Presenter(s)

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Presentation Summary

- Demographics of a typical “fraudster”
- Characteristics of organizations that are more fraud and error resistant
- COSO’S Internal Control Framework
- Selected key controls that should be in place
  - Underwriting cycle
  - Loss cycle
  - Treasury cycle
  - Investment cycle
  - Financial reporting
- Questions all Boards should ask Management
Who Is Committing the Fraud?

Fraud Discovered by...

- Chance: 11%
- Preceded by "red flag": 32%
- Initial "red flag": 25%
- Other: 26%

Department

- Finance: 36%
- CEO: 35%
- Operations/Sales: 29%
- Other: 29%

Level within the Organization

- Sr. Management: 36%
- Management: 35%
- Other: 29%

Gender

- Female: 32%
- Male: 26%

Department

Source: http://www.antifraudcollaboration.org
Who Is Committing the Fraud?

Methods Used to Override Controls

- Weak internal controls
- Reckless, dishonesty regardless of controls
- Collusion to circumvent good controls

Fraud Committed...
- In collusion with another 61%
- Acting alone 39%

Time at Organization

- Other: 11%
- Over 10 years: 33%
- 6-10 years: 27%
- 3-5 years: 29%

Source: http://www.antifraudcollaboration.org
Why People Commit Fraud: The Fraud Triangle

Opportunity

Companies are decentralized with inconsistent internal controls

Lack of infrastructure and controls in locations

Layoffs and salary cuts creates personal financial hardship

Tight credit environment

Stock prices are unstable

More regulatory focus increased

Internal and External Pressure

Budgets are decreasing. Companies and organizations are doing more with less

Internal Controls

Companies are downsizing, impacting internal controls.

Large projects and acquisitions increases risks of costs not being noticed

Stressed and disgruntled employees may have greater ability to rationalize improper actions

Dissatisfaction with compensation compared to peers and supervisors

Opportunity to Commit Fraud

Pressure

External Pressure

Internal

Rationalization
Types of Fraud: Three Primary Categories

Fraud Tree

Corruption
- Conflicts of interest
- Bribery and corruption
- Illegal gratuities
- Bid-rigging/procurement

Fraudulent Statements
- Revenue recognition
- GAAP
- Reserves
- Non-financial (Disclosures)

Asset Misappropriation
- Cash larceny
- Theft of other assets – inventory/AR/fixed assets
- Fake vendor
- Payroll fraud
- T&E fraud
- Theft of data
Fraud Examples

• Improper claims liabilities being recorded on the FS
  • Fraudulent financial statements

• Claim payments being made for invalid claims
  • Fraudulent financial statements
  • Corruption
  • Asset misappropriations
Characteristics of Organizations that Are More Fraud Resistant

- Ethical tone at the top
- Professional skepticism
- Strong internal controls
COSO’S Internal Control Framework…
Five Inter-Related Standards:
1. Control Environment

Pervasive influence on all the decisions and activities of an organization

**Foundation** internal controls are built on

Effective organizations set a positive “**tone at the top**”

**Examples of soft controls:**

- Management philosophy
- Organizational structure
- Communication
- Competency of employees
## Control Environment

<table>
<thead>
<tr>
<th>Commitment to integrity and ethical values, aka &quot;Tone at the Top&quot;</th>
<th>Management sets an ethical climate that fosters honesty and integrity through their actions, code of conduct, whistleblower policy, etc.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Participation by those charge with governance</td>
<td>Board of Directors provides direction, attention and oversight strategic decisions, formal policies, bylaws, etc.</td>
</tr>
<tr>
<td>Management's philosophy and operating style</td>
<td>Views regarding managing business risks, including financial, operating and compliance risks, are appropriately reflected in policies and procedures</td>
</tr>
<tr>
<td>Commitment to competence</td>
<td>Organization hires and retains competent employees</td>
</tr>
<tr>
<td>Organizational structure</td>
<td>Structure is properly designed and documented in organizational charts, job descriptions and appropriate lines of reporting are put in place</td>
</tr>
</tbody>
</table>
## Control Environment

<table>
<thead>
<tr>
<th>Assignment of authority and responsibility</th>
<th>Authority levels and responsibility are assigned to qualified and experienced individuals - provides a basis of accountability and enforcement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Human resources policies and practices</td>
<td>Expectations regarding behavior, competence and integrity are established in policies and procedures to be used during hiring, orientation, compensation, promotion, evaluation and remedial actions</td>
</tr>
</tbody>
</table>
2. Risk Assessment

Risks are internal & external (economic conditions, staffing changes, new systems, regulatory changes, natural disasters, etc.) that threaten and can negatively influence the organization's ability to conduct business.

Risk assessment is the process of identifying, evaluating, and deciding how to manage these risks/events…

- What is the likelihood of the event occurring?
- What would be the impact if it were to occur?
- What can we do to prevent or reduce the risk?

Have any of you been through a risk assessment?
Comprehensive List of Risk Categories

- Financial statement risk
- Insurance risks - underwriting, reserving, investment and credit risks
- Outsourcing risk
- Vendor risk
- Compliance risk
- Legal risk
- Political risk
- Reputational risk
- Emerging risks
- Data and cyber security risks
- Competition risk
- Other operational and business risks
Risk Prioritization – All Risks except FS

Risk

Process of assessing the probabilities and magnitude of risk events

The results of this assessment are then used to prioritize risks to determine the less to more critical risks – called Ranking.

This ranking will help manage the needed resource to put in place control measures to mitigate or minimize the risks to a comfortable level.

Heat Map is often used by Management
Heat Map

Impact (1-5) | Probability (likelihood) (1-5)
---|---
5 Extreme | 5 Frequent
4 Major | 4 Likely
3 Moderate | 3 Possible
2 Minor | 2 Unlikely
1 Incidental | 1 Rare
Risk Assessment - Financial Statement
Risk

Brainstorming – What Can Go Wrong?

Should be done for each significant cycle
3. Control Activities

Tools - policies, procedures, processes - designed and implemented to help ensure that management directives are carried out and CONTROLS are put in place to assure that these directives are implemented and functioning properly.

The controls help prevent or reduce the risks that can impede the accomplishment of the organization’s objectives at an acceptable level.

Occur throughout the organization, at all levels, and in all functions.

Types of Controls

- Preventive
- Detective

Financial Statement Risks Control Activities may include, approvals, authorizations, verifications, reconciliations, security of assets, segregation of duties...
4. Communication and Information

Information

• Pertinent information must be captured, identified and communicated on a timely basis.

• Effective information and communication systems enable the organization’s people to exchange the information needed to conduct, manage, and control its operations.

Communication

• Internal communication - information is flowing up, down, and across the entity. It enables personnel to receive a clear message from senior management that control responsibilities must be taken seriously.

• External communication - it enables inbound communication of relevant external information and provides information to external parties in response to requirements and expectations.
5. Monitoring

Internal control systems must be monitored to assess their effectiveness… *Are they operating as intended?*

Ongoing monitoring is necessary to react dynamically to changing conditions…*Have controls become outdated, redundant, or obsolete?*

Monitoring occurs in the course of everyday operations, it includes regular management & supervisory activities and other actions personnel take in performing their duties.

Separate evaluations, conducted periodically, will vary in scope and frequency depending on assessment of risks, effectiveness of ongoing evaluations, and other management considerations - can be done by the process owner, internal audit and/or consultant.
5. Monitoring

Findings are evaluated and deficiencies are communicated to management and the board of directors as appropriate.

Remediation plan

Findings follow-up to ensure they have been remediated
Financial Statement Risks & Internal Controls
Weak Internal Controls Increase Risk Through...

**Business Interruption** - system breakdowns or catastrophes, excessive re-work to correct for errors.

**Erroneous Management Decisions** - based on erroneous, inadequate, or misleading information.

**Fraud, Embezzlement, and Theft** - by management, employees, customers, vendors, or the public-at-large.

**Statutory Sanctions** - penalties arising from failure to comply with regulatory requirements, as well as overt violations.

**Excessive Costs/Deficient Revenues** - expenses which could have been avoided, as well as loss of revenues to which the organization is entitled.

**Loss, Misuse, or Destruction of Assets** - unintentional loss of physical assets such as cash, inventory, and equipment.
Benefits from Strong Internal Controls

- Reducing and preventing errors in a cost-effective manner.
- Ensuring priority issues are identified and addressed.
- Protecting employees and resources.
- Providing appropriate checks and balances.
- Having more efficient audits, resulting in shorter timelines, less testing, and fewer demands on staff.
Effective Internal Controls…

- Make sense within each organization’s unique operating environment.
- Benefit rather than encumber management.
- Are not stand-alone practices; they are woven into day-to-day responsibilities.
- Are cost-effective.
1. Separation of Duties

Divide responsibilities between different employees so one individual doesn’t control all aspects of a transaction.

Reduce the opportunity for an employee to commit and conceal errors (intentional or unintentional) or perpetrate fraud.
2. Documentation

Document & preserve evidence to substantiate:

• Critical decisions and significant events...typically involving the use, commitment, or transfer of resources.

• Transactions...enables a transaction to be traced from its inception to completion.

• Policies & Procedures...documents which set forth the fundamental principles and methods that employees rely on to do their jobs.
3. Security of Assets

Secure and restrict access to equipment, cash, inventory, confidential information, etc. to reduce the risk of loss or unauthorized use.

Perform periodic physical inventories to verify existence, quantities, location, condition, and utilization.

Base the level of security on the vulnerability of items being secured, the likelihood of loss, and the potential impact should a loss occur.
4. Reconciliation & Review

Examine transactions, information, and events to verify accuracy, completeness, appropriateness, and compliance.

Base level of review on materiality, risk, and overall importance to organization’s objectives.

Ensure frequency is adequate enough to detect and act upon questionable activities in a timely manner.
5. Reconciliation & Review

More is not necessarily better

• Controls that do not work together leaving holes
• Cost of duplicated or inefficient controls
• Controls that do not align with the importance of the risks

Complex and poorly implemented controls

• Not understood or followed
• Inconsistently applied
• Control effectiveness can degrade over time

No value for the cost

• Controls cost money
• Duplication of ineffective controls do not provide benefits
Controls over significant cycles
# Underwriting Cycle

<table>
<thead>
<tr>
<th>Risk (WCGW)</th>
<th>Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premium amounts do not include premiums from all policies and are not accurately recorded.</td>
<td>Detail policy record is agreed to each policy, endorsement, and/or cancellation on a weekly basis and verify that only policies, endorsements, and/or cancellations approved by authorized individuals have been issued. Premiums are also agreed to the policy record.</td>
</tr>
<tr>
<td>Retroactive premium adjustments are not properly recorded.</td>
<td>Retroactive premiums and experience rated premiums are calculated based on the policy provisions on a yearly basis and reviewed by the Controller for accuracy.</td>
</tr>
<tr>
<td>Reinsured policies are not properly identified, and premiums on ceded reinsurance are not properly recorded.</td>
<td>Risks covered by reinsurance agreements are identified. premiums ceded are calculated based on the reinsurance agreement terms. Premiums ceded calculation is reviewed on a monthly basis by the CFO.</td>
</tr>
<tr>
<td>Uncollectible agents' balances/contributions receivable are not identified and accounted for.</td>
<td>Receivable balances are aged on a monthly basis and the aging report is reviewed by the Controller. Delinquent accounts are investigated and write-offs of bad debts are approved.</td>
</tr>
</tbody>
</table>
### Loss Cycle

<table>
<thead>
<tr>
<th>Risk (WCGW)</th>
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<tbody>
<tr>
<td>Claim data are not accurately and appropriately recorded and maintained within system.</td>
<td>A claim record is created in the claim system which automatically assigns a claim number, system creation date, and time of report. The assigned claim number cannot be deleted and system assigned date and time cannot be modified.</td>
</tr>
<tr>
<td>Initial and adjustments to claim case reserves are not appropriately set by adjuster.</td>
<td>The adjuster’s limits to initiate and adjust the reserve are tied to authority levels. Changes in outstanding loss reserves by more than $25,000 are reviewed by the lead claim adjuster on a by-weekly basis.</td>
</tr>
<tr>
<td>Reinsurance recoverable on paid and unpaid losses is not properly recorded.</td>
<td>Claims reaching the reinsurance limits are compiled in excel on a monthly basis and are reviewed by the controller. Reinsurers are billed on a monthly basis based on the excel worksheet. Bills are reviewed by the lead claim adjuster before being sent out.</td>
</tr>
<tr>
<td>Paid losses and related accounts are not recorded in the proper amounts.</td>
<td>Payments are tied to authority levels. Payments’ withdrawals from claim bank account are reconciled on a monthly basis to the loss run and reviewed by controller.</td>
</tr>
</tbody>
</table>
## Treasury Cycle

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<thead>
<tr>
<th>Risk (WCGW)</th>
<th>Control</th>
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<tbody>
<tr>
<td>Cash receipts have not been posted to the GL.</td>
<td>A reconciliation of the cash accounts is performed to ensure that all activity, which includes the wires, has been correctly posted to the ledger and reviewed by the controller.</td>
</tr>
<tr>
<td>Cash disbursements (wire, EFT, or check) are unauthorized/misappropriated.</td>
<td>Expenditures must be reviewed and approved in accordance with the Company’s authority level prior to payment.</td>
</tr>
<tr>
<td>All payments may not be processed or the GL may not be updated. Checks issues for payable balances have not been recorded within the GL.</td>
<td>A reconciliation of the cash accounts is performed to ensure that all activity, which includes the wires, has been correctly posted to the ledger. The reconciliation is reviewed by the CFO.</td>
</tr>
<tr>
<td>Unauthorized bank accounts may be opened or unauthorized bank account closures may occur.</td>
<td>Request is documented in an authorization letter approved by two authorized officers.</td>
</tr>
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</table>
## Investment Cycle

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<tr>
<th>Risk (WCGW)</th>
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<tr>
<td>Securities and investment assets included in the balance sheet physically do not exist and/or are incomplete.</td>
<td>Reports and confirmations of securities purchased and sold are reconciled to entity records by the staff accountant on a monthly basis and reviewed by the controller. Additionally the investment statement is reconciled to the GL by the staff accountant and reviewed by the controller.</td>
</tr>
<tr>
<td>Amortization &amp; accretion of bond premiums and discounts amounts are not properly calculated.</td>
<td>The staff accountant prepares the amortization schedule on a monthly basis and agrees to the discount/premium to entity records. The schedule is reviewed by the controller.</td>
</tr>
<tr>
<td>Securities valuations are incorrect.</td>
<td>The senior accountant prepares a price comparison of all the portfolios to Bloomberg pricing. This comparison identifies any securities for which the price differs between the custodian and Bloomberg pricing by more than 3% for debt securities and 1% for equity securities. The comparison is provided to the Controller for review.</td>
</tr>
</tbody>
</table>
## Financial Statement Review Cycle

<table>
<thead>
<tr>
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<tr>
<td>Unauthorized closing entries are made to prior periods.</td>
<td>Postings to prior periods are restricted.</td>
</tr>
<tr>
<td>Sub-ledger to general ledger postings are inaccurate/incomplete or unreconciled.</td>
<td>Sub-ledgers are reconciled on a monthly basis to the general ledger and reviewed by the Controller. The controller cannot post JE.</td>
</tr>
<tr>
<td>Invalid transactions are recorded.</td>
<td>Journal entries posting are restricted to approved personnel and journal entries are approved by the controller.</td>
</tr>
<tr>
<td>Related party transactions are not properly recorded or eliminated.</td>
<td>On a quarterly basis, the CFO reviews all RPT for proper recording and disclosures.</td>
</tr>
<tr>
<td>Financial statements, including disclosures, are inaccurate or incomplete.</td>
<td>The controller and CFO reviews financial statements for accuracy and completeness.</td>
</tr>
</tbody>
</table>
Responding to a Whistleblower

- Take it seriously – set the tone
- Respond promptly
- Inform counsel – either external or internal
- Assess credibility
- Evaluate resources to respond
- No retaliation
Things that Should Keep You Up at Night

- Low interest rate environment
- CATS
- Reserve Adequacy
- ComFrame
- Group Supervision
- Regulatory Change
- Execution of Regulatory Change
- The Future of Reinsurance
- Affordable Care Act
- Feds Getting More Involved
- Run-Off Companies
- Long-Term Care Insurance
- Regulatory Talent
- Talent for Industry
- Cyber Risk
Presenter Info

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