

**Fraud Risk Assessment  
Cash Disbursement Cycle**  
*part 1 of 3*

Massachusetts Municipal Auditors' & Accountants' Association  
Annual Meeting – June 16, 2014  
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**Agenda – Fraud Risk Assessment in  
Cash Disbursement Cycle**

- Internal vs. External Cash Disbursement Fraud
- 5 most common insider fraud schemes
- Common external fraud schemes
- Fraud triangle
- Municipalities' vulnerabilities
- Red Flags
- Incorporating Fraud Risk Assessment into Operations
- Key Detection Tools

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**Informal Poll**

- How many in the room worked at an organization that was the victim of fraud?
- Was it within your department?
- Did it pertain to cash handling?

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### Fraud Statistics

In its 2014 Global Fraud Study, the ACFE reported:

- The median loss caused by fraud was \$145,000
- The medium duration of fraud (start to end) was 18 months
- Asset misappropriation was the most common form of fraud
  - This is the most applicable to municipalities
- Banking and financial services, **governments** and manufacturers had the highest reported fraud incidents in this survey

Full study can be found at [www.acfe.com/rtn-download-2014.aspx](http://www.acfe.com/rtn-download-2014.aspx)

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### Fraud Fact – Cash Disbursements

- Fraudulent disbursements are the most common form of asset misappropriation (i.e., stealing) according to the Association of Certified Fraud Examiners.
- In a municipality, fraudulent disbursements are a prime area for *material* theft in a very short span of time.
- Cash receipts are likely a more frequent area of municipal fraud, but generally take more time to become *material*.

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### Internal vs. External

- Internal fraud originates within an organization
  - Employees; and/or
  - Board and committee members
- External fraud originates outside an organization
  - Vendors
  - Customers
  - Hackers

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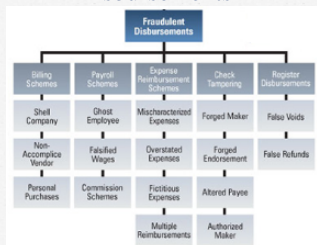
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### Uniform Occupational Fraud Classification System – Fraudulent Disbursements



Source: Association of Certified Fraud Examiners www.acfe.com

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### Common Internal Fraud Schemes

- 5 **common** types of internal fraud schemes:
  1. Billing
  2. Payroll (*subject to a separate presentation*)
  3. Expense reimbursements
  4. Check tampering
  5. Register disbursement
- These fraud schemes relate to the theft of an organization's assets – most notably CASH.

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### Billing Schemes

- This is the most common and most costly form of fraudulent disbursement.
- The fraudster will cause the municipality to purchase goods/services that are either overpriced, unnecessary or nonexistent.
- Fraudster can benefit from:
  - Personal receipt of goods/services that appears to be business-related;
  - Cash receipt from the municipality making payment to a shell, or dummy company.

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### Expense Reimbursement Schemes

- This is a common target for fraud by an insider.
- Falsifying expense reports results in cash to the fraudster through the payroll system.
- Primarily related to:
  - Travel
  - Personal use of vehicle (i.e., mileage)
  - Meals and entertainment

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### Check Tampering Schemes

- This will likely be perpetrated by someone within the Accounting/Treasury/IT functions.
- Accomplished by:
  - Preparing a valid municipal check to the fraudster or an accomplice, or
  - Intercepting a check intended for a third party and manipulating the check for his/her benefit
- Access to check stock, signature stamps, printer cards is generally needed.

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### Register Disbursement Schemes

- With respect to municipalities, refunds to customers/tax payers at both the municipal level and enterprise level represents greatest risk.
- These disbursements appear valid on the books, but are fraudulent.
- This fraudster will likely be in an area within the Accounting/Collections/Treasury functions.

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### External Fraud Schemes

- Bid Rigging and Bid Rotation
  - External vendors colluding with each other
- Overbilling Schemes
  - Many times will include an insider – kickbacks
- Illegal Gratuities
- Other Corruption:
  - Bribery
  - Extortion and/or
  - Conflicts of Interest

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### Fraud Triangle

3 key reasons why fraud occurs.

Developed by Dr. Donald Cressey, a criminologist, whose research focused on embezzlement.



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### Municipalities' Vulnerabilities

- Why are municipalities vulnerable?
  - Inappropriate/incompatible segregation of duties
  - Culture of trust
  - Use of part-time employees
  - Over-reliance on key employees
  - Improper employee background checks
  - Budget constraints
  - Political implications to exposing fraud

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### Independent Auditors' Role in Fraud Detection

- Auditors are required to consider fraud in the planning and execution of an audit, but are not required to audit for fraud ... this will be noted in your engagement letter.
- A clean audit opinion on your financial statements specifically disclaims an opinion on internal controls.
- The clean Yellow Book opinion also disclaims an opinion on internal controls.

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### Red Flags for Insider Fraud

- Change in lifestyle
- Not taking vacation, sick or other days off
- Employee change in work habits/behavior:
  - Coming in early and staying late
  - Trying to do more work alone or unsupervised
  - Insists on doing work the he/she should not do or that he/she normally would have walked away from
- Employee is known to be having personal financial stress

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### Red Flags for Insider Fraud (cont'd)

- Unusual, close relationship with outside vendors
- Vendor/customer complaints about payment application
- Known or suspicion of gambling/drug/alcohol abuse
- Brags about recent gambling wins
- Recently demoted
- Has a wheeler-dealer personality

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### Red Flags for Vendor Fraud

- Complaints from other vendors on pricing
- Bid prices drop when new bidders enter
- Qualified bidders refrain from bidding
- Different bidders make same errors on bids
- Winning bidder is always the last to submit bid
- Unusual one-time extra charges/change orders
- Many vendor transactions under the \$5K/\$10K threshold for Chapter 30B
- Vendor makes an unusually high number of visits to the municipality

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### Incorporating Fraud Risk Assessment into your Operations

- Assess where you are most vulnerable
- Do not exclude anyone from your assessment ... this isn't personal, it's business
- Evaluate the controls you have in place in these vulnerabilities
- Identify gaps
- Incorporate controls
- Document controls
- Communicate controls

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### Enhancements to Internal Controls May Include

- Fraud policy
  - Effectively communicated
  - Includes clear policy for punishment
- Enhanced training
- Background and credit checks
- Effective whistleblower system
- Appropriate system authorizations
- Use of strong passwords and password
- Periodic internal audits
- Cross training

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### Key Fraud Detection Tools

- > Periodic, unannounced internal audits
- > Employee tips
  - > Open door policy
  - > Confidential whistleblower hotline
    - > AG's hotline is (800) 322-1323
- > **Timely** reconciliation of accounts
- > Timely budget to actual analyses
  - > Revenues as well as expenses
- > Check logs with signoffs between Accountant and Treasurer ... keep track of the sequence of your checks
- > External audit

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### Questions



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