The Role of Internal Controls in the Fight Against Fraud

John Tonsick, CFE, CPA
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“The Conjurer”—Hieronymus Bosch—Late 15th Century
The views and opinions expressed in this presentation are my own. They do not necessarily reflect the opinions of Broadcom Corporation.
The Fraud Triangle

Immediate Need

Rationalization

Opportunity
Red Flags

- New car every two years
- Expensive home
- Season box at baseball games
- Vacations—Alaska, the Bahamas, Antarctica
- Expensive Nikon camera
- Boat
- Weekend trips to Vegas
- Second home in Vegas
Nonprofit Fraud

- $500,000 in two years
  - $250K: traveler’s checks
  - $150K: credit card
  - $100K: skimming
- Prison and restitution
- Millions over the preceding decade
The History of Internal Controls

• 1920s and 1930s
• American Institute of Accountants
  – 1936: “Internal check and controls” to safeguard cash and assets
  – 1949: defined “internal control”
The History of Internal Controls

- Securities Act 1933—audited financial information
- Securities Exchange Act 1934
- No requirements to report on internal controls
History of Internal Controls
Foreign Corrupt Practices Act—1977

- 1973
  - Watergate Special Prosecutor
  - SEC
  - Senator Frank Church
- 400 American companies
  - Illegal domestic political contributions
  - Bribing everyone
  - Falsified records
  - Secret “slush funds”
History of Internal Controls
Foreign Corrupt Practices Act—1977

- Gulf Oil
  - President of the Republic of Korea
- Northrop
  - Saudi Arabian General
- IT&T
  - Funded Pinochet in Chilean Coup
- Lockheed
  - Japanese Prime Minister Tanaka
  - I.G. of Dutch Armed Forces (married to the Queen)
  - $250M loan guarantee to avoid bankruptcy
History of Internal Controls
Foreign Corrupt Practices Act—1977

• Required corporations:
  – Keep accurate books, records
  – SEC registrants to maintain responsible internal accounting control system
A New Century, New Scandals

ENRON

WORLDCOM

HEALTHSOUTH

Global Crossing
Sarbanes-Oxley Act 2002

- A new regulatory structure for accounting firms
- Tighter corporate controls
- New disclosure requirements
- New record retention requirements
- Tougher penalties
The Great Recession

- Gross outlays
  - $4.6 trillion
- Net outlays after repayments:
  - $3.3 trillion
- Government bailout guarantees
  - $16.9 trillion

Source: www.usfederalbailout.com
New Century Financial Corp.

- Founded 1995
- December 31, 2006
  - Market cap $1.75 billion
  - $51.97/share—high point
  - $50 billion sub-prime loans
  - Second largest issuer in the country
- Projected
  - $400M to shareholders
  - Continued growth and profitability
New Century Financial Corp.

- February 2007 – Company restated 2006 quarterly financials
- March 2007 – NYSE suspended trading
  (Market cap – $55 Million)
- April 2007 – Filed Chapter 11
- April 2007 - KPMG resigned
- March 2008 – Court Examiner finds risky loan practices and improper accounting practices
- December 2009 – CEO, CFO and Controller charged with securities fraud.
Committee of Sponsoring Organizations ("COSO")

• Independent private sector initiative. 1985
  – American Accounting Association, AICPA, FEI, IIA, IMA
  – Studied factors that lead to fraudulent financial reporting
  – Developed recommendations for public companies and their independent auditors
Internal Control

• A process designed to provide reasonable assurance regarding:
  – Effectiveness and efficiency of operations
  – Reliability of financial reporting
  – Compliance with applicable laws and regulations
1987 COSO Model
1992 COSO Integrated Framework

- Operations
- Financial Reporting
- Compliance

- Monitoring
- Information & Communication
- Control Activities
- Risk Assessment
- Control Environment
2004 COSO Enterprise Risk Management Model

Internal Environment
- Objective Setting
- Event Identification
- Risk Assessment
- Risk Response
- Control Activities
- Information & Communication
- Monitoring
2013 COSO Enterprise Risk Model
1987 COSO Model
What’s Wrong with COSO?
Preventive Controls

– What you do to ensure that the right things happen/wrong things don’t happen
Preventive Controls

- Completeness
- Accuracy
- Authorization
- Segregation of duties
- Security
  - Physical
  - IT
Detective Controls

- What you do to find the things that preventive controls didn’t prevent
Detective Controls

- Audits
- Physical verification
- Reconciliations
- Management reviews
Weak Internal Controls: An Open Door to Fraud
Using Internal Controls to Supercharge Investigations
Stop Me When You Think We Have a Problem

- Director of accounting
  - Received cash
  - Made bank deposits
  - Received and approved vendor invoices
  - Wrote checks/wire transfers
  - Posted G/L
  - Reconciled bank accounts
  - Custodian of records
Traveler’s Checks

• Control objectives:
  – Authorization
  – Segregation of duties

• Procedures:
  – Accounting director ordered traveler’s checks and wire transfers via telephone or fax
  – Without involvement of anyone else
Credit Card

• Control objectives:
  – Authorization
  – Segregation of duties

• Procedures:
  – Accounting director master card holder
  – CEO approved photocopies of invoices.
Cash Receipts

• Control objectives:
  – Completeness
  – Accuracy
  – Segregation of duties

• Procedures:
  – Two people open the mail and list deposits.
  – One list to the CFO; one list plus cash and checks to accounting director
  – CFO compares list to deposit slip and bank statement.
The Cover-Up

- Bank reconciliations
- General ledger
- Manipulated the auditors
Outcome

• Auditors fired!
Outcome

- Six months in prison
- Six months home confinement
- Three years probation
- Restitution
Rationalization

- The charity’s weak internal controls proved too much of a temptation.
Questions
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