Discovering the Secrets of Detecting Fraud in Accounts Receivable

Speaker

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Introduction

- Fraud happens.
- Don’t be surprised when you observe the accounts receivable staff under pressure.
- The fear of detection causes …..

STRESS

How to Be Successful

- Detect fraud by knowing how fraudsters conceal their schemes.
- Focus your audit testing on these known methods.

My Life Experiences in Fraud

- My two decades of life experience:
  - Managing statewide fraud program for Washington State Auditor's Office.
  - Wide variety of utilities, taxes, courts, etc.
    - Some revenue controlled in districts.
    - Some revenue controlled in departments of large organizations.

Four-Part Presentation

- Part One: Internal Control Weaknesses
- Part Two: Common Cash Receipt Fraud Schemes
- Part Three: Falsification of Accounting Records
- Part Four: A Complex Accounts Receivable Fraud Case Study.

Key supervisor who makes the daily bank deposit is the employee most likely to succeed in perpetrating a fraud (in all of the above).

Part One

Internal Control Weaknesses

Two Major Internal Control Weaknesses

- Key employees do too much.
  - Had access to and controlled all revenue.
- Managers do not monitor their work.

Employees operate in secret while in plain sight of everyone.

Why?.....

Trust but Verify Concept

- Managers use “blind trust.”
  - Tell employees what to do.
  - Expect them to do it.
  - Never monitor their actions to see if expectations are met.
- Managers should use “trust but verify.”
  - Monitor employee actions.
  - Chinese saying: “It’s OK to trust employees, just always keep one eye open!”

Two Types of Employees

- There are two types of employees:
  - Doers; and,
    - Most internal controls exist here.
  - Reviewers (supervisors).
    - Few or no controls where managers monitor the work of supervisors in the same way they review the work of their subordinates.
- Fraudsters ignore or compromise the system of internal controls, and just don't play by the rules!

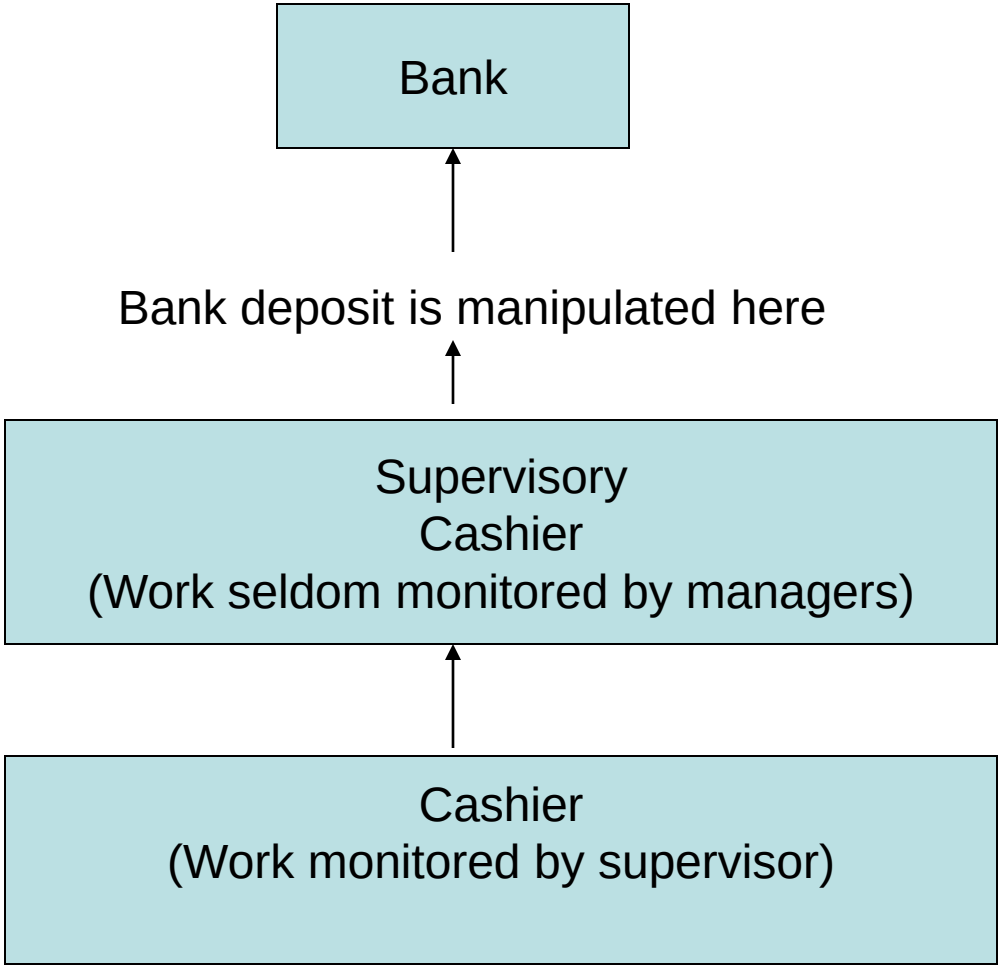
Crossing the Line from Honest to Dishonest Employee

- When managers don't monitor the work of supervisors who make the daily bank deposit, these key employees:
  - Often cross the line from being an honest employee to becoming a dishonest employee;
  - Manipulate the contents of the daily bank deposit; and,
  - Defraud their employer by misappropriating revenue.
  - Fraud is just that simple!

Internal Control Danger

- We expect doers to follow the rules.
- We expect supervisors to monitor the work of the doers.
- Then the supervisor makes the bank deposit.
- We think we’re done.
- But, don’t assume too much here…..

Bank Deposit Process



Largest Frauds and the Biggest Internal Control Failure

- Every large revenue fraud that has occurred in the past, is ongoing now without detection, and will ever occur in the future involves this internal control failure:
- No one monitors the work of key employees who make the daily bank deposit.
- Therefore, this is the number one cause of revenue fraud anywhere in accounts receivable.

Identifying “At Risk” Employees from Their Work Habits

- Come to work early or leave late;
- Work nights and weekends;
- Seldom missing for leave or vacation;
- Report to office during brief absences; and,
- Ask others to hold work while they’re gone.

Identifying “At Risk” Employees from Their Work Habits (Continued)

The key issue is **CONTROL** of the work environment.

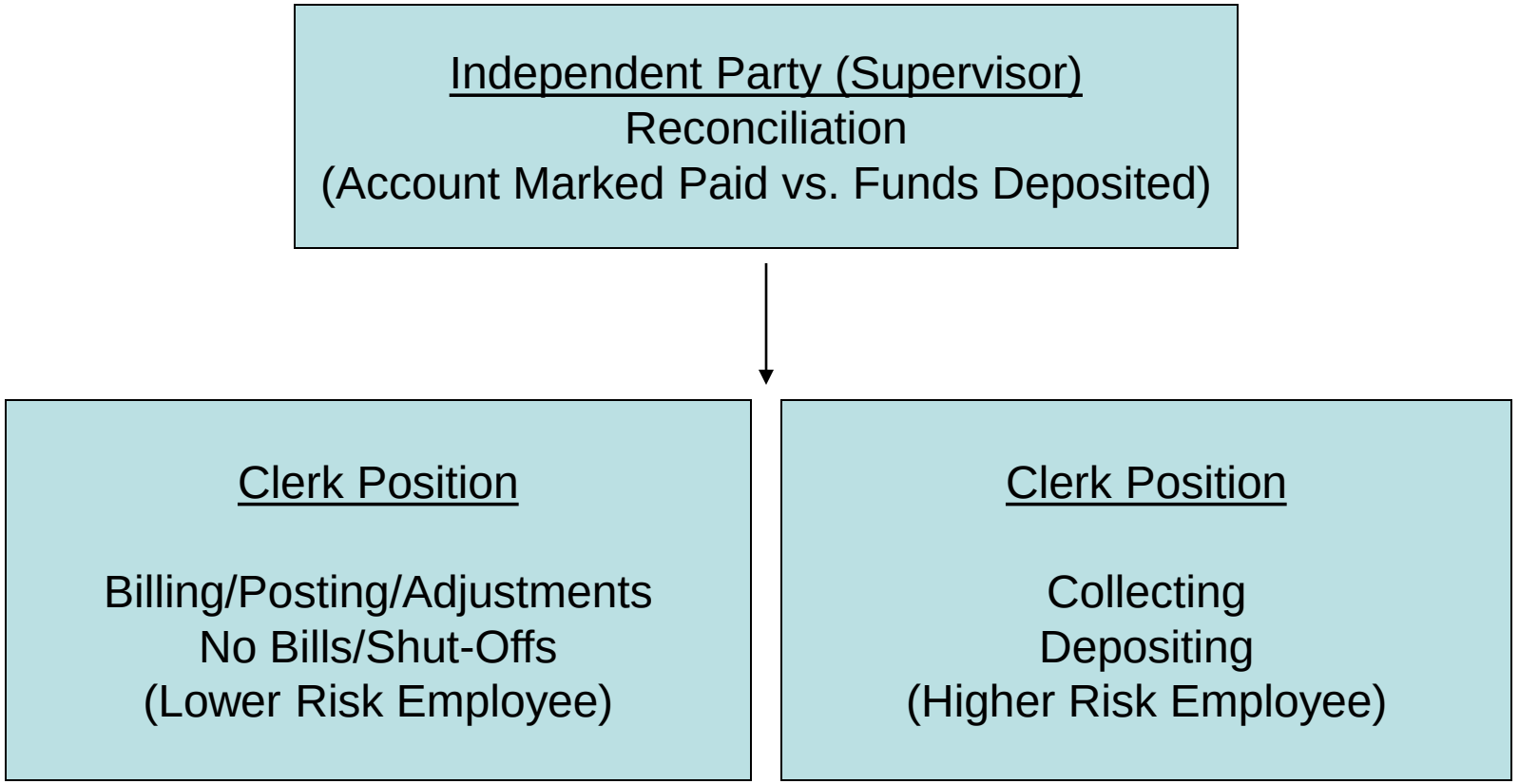
Use of Personal Computers for Accounting Purposes

- Small organizations use personal computers for accounting purposes.
- There are no internal controls in this environment.
  - Anything can be changed without leaving an audit trail.
- If fraud exists, there will either be missing or destroyed documents.

“Off-Book” Accounts Receivables

- Some organizations only collect funds from current account balances.
- Delinquent accounts are sent to a collection agency due to the lack of staff.
- Delinquent accounts receivables are not recorded in the accounting system or reported in financial statements.
- This revenue becomes a prime target for fraudsters due to lack of monitoring by managers.

Accounts Receivable Duties and Responsibilities Chart



Segregation of Employee Duties

- 3-person operation (ideal controls).
  - Billing and posting.
  - Collecting and depositing.
  - Independent supervisor reconciles the accounting information.
    - Agrees accounts marked “paid” with amount of bank deposit (records vs. money).
    - Fraud is quickly detected in this scenario unless the review is performed in a perfunctory manner.

Segregation of Employee Duties

- 1-person operation (no controls).
- One person does everything.
- Organization must independently monitor the work of this employee.
  - Mayor or manager.
  - Governing body.
  - Citizen volunteer.

Segregation of Employee Duties

- 2-person operation (some controls).
  - Billing and posting.
  - Collecting and depositing.
- When there is no independent supervisor, who should reconcile the money and records for agreement, and why?
  - Billing and posting usually have no $$ access.
    - Least risk – normally will report differences.
  - Collecting and depositing is primary concern.
    - Highest risk – will not self-report differences.

Segregation of Employee Duties

- **DANGER** – Remember ….
- Internal controls self-destruct at lunch and on breaks when record keepers become relief cashiers.

Secrets to Detecting Fraud in Accounts Receivable (1 of 2)

- Study the system of internal controls. Focus on employees who perform too many tasks. Determine if managers monitor their work.
- Search for missing transactions when personal computers are used for accounting purposes by comparing manual accounting records to computer accounting records for agreement.
  - Confirm transactions with customers.
  - Obtain copies of checks.
  - Look at check endorsements (probable cause).
  - Subpoena employee's personal bank records.

Secrets of Detecting Fraud in Accounts Receivable (2 of 2)

- Fraud examiners should:
  - Observe client employee changes in behavior and attitude.
  - Observe client employees who have access to and control all revenue and who also make the daily bank deposit.
  - Listen and observe others to identity “at risk” employees.
  - Develop CAATs to identify transactions outside normal business hours.
  - Inquire about who performs relief cashier duties.
  - Determine if employees are required to take vacations and cross-train employees by switching duties.
  - Verify that the organization has a “last look” policy to analyze the contents of the daily bank deposit after it’s been prepared and before it’s been made.
  - Search for “off-book” accounts receivables.

Part Two

Common Cash Receipt Fraud Schemes

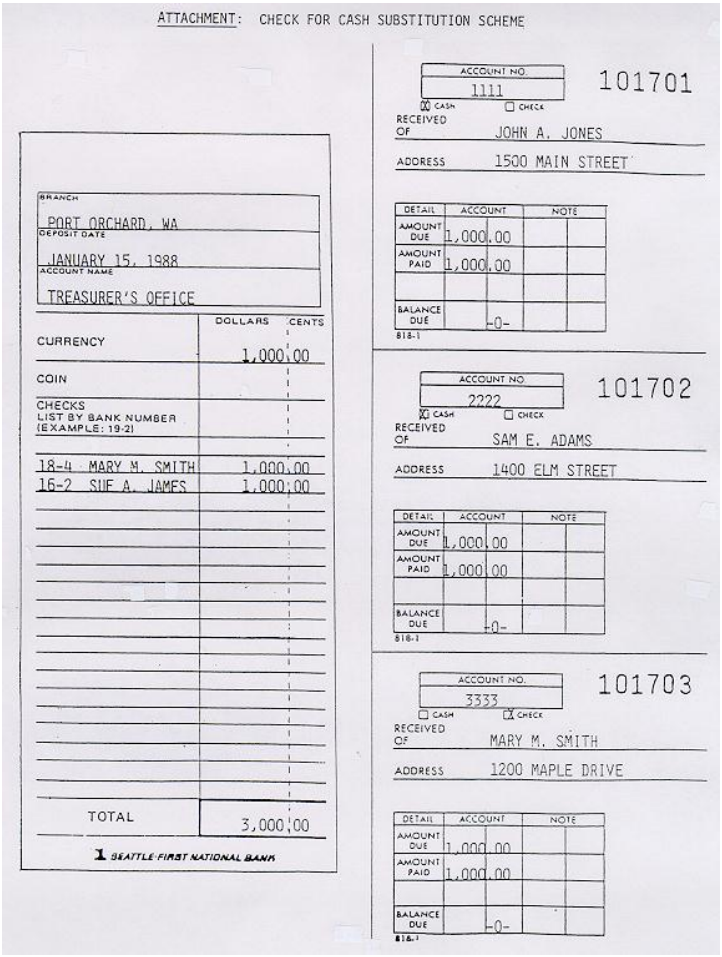
Check-for-Cash Substitution Scheme (#1 Fraud)

- Unrecorded revenue checks are stolen (no accountability).
  - Sources are by mail (no receipt expected) or from customer (“Do you need a receipt?”).
  - Checks substituted for cash in till drawer and bank deposit.
  - Mode of payment on cash receipting forms will not equal check-and-cash composition of the daily bank deposit.
  - Currency is simply stolen.
  - This is not cashing a check out of cash receipts.
- Crime of choice for a supervisory cashier who makes the daily bank deposit.
- Miscellaneous revenue streams are prime targets due to lack of monitoring by managers.

Check-for-Cash Substitution Scheme

- Daily balancing activity is a two-step process:
  - Agree total recorded cash receipts with total daily bank deposit total amount.
  - Agree mode of payment information from cash receipts documents with the check and cash composition of the daily bank deposit.
- Fraud attribute in the daily bank deposit:
  - More checks and less currency when compared to cash receipting system mode of payment for transactions

Check-for-Cash Substitution Scheme -Training Example



ATTACHMENT: CHECK FOR CASH SUBSTITUTION SCHEME

BRANCH: PORT ORCHARD, WA
DEPOSIT DATE: JANUARY 15, 1988
ACCOUNT NAME: TREASURER'S OFFICE

	DOLLARS	CENTS
CURRENCY	1,000	00
COIN		
CHECKS LIST BY BANK NUMBER (EXAMPLE: 19-2)		
18-4 MARY M. SMITH	1,000	00
16-2 SUE A. JAMES	1,000	00
TOTAL	3,000	00

1 SEATTLE-FIRST NATIONAL BANK

ACCOUNT NO. 1111 — 101701
☒ CASH ☐ CHECK
RECEIVED OF JOHN A. JONES
ADDRESS 1500 MAIN STREET

DETAIL	ACCOUNT	NOTE
AMOUNT DUE	1,000.00	
AMOUNT PAID	1,000.00	
BALANCE DUE	-0-	

818-1

ACCOUNT NO. 2222 — 101702
☒ CASH ☐ CHECK
RECEIVED OF SAM E. ADAMS
ADDRESS 1400 ELM STREET

DETAIL	ACCOUNT	NOTE
AMOUNT DUE	1,000.00	
AMOUNT PAID	1,000.00	
BALANCE DUE	-0-	

818-1

ACCOUNT NO. 3333 — 101703
☐ CASH ☒ CHECK
RECEIVED OF MARY M. SMITH
ADDRESS 1200 MAPLE DRIVE

DETAIL	ACCOUNT	NOTE
AMOUNT DUE	1,000.00	
AMOUNT PAID	1,000.00	
BALANCE DUE	-0-	

818-1

Lapping Scheme (#2 Fraud)

- Cashiers misappropriate money from one customer's payment and then apply another customer's payment to the account initially manipulated.
  - A version of "robbing Peter to pay Paul"
- Scheme becomes complex as the number of manipulated transactions and the amount of dollar losses increase over time.
  - Employee must keep accurate records of accounts being manipulated.

Employee Actions

- Initially keep records of borrowing (stubs).
- Intend to repay the funds.
- Scheme gets too big and control is lost.
- Stops keeping records.
- Stress increases.
- Makes mistakes and gets caught.
- Be thankful for family emergencies when the employee leaves and someone else does their job while they’re gone.

Lapping Scheme Process

- Employee:
  - Collects $100 from customer “A” and steals it.
  - Collects $100 from customer “B” and posts payment to account of customer “A.”
  - Collects $100 from customer “C” and posts payment to account of customer “B.”
  - Net cumulative effect of the loss involves only customer “C” at the end of the scheme (account not yet posted).

Lapping Scheme

- Employee might conceal losses in delinquent or “slow-pay” accounts.
- Organization should include the date of customer payment on billing statements (versus “payment – thank you”).
- Use the customer as a part of the internal control system.

Secrets to Detecting Fraud in Accounts Receivable (1 of 2)

- Fraud examiners should:
  - Test composition of the bank deposit near the end of the billing cycle.
  - Review the mathematical accuracy of utility stub batches.
  - Conduct unannounced cash counts.
  - Determine how managers monitor miscellaneous revenue streams.

Secrets to Detecting Fraud in Accounts Receivable (2 of 2)

- Ensure managers monitor the work of key supervisors before the bank deposit is made by:
  - Reviewing it in the office and accompany staff to the bank.
  - Having the bank return the deposit to the organization for review.
  - Having the bank copy all documents in the bank deposit for subsequent review.

Part Three

Falsification of Accounting Records

Falsification by Cashiers

- When cashiers initially record accounts receivable transactions they:
  - Misappropriate funds from some transactions and dupe record keepers into posting all accounts “paid.”
  - Record all cash receipt transactions on a cash register system and interface it with an accounts receivable system that marks all accounts “paid.”
    - Eliminate entire batches of documents from the cash register; and,
    - Reenter check payments on cash register system and misappropriate cash payments.
      - Batch numerical sequencing irregularities.
  - Misappropriate funds received from a record keeper before making the daily bank deposit.

Falsification by Record Keepers

- When record keepers initially record accounts receivable transactions they:
  - Record check payments in the accounting records and turn-in funds to cashier using a “sub-total” report. The cashier deposits these funds. Then, they record cash payments, misappropriate the funds, prepare a “total” report (all accounts are marked paid) and destroy it.

Key Attribute of Fraud

- The number and amount of customer accounts marked “paid” is greater than the number and amount of customer payments deposited in the bank.
- This imbalance rests in plain sight awaiting discovery.

Common Method of Concealing Fraud in Accounts Receivable

- Employees use two methods:
  - Write-off the customer's account balance for any manipulated payments.
    - A computer "exception" report listing all write-off transactions is critical.
  - Allow the customer's account balances to become delinquent (risky).
    - Employees manipulate prior account balance information both inside and outside the organization by "stealing the statements."

Independent Customer Service Function

- Organizations should establish an independent customer service function for accounts receivables to:
  - Investigate customer complaints about their accounts; and,
  - Research any other irregular transactions.

Additional Methods of Concealing Accounts Receivable Fraud

- Employees falsify accounting records:
  - The “no-bill” report. A list of accounts not currently receiving service.
  - The “shut-off” report. A list of delinquent accounts that will have services disconnected unless payment is made by a specific due date.

Currency in Bank Deposits

- Organizations should be able to estimate the amount of currency deposited in the bank over time as a percentage of total amount of bank deposits made.
- Managers should periodically review this information to ensure their expectations are met.
  - The risk of fraud is high when there is little or no currency in bank deposits.

Secrets to Detecting Fraud in Accounts Receivable (1 of 3)

- Fraud examiners should:
  - Compare total amount of bank deposits with total amount of accounts receivable payments posted to customer accounts over time.
  - Scan bank deposits to determine the amount of currency being deposited (and percentage).
  - Know the difference between “sub-total” and “total” accounting reports.
  - Compare batch sequence numbers from the cash register system to the accounts receivable accounting system to identify any missing or unprocessed batches.

Secrets to Detecting Fraud in Accounts Receivable (2 of 3)

- Fraud examiners should:
  - Review computer “exception” reports listing all write-off transactions for authorization, approval, and support.
  - Confirm delinquent account balances by sending account history statements to customers.
  - Review “no-bill” reports and customer files to determine if this status is justified.

Secrets to Detecting Fraud in Accounts Receivable (3 of 3)

- Fraud examiners should:
  - Review “shut-off” reports to ensure services were terminated as required.
  - Verify that all billing statements include a date of prior payment (not “payment -thank you”).
  - Verify that the organization has established an independent customer service function.

Part Four

A Complex Accounts Receivable Fraud Case Study

- The most complex accounts receivable fraud case I ever encountered in my 42.5-year audit career at federal, state, and local government levels.

Water District Fraud Case Study

Case Summary:

- Perpetrator: Accounts receivable clerk
- Loss Amount – $357,237 (undetermined period of time)
- Manipulated 4,000 accounts (23%) from universe of 17,500 total customers.

Water District Fraud Case Study (Continued)

Inadequate segregation of duties:

- The accounts receivable clerk:
  - Received all revenue, including checks that came through the mail.
  - Posted customer accounts “paid.”
  - Prepared the daily bank deposit.
  - Reconciled the monthly bank account.

Water District Fraud Case Study (Continued)

Inadequate segregation of duties:

- The accounts receivable clerk:
  - Established unauthorized “suspense” accounts to conceal manipulated cash receipt transactions.
  - Wrote-off customer account balances without approval.
  - Controlled customer feedback (telephone password protected)
    - Placed a notice on utility bills for customers to contact her about problems with their accounts with the help of other staff.

Water District Fraud Case Study (Continued)

- The accounts receivable clerk perpetrated the following fraud schemes:
  - Check-for-cash substitution scheme.
  - Lapping scheme.
  - Wrote-off account balances (pre-bill, post bill, and other false adjustments).

Water District Fraud Case Study (Continued)

- No one monitored her work or composition of the daily bank deposits.
- No one noticed there was very little currency in the daily bank deposits.
- There were no computer “exception” reports for account write-offs.
- Delinquent accounts receivables were not monitored and there were no accounts receivable aging reports.
- In lieu of utility stubs, there was a wide variety of irregular documents present in the supporting documents for cash receipt batches.

Water District Fraud Case Study (Continued)

- Detection of the Fraud:
  - Annual audit. Miscellaneous revenue transaction discrepancy.
  - Issued audit report and started a special investigation.
  - Worked undercover with bank deposit and cash receipting records.
  - Computer conversion and joint operation with a sewer district with same customer base.

Water District Fraud Case Study (Continued)

- Detection of the fraud (continued):
  - Set-up fictitious computer training class.
  - Observed office working conditions.
  - Unannounced cash count. One deposit was "kind of messed up" (code for fraud).
  - Interview with suspect and confession (thanks for making it stop).

Water District Fraud Case Study (Continued)

- Sentencing:
  - Plea bargaining agreement with County Prosecutor's Office.
    - Pleaded guilty to misappropriating $357,237.
    - Sentenced to a term of 33 months in a state correctional facility.

Discovering the Secrets of Detecting Fraud in Accounts Receivable

Questions and Answers

Discovering the Secrets of Detecting Fraud in Accounts Receivable

Thank you for your participation and attendance today.