Fraud Risk Assessment
Cash Receipts Cycle
part 2 of 3

Massachusetts Municipal Auditors' & Accountants' Association
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Agenda – Fraud Risk Assessment in Cash Receipts Cycle

- Part 1 Review
- Fraud Tree – Cash Receipts Portion
- 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 victimized by fraud?
- Was it within your department?
- Did it pertain to cash handling?

Part 1 Review – Assessing Fraud Risk in the Cash Disbursement Cycle

- Fraud is generally perpetrated **internally** or **externally.**
- Fraudulent disbursements account for the largest dollar frauds in municipalities in the shortest time. Cash receipts are more **frequently** the subject of fraud, but generally take more time to become *material*.
- General culture within municipalities make it more susceptible to fraud risk
  - Segregation of duties
  - Budget constraints
  - Culture of trust
  - Political implications to exposing fraud

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Fraud Statistics

In its 2014 Global Fraud Study, the Association of Certified Fraud Examiners (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/rttn/docs/2014-report-to-nations.pdf

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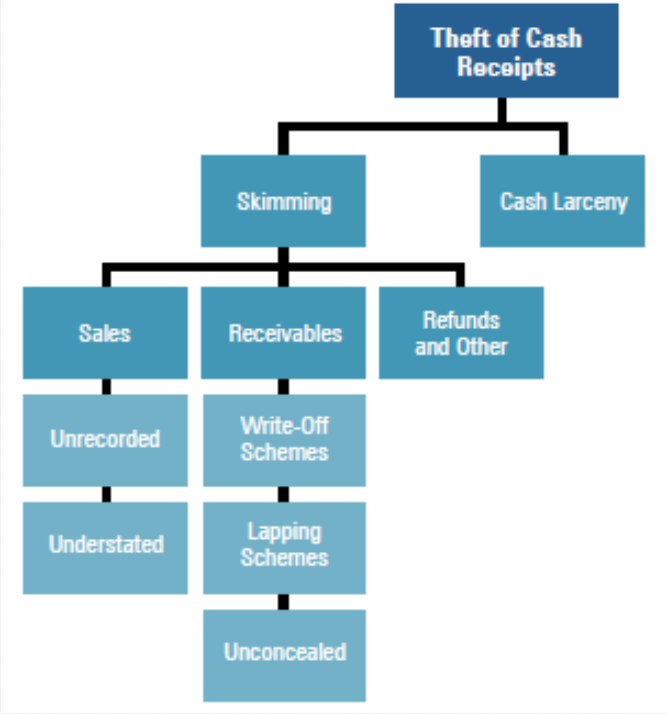
Uniform Occupational Fraud Classification System – Cash Receipts Fraud



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

Common Internal Fraud Schemes

- Skimming
  - Any scheme where cash is stolen **BEFORE** it is recorded in the books.

- Larceny
  - Any scheme where cash is stolen **AFTER** it has been recorded in the books.

Skimming Schemes

- More difficult to detect than larceny schemes because cash was stolen **BEFORE** it was recorded in the books. Therefore, **NO** documentation exists!
- Most basic type (and most common) involves taking cash from a sale and simply not recording it.
- More complicated schemes involve applying one customer's payment to another's account. This is referred to as lapping. Very complicated and takes time (and patience) to accomplish.

Skimming Schemes (con't.)

- Other skimming schemes include:
  - Falsely issuing a credit memo (or in the case of municipalities, an abatement or exemption).
  - Writing off customer balances in which collection actually took place (less likely, but still a risk in a municipality).
- Skimming example that's easily relatable to those outside the accounting world:
  - Waiter in a busy restaurant doesn't "ring up" your cash sale.
- Often perpetrated by a single person – collusion not as likely.

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Skimming Schemes (con't.)

Areas in a municipality that are most susceptible to skimming include:

- Treasury and Accounting
- Collector
- Schools
- "Entrepreneurial" Departments

Larceny

- Much less sophisticated than a skimming scheme and with basic internal controls like cash counts and reconciliations can be easy to detect.
  - As a result, cash larceny accounts for a relatively small amount of frauds.

- Examples include thefts from:
  - Cash boxes;
  - Register drawers; and
  - Bank deposits

- Generally start small (within acceptable "shrink" levels) and then grow.

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External Fraud Threats to Cash Receipts

- Likely due to outside computer threats.
  - Phishing – an outside attacker will lure your tax payer or service user to a fake website using authentic-looking emails and municipal logos/seals.
  - Web Bots – programs secretly installed on a municipality's computer system that allow a malicious user to control it remotely.
- Mitigate your risk of fraud from outside computer threats by having a security audit, hire/contract with an IT professional, and install/update IT security tools.

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Fraud Triangle

3 key reasons why fraud occurs.

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

Municipal 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

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 they should not do or that they normally would have walked away from
- Employee is known to be having personal financial stress (health, college, marital, etc.)

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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

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 for these vulnerabilities
- Identify gaps
- Incorporate controls
- Document controls
- Communicate controls

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Enhancements to Internal Controls May Include:

- Effective whistleblower system
- Fraud policy
  - Effectively communicated
  - Includes clear policy for punishment
- Enhanced training
- Background and credit checks
- Appropriate system authorizations
- Use of strong password(s) and periodic changes
- 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 your check sequence(s)
- External audit

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Questions

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