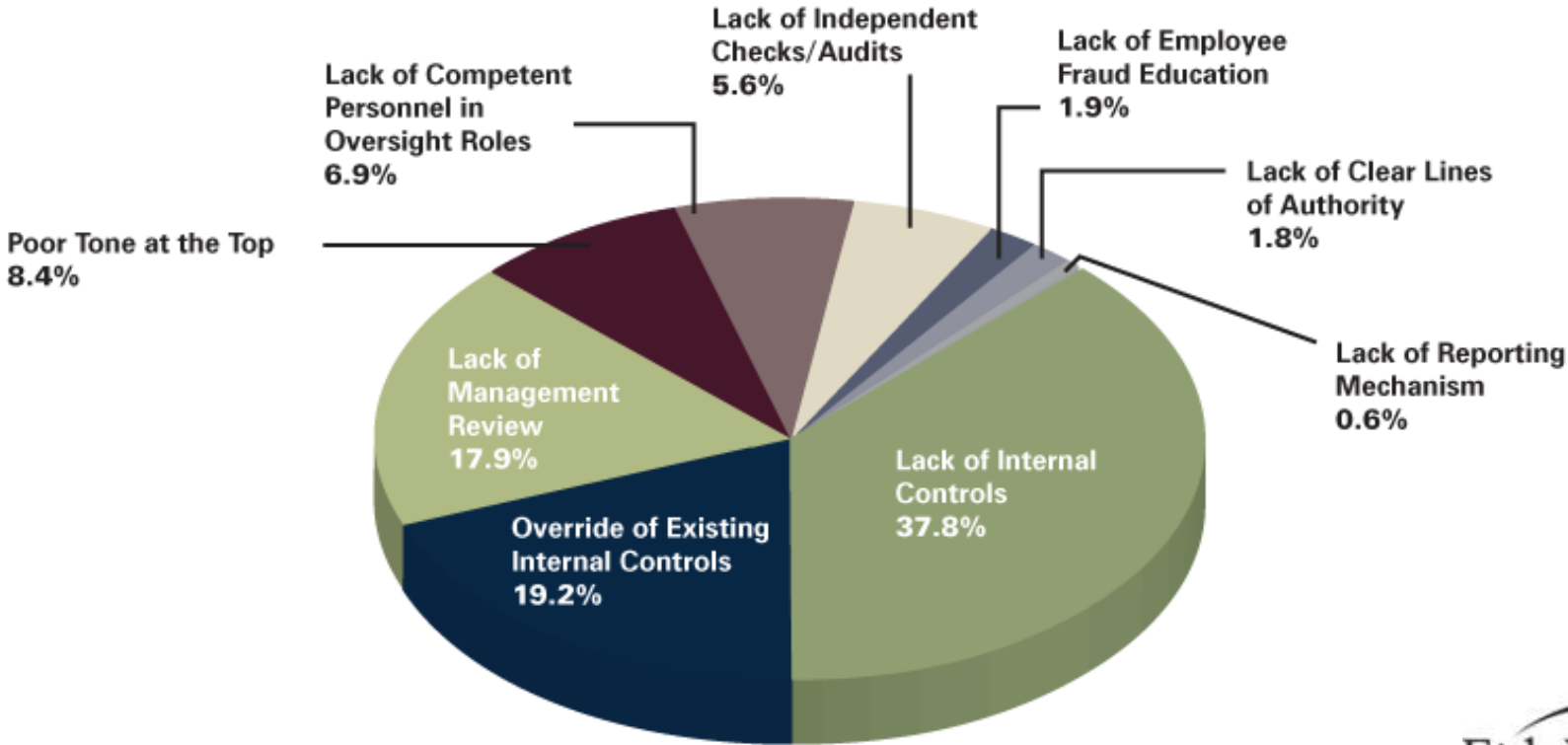
## Other Reasons Why Fraud Occurs:

- Collusion
- Management override of internal controls
- Lack of active director control over management
- Weak ethics policy or code of conduct



# Internal Control Weaknesses

## Primary Internal Control Weakness Observed by CFEs



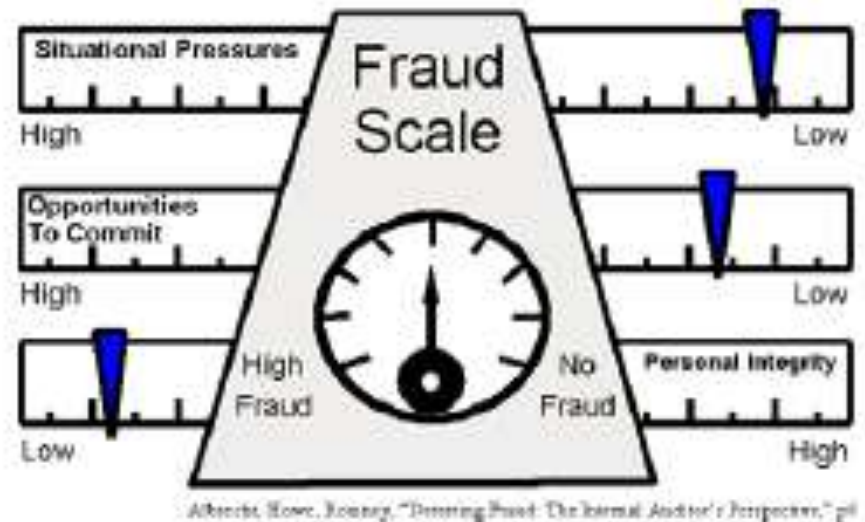
# Internal Controls and Fraud Risk

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- Probability of fraudulent activity is typically based on the following factors:
  - How easy it is to commit fraud
  - Company's fraud history
  - Motivational factors leading to fraud



# Fraud Triangle and Scale



# Why are Internal Controls Important?

- ζ 75% of businesses are victims of fraud
- ζ 5% of Total Revenue
- ζ 18 months before detection
- ζ Less than 100 employees, most vulnerable
  - Median loss per incident = \$160,000
  - Utilities Industry's median loss per incident = \$120,000



Source: ACFE 2010 Report to the Nations



# Best Practices – Internal Controls

- *Basic principle:*
  - People rarely commit fraud if they think they will be caught
- *Perception of detection:*
  - Most effective deterrent to fraud



# Best Practices – Internal Controls

- *“Tone at the Top”*
  - Managers need to communicate the idea that they are serious about their fraud detection and prevention efforts
- *Employee Education*
  - Internal controls for monitoring employees
  - Company fraud (ethics) policy



# Best Practices – Internal Controls

- Proactive policies
  - Surveillance
  - Fraud assessment questioning
  - Mandatory vacations
  - Surprise audits
  - Physical security measures
  
- Vigorously pursue dishonest acts
  
- Anonymous reporting program (Hotline)
  - No. 1 way to detect fraud (Fraud Survey)



# Best Practices – Internal Controls

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## Why Reporting Systems are Important:

*“If you want to know what’s really going on in most companies, you talk to the guy who sweeps the floors. Nine times out of ten, he knows more than the president. So I make a point of knowing what my floor sweepers know—even if it means sweeping floors.”* – Kenneth A. Hendricks



# Best Practices – Internal Controls

- Background checks (criminal history/financial pressure)
- Segregation of duties:
  - Authorization
  - Recordation
  - Custody of assets
- Proper procedures for authorization
- Adequate documents and records
- Physical control over assets and records
- Independent checks on performance
- Employee dishonesty insurance coverage



# Best Practices – Internal Controls

## Cash Receipt Function:

- Separate cash handling from recordation function
- Separate functions related to the receipt of the mail:
  - One individual opens mail
  - Second individual prepares cash receipt listing
- Endorse/deposit receipts ASAP
- Reconcile deposit slips to cash remittance lists



# Best Practices – Internal Controls

## Cash Disbursement Function:

- Authorized check signer must:
  - Examine supporting documentation before signing each check
  - Mark each invoice as paid
  - **NEVER** pre-sign checks
- Separate individual from preparing check and signing should mail the checks
- Cancelled checks should be examined on a periodic basis by an individual independent of cash disbursement functions



# Best Practices – Internal Controls

## Inventory:

- Segregate the following duties:
  - Purchasing
  - Receiving
  - Inventory counts
  - Investigation of inventory loss
- Perform multi-level review of purchases
- Set pre-determined authorization amounts for purchasers; Require two or more approvals over the set amount
- Investigate all inventory discrepancies



# Best Practices – Internal Controls and Fraud

***Implementing internal controls (fraud prevention) is easier and less costly than fraud detection.***



# Case Example

<b>Case 1</b>	<b>Details</b>
Victim	City Utility
Perpetrator	Bookkeeper (23 year employee)
Type of scheme	Theft of customer receipts
About the fraud	3 year scheme; Physically handled payments and had the ability to make adjustments
Total losses	\$243,000
Prevention tool	Segregate cash handling and recordation functions

# Case Example

<b>Case 2</b>	<b>Details</b>
Victim	Electric Cooperative
Perpetrator	General Manager (new hire)
Type of scheme	Unauthorized use of corporate credit card and business accounts
About the fraud	4 month scheme; No independent review during duration of scheme
Total losses	\$60,000
Prevention tool	Independent examination of GM's financial transactions

# Case Example

<b>Case 3</b>	<b>Details</b>
Victim	Utility Company
Perpetrator	Electrical Contractor
Type of scheme	Submission of invoices with inflated charges; Facilitated through bribery
About the fraud	2 years; Collusion involved
Total losses	\$232,000
Prevention tool	Reporting system; Multi-level review process for approval of invoices for payment

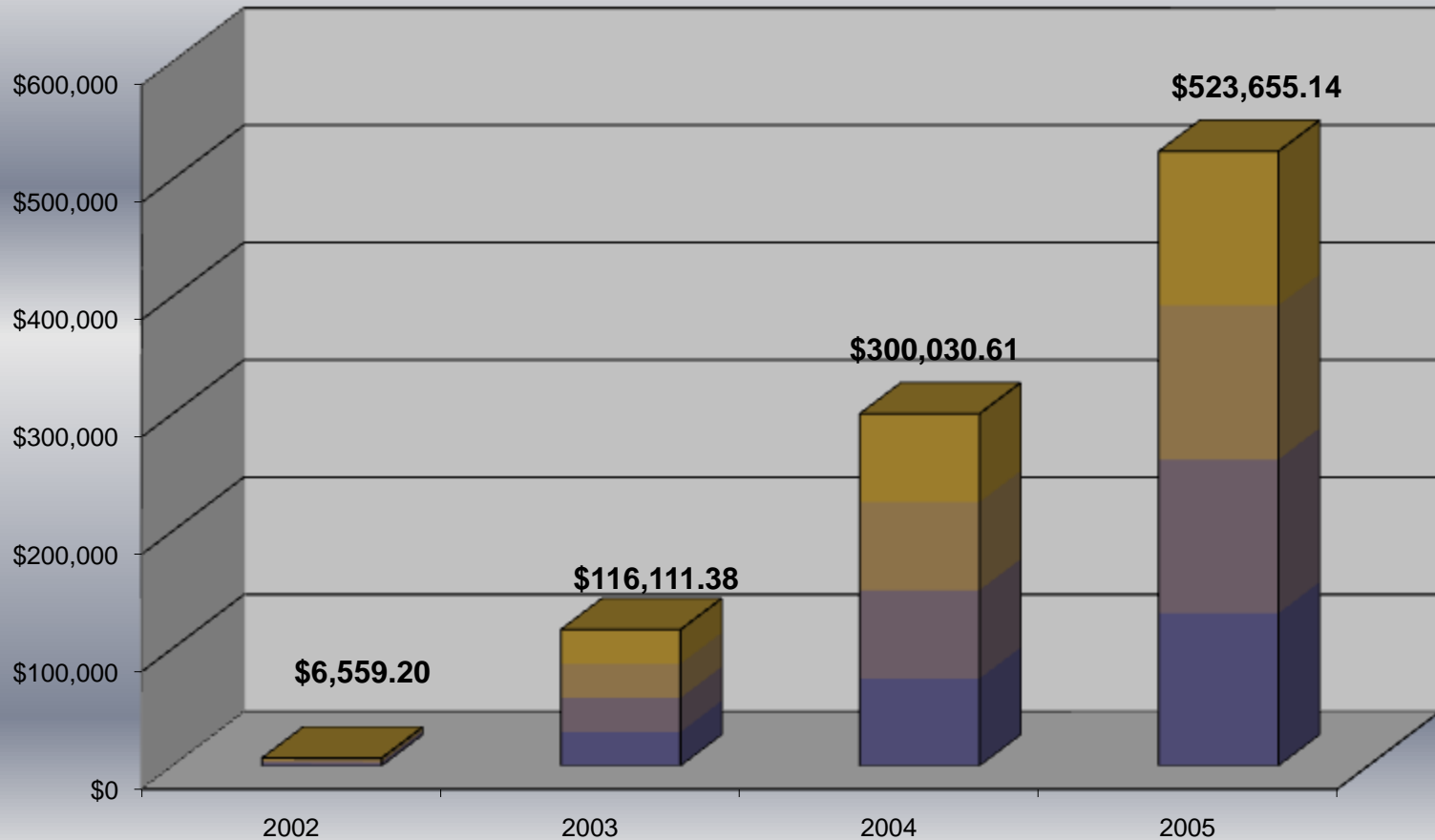
# Case Example (Illustration of Inventory Fraud)

<b>Case 4</b>	<b>Details</b>
Victim	Hospital
Perpetrator	Supervisor of Materials Management
Type of scheme	Theft of inventory; Sold assets through eBay/PayPal
About the fraud	4 year scheme; Lack of segregation of duties
Total losses	\$946,000
Prevention tool	Segregate purchasing, inventory count and investigation functions

Stock Number	Adjustment Total	Description	Common Name	Active
Z08430	\$341,034.98	Test Strip Glucose "Accu-Chek" Inform Monitor Comfort Curve H	Glucose Test Strips Accu-Chek	Yes
Z08206	\$219,287.55	Test Strip One Touch Ultra**Glucose Strip** <Use z67840>	One Touch Ultra Strip 020-244	No
Z08200	\$85,532.47	Test Strip Glucose Lifescan ** Use roche z08430 12-2004*	Surestep Test Strip 010-797	Yes
Z01932	\$48,750.00	Sensor Oximeter Adult DS-100A Finger Clip Sensor Re-Use	Oximax Durasensor Adult Reuse	Yes
Z58326	\$48,709.44	Sensor Oximeter Neonate/Adult w/Adhesive Oxisendor II Disp	Oximeter Sensor Neonatal/Adult	Yes
Z58327	\$31,747.20	Sensor Oximeter Peds Disp w/Adhesive Oxisensor II	Oximeter Sensor Peds Disp	Yes
Z01931	\$30,325.80	Sensor Oximeter Pulse 18" w/Adhesive Oxisensor II Disp	Oximeter Sensor Adult Disp	Yes
Z10019	\$25,192.83	Cartridge Inkjet Tri-Color 78 Series 900-1220 High Yield	Deskjet Print Cartridge C6578	No
Z01933	\$24,714.30	Sensor Oximeter Infant Max-I Disp	Infant 02 Sensor Disp Max-I	Yes
Z04217	\$19,741.57	Cartridge HP DJ 870CXI Black	Inkjet Black HP Deskjet 870CXI	Yes
Z10396	\$15,811.56	Cartridge Inkjet HP Black 910/920 Fax 600 Deskjet/Writer	HP 51629A Inkjet Cartridge	Yes
Z10018	\$12,148.50	Cartridge Inkjet Print Black HP Deskjet 810 812 825 840	Inkjet Cartridge Black C6615DN	No
Z70155	\$9,284.71	Cartridge Inkjet Tri-Color 49 313 Page Yield	Deskjet Print Cartridge 51649A	Yes
Z10013	\$6,828.05	Toner Black Espon C80 Series Printer 1240 Page Yield	Epson C80 Cartridge Black	Yes
Z04225	\$6,219.00	Cartridge Ink Black Epson 900 Printer	Epson 900 Black Ink Cartridge	No
Z04166	\$5,481.14	Cartridge Toner HP Fax HEW51626A	HP Fax Cartridge Toner	Yes
Z04224	\$4,362.72	Cartridge Ink Color Epson 900 Printer	Epson 900 Color ink Cartridge	Yes
Z10017	\$2,958.46	Cartridge HP LJ 1000 1200 3300 1220 Series 3500 Page Yield	HP Laserjet Toner Black C7115X	Yes
Z04218	\$1,853.89	Cartridge Toner HP870CXI Color	HP870CXI Color Toner Cartridge	Yes
Z04215	\$1,823.10	Cartridge, Faxphone 8640 Black Fax/Copier on Units	Cartridge, Black Faxphone	Yes
Z04101	\$1,762.29	Battery 9 Volt Lithium for HP Telemetry System	9 Volt Lithium Battery	Yes
Z04223	\$1,480.52	Cartridge Toner HP4000OEM HEWC4127X- PGMX CIM10127	HP 4000 Toner Cartridge	Yes
Z02455	\$1,306.25	Cartridge LJ II & III Series Pls Return Used to Warehouse	HP Laserjet II & III Toner	No

**\$946,356.33**

### Inventory Adjustment by Year User - DOE





CATEGORIES FASHION MOTORS DEALS CLASSIFIEDS

accucheck All Categories Search Advanced

Related Searches: accu-chek comfort curve, accu chek active, accu check aviva, accu chek compact, accu chek aviva, accu chek advantage

733 results found for accucheck Save search

Categories

Health & Beauty (663)

Medical, Mobility & Disability (620)

Health Care (21)

Coupons (10)

Other (4)

Wholesale Lots (2)

More

See all categories

Condition

- New (641)
Used (23)
Not Specified (69)
Choose more...

Price

All items Auctions only Buy It Now Products & reviews BETA

View as: list grid columns

Sort by: Best Match

Page 1 of 15



2 boxes Accu Chek Comfort Curve Test Strips, NIB 100

Location: Illinois
Watch this item



Buy It Now or Best Offer

\$34.00 Free shipping

2d 5h 29m



FREE Accu-Chek Meter!

Expedited shipping available

Location: Illinois
Watch this item

0 Bids

\$0.99 Free shipping

5m



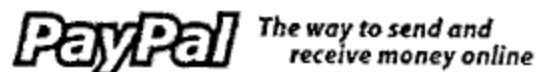
10 Boxes Accucheck Active test strips

Location: Florida

8 Bids

\$95.00

56m



## You've Got Cash!

Dear

This email confirms that the Pending eCheck you received for \$4,896.00 USD from [redacted] has cleared. The funds are now reflected in your PayPal balance. If the payment is not reflected in your PayPal balance, please check the status of the transaction in your Account History. Log in to your account and go to the History subtab of the My Account tab. If the Status of the payment is listed as "Unclaimed," click the Accept button to reflect this transaction in your balance.

### eCheck Details

**Amount:** \$4,896.00 USD  
**Transaction ID:** 64314685EG737040B  
**Note:** Thanks again

### Payment Details

**Buyer:** [redacted]  
**Subject:** 4 cases

[View the details of this transaction online](#)

### Protect You

Make sure you  
your password  
websites.

To safely and s  
PayPal website  
open a new we  
Internet Explor  
and type in the  
sure you are or  
website.  
<https://www.paypal.com>  
) to be sure yo  
PayPal site.

PayPal will nev  
your password

For more infor  
protecting your  
please review c  
<https://www.paypal.com/privacy>  
ritytips

### Protect You

You should nev  
PayPal passwor  
including PayPa



My Folders[Hide] Subject:Re: 4 cases of MAX-N

- Drafts and pre-...

To: @yahoo.com>  
Great  
Thanks

- Important

- Non-paying bidders

-- @yahoo.com> wrote:

- Off eBay purcha...

> They'll be there by tomorrow. Had to ship separate,  
> sorry.

- Online Rx

>  
> @yahoo.com>

- Online casinos

> wrote:  
> Do you have tracking for this cases?

- Online purchases

> I need them Urgent  
> They were paid on 9/23  
> Thanks

- Paypal

>



## Paypal transaction history for

Date	Time	Type	Status	To/From	Currency	Amount	Transaction ID
12/30/2004	22:09:26 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-301.5	0VU360990F185740N
12/30/2004	0:25:47 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-401.5	15877384HR666633P
12/28/2004	20:08:10 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-281.5	6P233554FD820162T
12/28/2004	13:05:06 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-101.5	24K359132M212913B
12/26/2004	23:09:53 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-201.5	9TL87753KH713213C
12/24/2004	0:23:46 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-61.5	1245549474333783B
12/23/2004	23:30:37 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-41.5	5HD55089YP838970K
12/23/2004	22:44:50 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-201.5	66670903X2662141L
12/23/2004	16:38:10 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-201.5	2GE30691868099015
12/22/2004	0:48:47 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-101.5	47C727187B184180U
12/21/2004	23:51:30 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-201.5	77L82014N52962708
12/21/2004	13:21:37 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-81.5	2HP78069TC848000V
12/21/2004	12:06:53 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-101.5	0K984287N69371516
12/20/2004	22:51:34 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-41.5	06R605892R652203C
12/20/2004	22:43:19 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-41.5	6CA8678579309612E
12/20/2004	14:27:59 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-61.5	3UL77717GE365472H
12/20/2004	13:02:59 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-301.5	3E527775JD792993Y
12/16/2004	14:42:59 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-201.5	3BA80587VV1852011
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11/19/2004	18:16:31 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-401.5	24468320UK286712N
11/18/2004	11:39:51 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-401.5	5U004137E5295123C
11/17/2004	13:01:16 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-401.5	65L4634996361205L
11/16/2004	14:58:18 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-401.5	3JG50859235410806
11/15/2004	13:33:46 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-401.5	2S119175GB480814R
11/11/2004	14:43:31 PST	ATM Withdrawal	Completed	100 NORTH HAYFORD AIRWAY HEIGHT WA	USD	-61.5	4K056992X28251308



## PRESS RELEASE

FOR IMMEDIATE RELEASE	FOR INFORMATION CONTACT:
Tuesday, May 01, 2007	Thomas Rice, First Assistant U.S. Attorney (509) 353-2767

### **“FORMER [REDACTED] EMPLOYEE SENTENCED TO PRISON FOR STEALING OVER \$644,000 OF MEDICAL AND OFFICE SUPPLIES”**

Spokane – Today, James A. McDevitt, United States Attorney for the Eastern District of Washington, announced that [REDACTED], age 42, of Spokane, Washington, was sentenced to a 12 month and one day term of imprisonment to be followed by a 3-year term of court supervision. He was ordered to report for service of his sentence as directed by the U.S. Marshal.

On December 20, 2006, [REDACTED] was charged with, and pleaded guilty to, one count of Health Care Fraud, four counts of Theft of Property and Assets of a Health Care Benefit Program, and four counts of Money Laundering. The charges related to [REDACTED]’s criminal conduct while he was employed as a Materials Supervisor in the Central Distribution Department at [REDACTED]. As a Materials Supervisor, [REDACTED] had responsibility for receiving, warehousing, distributing, and reordering inventory items. [REDACTED] had access and authority to record receipt of inventory, to modify purchase orders, and to make adjustments to [REDACTED]’s internal inventory account.

[REDACTED] devised a scheme to obtain money by stealing items from [REDACTED]’s inventory and then inputting materially false adjustments to [REDACTED]’s inventory account for the items. The items included medical supplies, such as glucose strips and sensor oximeters, as well as office supplies, such as ink toner and cartridges. [REDACTED] sold the stolen items, using both eBay and direct e-mail communication with unwitting purchasers. [REDACTED] instructed the purchasers to deposit payment for the items into a PayPal account that he established. Between approximately January 3, 2002, and October 18, 2005, over \$644,000 was deposited into [REDACTED]’s PayPal account, which funds represented the purchase price for the inventory items he had stolen and then sold over the Internet.

# Bottom Line – Best Practices

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- Segregate duties (ARC) if possible
- If segregating duties is not possible, utilize independent checks
- Increase perception of detection
- Implement an anonymous reporting system
- Do NOT overlook suspicious transactions
- Ask questions



# Contact Information

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