When Cash Is "Hot-Wired" For Fraud

By: Ron Marden and **Dwayne McSwain**

Abstract

Dave Martin. a CIA and CPA with three years of auditing experience with a small public accounting firm, had just started his new job with Conklin-Sterns Manufacturing (CSM) as an internal auditor. This position was new for both Dave and Conklin. CSM had recently created the internal auditing position upon the recommendation of its external auditors, a large regional CPA firm that has been doing CSM's audit for the past six years. The new internal audit position was created with the internal auditor reporting directly to the board of directors and reporting administratively to the vice president for operations. Dave had plans to first create a charter for the internal auditing "department." Although there was only one internal auditor at this time, he had visions of growing the department over time as the value of his services were proven to the board. However, when Dave arrived for his first full day, he was greeted by Bert Holmes, the vice president for operations. It seemed Bert had already identified several areas of concern, with one issue being most pressing. He was not comfortable with the current state of control over some of the processes and, in particular, had an uneasy feeling about the "true" cash count.

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WHEN CASH IS "HOT-WIRED" FOR FRAUD

Based on a true story, this article highlights the importance of wire transfer controls and the value of internal auditing.

RON MARDEN AND DWAYNE MCSWAIN

Dave Martin, a CIA and CPA with three years of auditing experience with a small public accounting firm, had just started his new job with Conklin-Sterns Manufacturing (CSM) as an internal auditor. This position was new for both Dave and Conklin. CSM had recently created the internal auditing position upon the recommendation of its external auditors, a large regional CPA firm that has been doing CSM's audit for the past six years. The new internal audit position was created with the internal auditor reporting directly to the board of directors and reporting administratively to the vice president for operations.

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Dave followed Bert to his office and then listened as Bert talked about the internal auditor's job responsibilities. Bert said that Dave would have three main areas of responsibility: performing operational audits of the manufacturing process, auditing the various accounting functions of the company, and acting as a liaison with the external auditors. Bert asked Dave to grab a cup of coffee with him before giving Dave a tour of the facilities and introducing him to CSM's employees. One of the first employees Dave was to meet was Marge Smith, a pleasant, elderly woman who

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was a CPA and CSM's head accountant. Marge supervised three bookkeepers who had very little accounting experience. Bert introduced the two and proudly stated that Marge not only took care of all the accounting but had worked for CSM for nearly 14 years and was considered one of the hardest workers in the firm. In fact, she was frequently kidded by co-workers as a "workaholic" because she hadn't missed a day of work or even taken a vacation leave in more than five years. Marge kindly welcomed Dave to the company and said she looked forward to seeing him around. Afterward, Bert walked Dave through the different departments of the company, introducing him to other employees and providing an overview of the operations in each area.

Finally settling into his office, Dave decided to write down his understanding of the CSM's overall operations. While writing his narrative, he drafted a flowchart of the operations. Dave then remembered that the external auditors would have already documented the company's internal controls, so he called the partner-in-charge, explained his situation, and asked for copies of the workpapers. The partner said that Dave was welcome to come and review the workpapers at the firm's office, and that he could make copies of what he wanted as long as the originals stayed in the office. Dave agreed and made this his top priority for day two.

As Dave studied the external auditors' workpapers, one finding jumped out at him and seemed to be unresolved or unaddressed. Dave was aware that CSM bought its raw materials from a number of firms overseas and ultimately sold the end product both nationally and internationally. To expedite these transactions, many of the purchases and sales were conducted using wire transfers. This made Dave's professional skepticism go on high alert since the external auditors had found the controls over wire transfers to be somewhat lacking. It seemed there was no segregation of duties. This was Marge's area, and she was responsible for all incoming and outgoing wires, overseeing the bookkeeping with the daily journal entries, and reconciling the wire transfer clearing accounts. Given that Bert was particularly concerned over the cash account, Dave believed this was an area needing further investigation.

Dave remembered how Marge had not missed a workday or taken a vacation in more than five years. Initially, this might seem like a good trait, but now Dave was not so sure. Dave recalled an Institute of Internal Auditors conference on internal controls that had promoted employee cross-training and mandatory vacations as one of the ways to help prevent fraud. He remembered hearing that employees sometimes do not take vacations because they do not want anyone to sit in on their jobs and discover their schemes.

Dave wanted to discuss his concerns with Bert, but was not sure how Bert might react. After all, Dave had just started work and Marge was a long-time, faithful employee. So, he continued working on his own narrative and flowcharts by starting with what the external auditors had. He felt this would be a good way to gain a more in-depth understanding of CSM's system of controls, while providing an impetus for taking corrective action.

Dave carried internal control questionnaires as well as copies of the external auditor's documentation to each department and told the employees what he was trying to accomplish. He asked for their help in updating the narrative and flowcharts, and he also asked for copies of all forms used. Upon receiving the requested feedback from each department, Dave created his own documentation of internal controls. Then, he took his new documents to each department and interviewed the employees to clear up any misunderstandings he may have had. Employees were more than willing to help and seemed somewhat excited that someone was taking an interest in what they were doing.

During this time, Dave decided to dig deeper in to his suspicions about Marge and analyze the wire transfers for the past several years. Since CSM had contracts with numerous firms it did business with, Dave requested and received an electronic file from CSM's bank that detailed all of the company's wire transfer activity for the past three years. Dave also requested two transaction files from Bert. One of Bert's files contained the daily cash transactions, and the other contained the transactions for the wire control accounts. Using a popular data extraction software program to compare transaction dates, Dave discovered at least a day's lag, and sometimes more, between CSM's booking of incoming wires to the clearing accounts and the third parties' records. Was Marge "lapping" wire transfers? This was a possibility because CSM had a policy of not putting a temporary hold on wired funds in order to provide customers with immediate shipping on sales and might explain why they had not complained.

Dave knew he had to report his findings to Bert and eventually to the board of directors; however, he wanted to investigate further to substantiate his initial findings. Armed with his new internal control documentation, Dave went back to visit Marge. Reviewing the document flowchart, Marge explained to Dave that all wire requests received after 2 p.m. went into the next day's business and would naturally have a later transaction date when posted. Dave agreed with Marge about the cutoff for outgoing wire transfers, but then he pressed her about incoming wires being post-dated. Marge said the reason for post-dating these transactions was because the third-party processing bank did not always credit CSM on the transaction date. Dave knew this was not true but did not confront Marge or indicate that he knew the truth.

Dave wrote a formal report that was to be given to the board of directors describing his findings. But first, Dave made an appointment with Bert for an exit review to discuss his findings and to give Bert an opportunity to address the issue and share his insight about the report. Initially, Bert seemed shocked, but he went on to say that somehow he was not surprised. He already had a gut feeling that something was amiss, but until now he did not have any proof. Bert was pleased with one of Dave's recommendations, which suggested that CSM add one week of mandatory vacation for all employees. Bert added that Marge could be the first to take vacation and justify it since she hadn't taken a day off in many years. Bert and Dave discussed the matter at length and wondered what else they should do about Marge. After all, Marge's reputation as a sweet, grandmotherly type would go a long way with most of the board members.

Based on his meeting with Bert, Dave reserved a spot on the agenda for the next board meeting to discuss his findings. Dave made sure his report was included in the agenda packet that committee members normally received the week prior to their meeting.

Upon receipt of the committee agenda and Dave's report, the board chair didn't wait and called an emergency meeting for early the next morning. The chair asked Bert to be present when Dave made his report. Presenting his report, Dave specifically recommended several universal rules for achieving internal control over wire transfers:

1. Do not permit any one employee to handle a transaction from beginning to end, emphasizing the separation of duties.
2. Keep information safe. Shred documentation with account information on it and do not automate passwords and other critical information.
3. Record transactions promptly.
4. Encourage customers to obtain receipts.
5. Have account reconciliations prepared by employees not responsible for wire transactions and check balances carefully.
6. All wire transfers must be supported by proper documentation.
7. If over a designated amount, allow transfers only with two authorized signatures, not one.
8. If you send wire transfers regularly, have the bank transfer agents set up text-message alerts to the CFO or other responsible officer for transfers sent over a certain amount.
9. All employees should be required to take at least one week of vacation annually.

Dave went on to suggest that a log of all wire transfers be kept daily, with a copy of the list being maintained by an assigned head wire transfer clerk and the original, with the appropriate journal entries, being sent to a separate bookkeeper. This bookkeeper would check the journal entries for completeness and accuracy by verifying the account codes and recalculating the ins-and-outs listed on the log. The entries, with supporting backup, would be forwarded to the vice president for operations for approval. Once approved, the head accountant would assign another bookkeeper to key the entries, cancel the documents by stamping them with the keyed date, and file the documents by date. Monthly, the vice president for operations or his designee would reconcile the wire transfers to a list of wire transfer activity received directly from the bank.

Impressed with his professionalism and willingness to look after the company's interest with such sensitivity, the board approved a mandatory vacation policy, effective immediately. Bert told the committee that he would let Marge know that day that she would be on vacation starting tomorrow.

While Marge was on vacation, Dave completed his first official audit for CSM. He found that during the last several years Marge had managed to embezzle more than $300,000 by "lapping" dozens of wire transfers. Additionally, she had been using wire transfers to directly pay for many of her personal expenses, such as credit cards that she used to buy clothing, jewelry, food, and other expenses. Since she was the head accountant, Marge had instructed her subordinates to make numerous fraudulent entries into CSM's accounting records to make it seem like these payments were legitimate business transactions. The three bookkeepers that worked for Marge were young and inexperienced and simply took Marge's word for authenticity. They were also careful to follow orders since Marge had the influence to have them fired.

Dave had a subsequent meeting with the full board of directors to present his findings. The matter was promptly turned over to the authorities where Marge was subsequently convicted of theft and bank fraud and given a different kind of mandatory vacation—five years in federal prison. Marge was also ordered to make restitution but had few assets to show for the money she had stolen. Justice might have been served, but CSM was not likely to ever recover the embezzled money.

As illustrated with this case, the internal auditing function may be one of the most important areas of oversight and control that a company can have. Preventive and detective controls a company might consider in this area are: organizing the separation of duties (which CSM has now done by installing a better system of checks and balances); adopting a verification process (CSM now has Bert review and approve all wire transfers); using terminal security features (only the head wire transfer clerk can access the CSM dedicated wire transfer terminal); and appointing a security supervisor (Dave will now be auditing all CSM wire transfers on a monthly basis).

The lessons CSM learned from its misguided trust in an employee, lack of controls, and unresponsiveness to the external auditors' warnings were costly. Wire transfer fraud can wipe out a firm's cash account with the push of a button; it's nearly undetectable without proper controls and at times even untraceable. CSM was fortunate to have the wherewithal to finally install an internal audit function and find an internal auditor such as Dave. ■