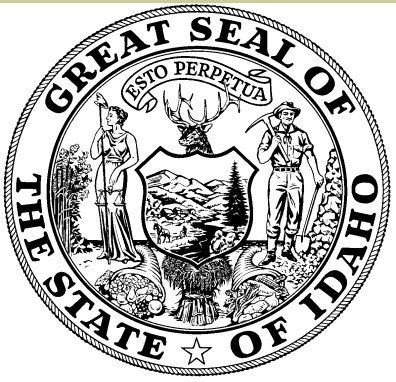
First Friday Fraud Facts+

November 1, 2013

The Idaho State Controller's Office distributes this newsletter as a cost-effective method of increasing awareness about ways to detect and prevent fraud, waste, and abuse in government.



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Welcome to First Friday Fraud Facts+ (F4+). This edition will cover the issue of management override of internal controls.

Internal Controls

Effective internal controls are vital for maintaining an efficient and ethical work environment. An organization's internal control structure should include all of the following internal control components:

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring activities.[1]

Management is responsible for establishing and maintaining effective internal controls in an organization. Consequently, there is a risk that management may override those controls, causing serious problems not only for the organization but also for the individuals and entities who depend on accurate financial statements issued by the reporting organization.

Detecting Internal Control Override

Some things to look for when checking for management override of internal controls:

- Backdated financial documents
- Modified entries made during the financial close process
- Misstated or unreported significant events
- Management collusion with other managers, employees, or related parties in order to recognize fictitious revenue[2]

Preventing Internal Control Override

The following questions can help in assessing the risk that management will override the internal controls:

- Is management dominated by a single person or group?
- Does the entity experience high turnover of senior management, internal auditors, or information technology staff?
- Are the organization's finances transparent?
- Does the organization have a code of conduct? If so, is it communicated and followed?
- Are members of management experiencing pressures to achieve financial targets?
- Are laws and regulations pertaining to the organization being followed?
- Does the human resource department in the organization have a whistleblower hotline in order to receive anonymous information about management integrity?
- Are accounting/finance duties segregated?
- Is the organization's accounting system up to date?[2]

FRAUD CASE

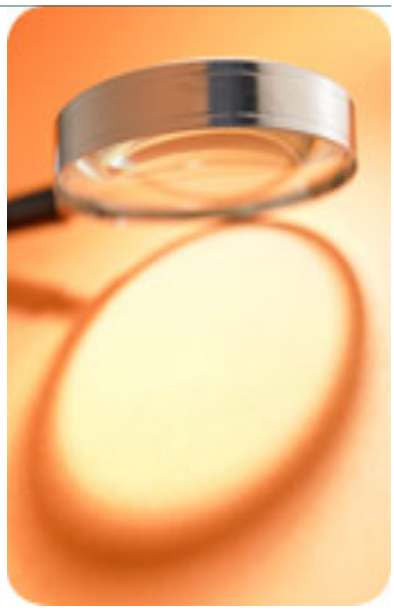
An assistant operations manager of a sports facility used his position to bypass the internal control system causing at least $491,000 in losses during a ten year period for a particular city.

One of the manager's job duties included processing bid requests for the facility's maintenance and operations equipment. During the years that he worked for the city, the manager became well acquainted with the vendors and familiar with the city's accounts payable system.

The manager noticed that a particular vendor was denied winning contracts, and that the vendor would never win contracts due to the vendor's high business operating costs. After the manager and the vendor discussed the situation, they decided to enter into a scheme, to allow the vendor to sell his products to the sports facility without a written contract. The manager, however, used the scheme to his own advantage.

In the scheme, the manager would order and pick up the merchandise from the vendor. The vendor would structure each sales transaction by submitting small invoices over several months to the manager for payment. The manager would then sign each invoice received, and send the invoice to the city's accounts payable department, since the city was responsible for the sports facility. Because the invoices were small, the accounts payable department never detected any issues and no one accounted for the receipt of the purchased goods.

After each order, the manager took delivery of the goods, sold the goods to third parties, and pocketed the money from the sales. When anyone at the city questioned the repetitive purchases, the manager would tell them that it was because traveling shows, which often visited the sports facility, frequently stole items from the facility, and that the stolen items needed to be replaced.



Eventually, the manager escalated his illegal activity by using the city's business charge account to buy products and then sold the products at local pawn shops. The city's police department discovered the fraudulent activity while routinely reviewing reports at local pawn shops.

The manager was eventually convicted of fraud and was ordered to pay restitution and sentenced to five years in prison.[3]

Fiscal Focus – Risk of Internal Control Override

Effective internal controls are not a guarantee that fraudulent activity will not occur within an organization. Those in management who are responsible for implementing and maintaining internal controls can sometimes override those controls.

A strict control environment is one way to minimize the risk of management override of internal controls. The control environment encompasses an organization's ethical standards and code of conduct, which is established by senior management. The "Control Environment and Organizational Structure Checklist" is a helpful tool in assessing an organization's control environment. The checklist can be found by going to the following website: http://www.sco.idaho.gov/. After going to the website, select "Control Environment (NASACT)" below "Financial Management Controls Checklists".

[1] *Internal Control – Integrated Framework (Executive Summary)*. Committee of Sponsoring Organizations of the Treadway Commission (COSO) (May 2013). Retrieved from http://www.coso.org/documents/990025P_Executive_Summary_final_may20_e.pdf on June 24, 2013.

[2] *Management override of internal controls: The achilles' heel of fraud prevention (2005).* American Institute of Certified Public Accountants, Inc. Retrieved from www.aicpa.org/ForThePublic/ on June 13, 2013.

[3] Dervaes, J.R. (2012). St. Valentine's day massacre (revisited) - A false billing scheme case study, part I and II. *Fraud magazine, Vol. 27, No. 4 & No. 5*, 8-10 & 62-64 (respectively).