CFE UPDATE

September-October 2001

Chapter Board of Officers

President: Linda L. Saunders, CFE, CPA, CGFM
Owner, Forensic Accounting Consulting (206) 842-4809
forensicCPA@compuserve.com
Bainbridge Island, Washington

Vice-President: Norman J. Gierlasinski, PhD, CFE, CPA, CIA
Professor, Central Washington University (206) 439-3800, Extension 3825
normang@cwu.edu
SeaTac, Washington

Secretary-Treasurer: Joseph R. Dervaes, CFE, CIA (360) 710-1545
Association of Certified Fraud Examiners Fellow
Chairman of the Board of Regents, Association of Certified Fraud Examiners
Director of Special Investigations, Washington State Auditor's Office
dervaesj@sao.wa.gov
Port Orchard, Washington

Director-At-Large: Rober B. Gulliver, CFE,CPA, CISA, CBA
Owner, Robert B. Gulliver, CPA (253) 735-2392
RBG@halcyon.com
Auburn, Washington

Director-At-Large: Bernadette McBride, CFE, CPA
Owner, Bernadette McBride, CPA
Poulsbo, Washington

Scholarships. Chapter President Norm Gierlasinski made the Scholarship Committee report on the results of this years competition for the annual $500 scholarship award. The Chapter sponsored a Primary and Alternate candidate to the Association's Scholarship Program. The candidates and their status are as follows:

Chapter Primary Candidate: Deborah E. Mitchell, Central Washington University (SeaTac Center), Accounting Major, Graduates Winter 2002. Association Scholarship Winner.

Chapter Alternate Candidate: Monika Blas, Seattle Pacific University, Accounting Major, Graduates June 2003. Chapter Scholarship Winner.

Additional Candidate: Angela N. Taggart, University of Washington, Accounting Major, Graduates June 2002. Association Scholarship Winner.

<u>Fraud Tips</u>

By: Joseph R. Dervaes, CFE, CIA
Association of Certified Fraud Examiners Fellow
Chairman, Board of Regents, Association of Certified Fraud Examiners
Audit Manager for Special Investigations
Washington State Auditor's Office

<u>Segregation of Duties</u>

D.H. was the custodian of two checking accounts at a large school district. She was able to conceal the theft of $188,300 from a wide variety of miscellaneous revenue streams over a five-year period because she controlled all aspects of the checking accounts. Then she issued checks to herself and paid for her own personal bills directly from the accounts. The bank reconciliation wasn't reviewed by an independent party.

Why did D.H. embezzle $188,300 over a five-year period? There's not an easy answer; fraud isn't caused by just one factor. Witness the time-honored Fraud Triangle originated by renowned fraud researcher, Dr. Donald R. Cressey: one leg of the triange represents a perceived nonsharable financial need, the second leg is perceived opportunity, and the third is rationalization (Wells, Joseph T. *Occupational Fraud and Abuse.* Austin, Texas: Obsidian Publishing Company Inc., 1997.)

Even though Cressey's theory is 50 years old and may not be applicable in all situations, I've observed in my position that the second leg of the triangle, perceived opportunity, is often caused by a lack of internal controls. And the No.1 internal control weakness cited in the fraud reports from my office is inadequate segregation of duties. All activities and functions within every organization are at risk from this defect.

As the audit manager for special investigations for the Washington State Auditor's Office, I'm responsible for managing the agency's Fraud Program, one of the agency's highest priority functions. The Constitution of the state of Washington established the State Auditor's Office as the auditor of all public accounts. This means we audit all state agencies (approximately 170) and all local governments (approximately 35 different types and 2400 units of government). Because we are one of only a few states that have this broad audit authority, we detect and report more fraud in government than any other state. Another reason for the top statistics is because we concentrate on the area of greatest risk for fraud in our industry: the misappropriation of public resources by employees. For example, in the last 14 years, we reported 408 cases of fraud totaling $8,355,440 in losses.

My personal specialty is employee embezzlement fraud in the workplace because this is what most employees do once they decide to steal money from their employer in government. However, the same frauds that happen to us also occur in the private sector. So there's room for us all to learn from these experiences.

While monitoring fraud cases throughout the state, we've gathered important information about fraud. We've decided that learning from the past is one of the best ways to affect our future. So watching what the fraud perpetrators actually do and listening to what they say pays big dividends. For example, we use the information we obtain from the cases to develop internal fraud training courses for auditors and to present external fraud training seminars to the units of government we audit. I'd like to share some of these tips with you. I believe it's important for us to start where the problem often enters the organization – segregation of duties.

Internal Control Weakness. While we often concentrate on internal controls in major systems and functions, fraud perpetrators do the opposite by concentrating on the obscure processes in which no one expects fraud to occur. These devious employees know exactly what managers do and don't do, and they know exactly what auditors do and don't do. Once they realize where the weaknesses are in the review and audit process, they capitalize on them to commit their crimes. They simply commit the fraud that's allowed by their particular access and what they can control. It's these special domains of control that allow them to not only process irregular transactions but to conceal them from view, normally for months even and years.

The problem is that one employee has total control over a transaction from beginning to end.

The solution is to hire two or more employees to appropriately segregate the duties so no one employee has total control. That may sound obvious but not many of the organizations we audit have the funds or desire to hire extra employees. Since most organizations are doing more with less, we expect to see fewer employees these days. In fact, as organizations down-size or right-size due to economic pressures, the internal control structure, or key portions therof, often self-destructs in the process. Under these conditions, the need for internal controls actually increases, rather than decreases, as the number of employees decline over time. And this is the prime time for something to go wrong with segregation of duties for key employees.

So how do we encourage managers to deal with this dilemma even when they might not want to do so? First of all, we must communicate that failing to implement this internal control ***will ultimately*** lead to one thing: fraud. It's only a matter of time; the issue is simply "when," not "if." I've found that managers will act to correct this weakness when they finally realize their employees are tempted beyond their ability to handle the situation, and their employees' careers, (and possibly their own) are at tremendous risk if fraud occurs.

Also, when it's not possible to hire more employees, **the next best solution** is for managers to find ways to segregate employee duties without spending more money. The most common method to do this is to require that employees with similar tasks regularly switch specific duties to achieve the proper level of internal control.

Take the situation in which two employees manage checking accounts within an organization. In far too many cases, we find that only one person handles all aspects of each checking account. That person prepares, signs and issues the checks, and then receives the monthly statement directly from the bank and reconciles the checking account. Even though I think the monthly bank reconciliation is a very important task, supervisors often allocate only a minimal amount of time and effort for their review of the process, which is a major mistake. In this case, all managers must do is ensure each custodian independently reconciles the bank account maintained by the other employee. While this significantly improves internal controls, it adds no cost to the organization because no new employees are involved.

Finally, when there are no other options available, **the ultimate solution** is for managers to establish a monitoring program for this key employee which effectively accomplishes the segregation of duties without hiring another person to perform the task. Someone in a supervisory position must review the work of the employee to ensure the task is performed correctly, accurately, and without any loss of resources. Re-performing critical tasks is an important fraud deterrent and detection step. This monitoring only needs to be performed periodically in order to achieve the desired results. However, if the review isn't random – if the supervisor reviews the employee's work every Friday like clockwork – then fraud will always occur on Monday through Thursday.

If I had to emphasize only one word in all fraud training, it would be ***monitoring*** – the key to reducing fraud losses. I find that while managers almost always establish internal controls over critical processes, they often don't monitor these activities to ensure systems operate as designed. Fraud perpetrators either ignore or compromise the internal control structure in order to achieve their goal. Since they simply don't play by the rules, monitoring has to be part of the daily internal control routine in a healthy organization.

<u>Detection: the Primary Mission</u>. Because an inadequate segregation of duties is at the heart of every fraud that exists today, we must operate with the full knowledge that detecting this menace must be the primary mission or objective of managers and fraud examiners. To discover the duties and responsibilities of key employees, we must ask what they do, sign, approve, certify, authorize, supervise, review, reconcile, etc. The answers these questions should help us determine when an employee has too many or overlapping responsibilities that hinder segregation of duties.

Here's an alarming fact: ***Every*** active fraud currently exists because there is an inadequate segregation of duties somewhere within the organization. Think about this as you go to work tomorrow. Is it happening in your organization right now?