

# Internal Controls and Fraud Risks

Sarah Reichling and Elizabeth Maynard



CliftonLarsonAllen

[cliftonlarsonallen.com](http://cliftonlarsonallen.com)



# Objectives

At the end of this session you will be able to:

- Identify fraud risks within your Foundation
- Identify areas where you can strengthen internal controls to help prevent the fraud risks identified
- Understand that you can have good internal controls in a smaller business office environment

# The Purpose of Internal Controls

- To safeguard assets
- To produce accurate accounting data
- To contribute to efficient operations
- To promote compliance with board policy and donor restrictions
  - **BONUS:** *An employee working under a good system of internal controls is more easily protected from suspicion should any shortages or discrepancies occur.*

Internal controls help to limit the opportunity to commit fraud.

# Basic Concepts

- Internal controls are a process
- People affect internal controls
- Internal controls provide reasonable, *not absolute*, assurance

# Internal Control Process Elements

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

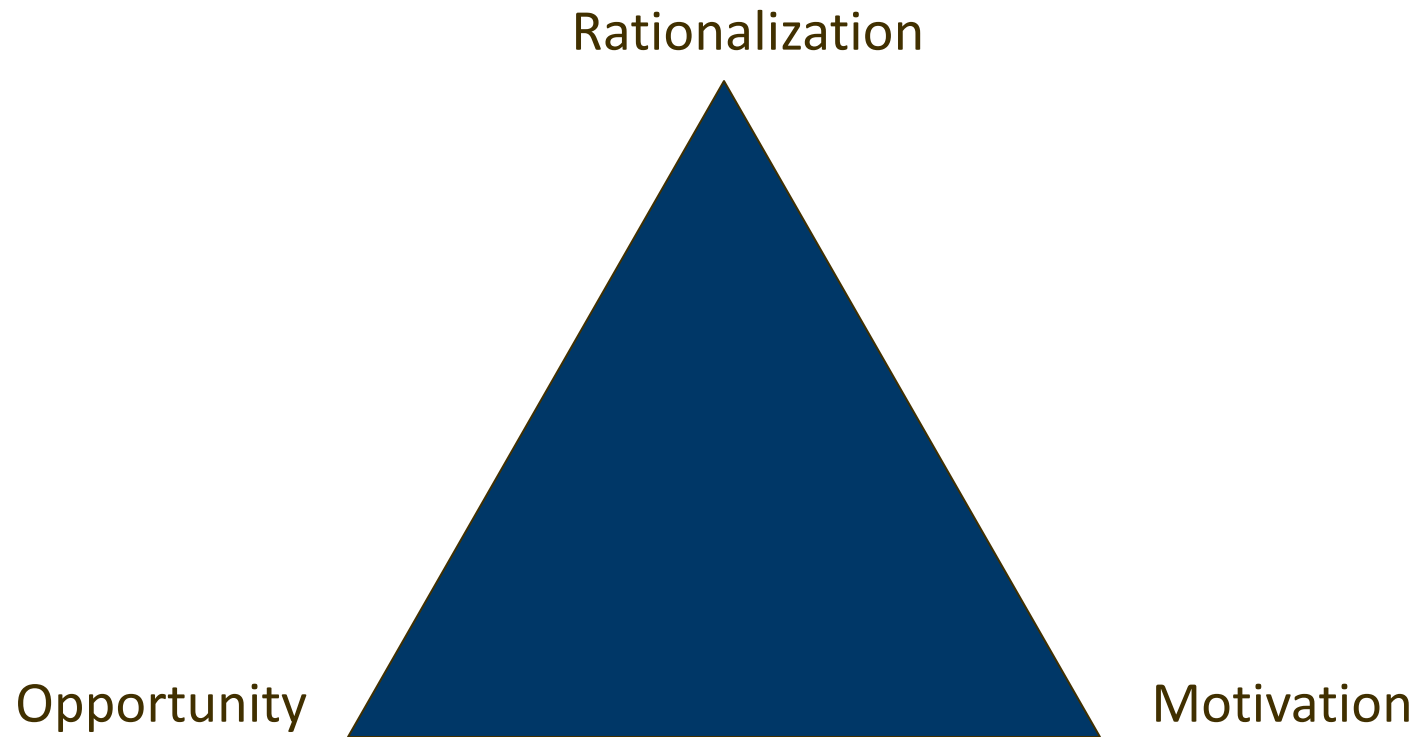
# Control Environment

- Clear lines of authority with importance placed on internal controls
- Publicized code of conduct
- Formal budget process and regular review of variances
- Goal to attract and retain competent staff
- Effective board committees and internal audit functions

# Risk Assessment

- Clear objectives about operating, financial reporting, and legal compliance functions
- Entity-wide review to assess and evaluate risk

# Fraud Triangle





# Control Activities

- Segregation of duties
- Independent counting or confirmation of assets
- Controlled access to electronic data
- Adequate backup and data recovery procedures

# Information and Communication

- Support for developing and maintaining effective financial management information systems
- Publicized channels for employees or interested parties to report suspected fraud
- Documented procedures for handling reports of suspected fraud
- Communicating to all employees as well as volunteers

# Monitoring

- Prompt follow-up on budget versus actual variances
- Comparison of actual assets against accounting records
- Are the controls in place still being used?

# Reality Check

Internal controls are only as effective as \_\_\_\_\_

Mistakes, collusion, and intentional disregard of the controls can all weaken the system.

Internal controls provide reasonable, \_\_\_\_\_, assurance.

# Basic Elements of Internal Control

- Who is responsible?
- Honest and competent \_\_\_\_\_.
- Segregation of duties and delegation
- Having \_\_\_\_\_ in place to process transactions
- Maintenance of accounting records and documentation
- Physical control over assets and records
- Independent \_\_\_\_\_ of performance

# Specific Controls

## Financial Reporting

- Budgets
- Timely comparative financial reports
- Detailed chart of accounts
- Policy and procedures manuals

# Specific Controls (continued)

## Bank Accounts

- Limited number of accounts
- Use of an entity name, not an individual
- Limited number of check signers
- Monthly reconciliations
- Regular review of cancelled checks and statements by independent party
- Online bill-pay; wire transactions

# Specific Controls (continued)

## Disbursements

- Pre-numbered checks
- Use of checks for all major payments
- No pre-signed checks
- Alteration and retaining of voided checks
- Signers should not have access to the accounting records
- Require adequate support (original invoices with proper authorization) before writing checks



# Specific Controls (continued)

## Cash Receipts

- List of all cash receipts should be made by someone without access to the accounting records
- Immediate endorsement of all receipts

# Specific Controls (continued)

## Fundraising

- Thank-you letters to donors
- Regular reconciliation of donor databases to contribution revenue
- Tamper-proof collection bags (events)
- Control access to safe
- Use of Desktop deposit

# Specific Controls (continued)

## Investments

- Use of independent custodians and investment managers
- Reconciliation of activity with managers' statements
  - Audit reports
  - Net asset value lookback schedule
  - SSAE 16 reports – receive and review

# Specific Controls (continued)

## PRI's and Grants

- Having a specific approval process in place for recipients
- Proper controls in place for the disbursement process
- Specific approval required for all write-offs and for allowance for doubtful accounts
- Monitoring and follow-up with recipients

# Specific Controls (continued)

## Internal Audits

- Procedures to review, vouch, or check the work of others in the Foundation
- Typical procedures:
  - Review of expense reports and credit card statements by the board/treasurer
  - Review bank statement for unusual activity
  - Review journal entries
  - Committee to select and vouch expenses or have all invoices on hand at committee meeting

# Rationalization

- Can we limit rationalization?
- **The Moral Code Discussion**
  - ◇ Dan Ariely: [The Moral Code Discussion - Video](#)
  - ◇ People do not always respond to economic incentives when considering committing fraud
  - ◇ **“Economic Rational Theory”**
    - Considers cheating (fraud) as a simple cost benefit analysis when deciding whether or not to commit a fraud
  - ◇ **“The Personal Fudge Factor Theory”**
    - There’s a level of cheating we cannot go over, but we can still benefit from committing fraud at a low degree as long as it does not change our impression about ourselves

# Rationalization (Continued)

- **The Personal Fudge Factor (Continue)**
  - A lot of people can cheat, but they cheat just by a little bit.
  - The probability of fraud occurrence goes down when people are reminded of their personal morality.
  - When we get bigger distance from the object of fraud, and we do not feel directly linked to the object fraud (I.e. Cash) occurrences of fraud increase.
  - The probability increases when we people around us doing the same.



# Internal Control Case Studies

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**See Handouts**

# Statistics

<b>Position</b>	<b>% of Incidents</b>	<b>% of Losses</b>
Executive	9	20
Electronic Data Processing Support Staff	19	22
Accounting	13	13
Treasurer	7	6
Collusion	39	32
Warehouse	13	7

(Statistics provided by the Federal Bureau of Investigation)

# Red Flags

- Indignant answers
- Unusual banking activities
- Decline in morale or attendance
- Unexplained budget variances
- Don't overlook the obvious
- Concentrate on fraud elements
- Know the people in your system
- Make fraud detection a regular part of your business
- Spend resources to detect fraud

# Common Internal Controls

- Custody separate from accounting
- Physical safeguards for investments on hand
- Segregation of duties in receipt of gifts
- Segregate custody from management
- Limit how and to where transfers can be made
- Authority over account – is it up to date?
- Record transactions in your ledger from custodial statement
- Reconcile, and reconcile often



# Questions?



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