
THE CORPORATE CON: INTERNAL FRAUD AND THE AUDITOR



Association of Certified Fraud Examiners

GLOBAL HEADQUARTERS • THE GREGOR BUILDING
716 WEST AVE • AUSTIN, TX 78701-2727 • USA

V. CASH SCHEMES

Introduction

Cash is the focal point of many accounting entries. Cash, both on deposit in banks and petty cash, can be misappropriated through many different schemes. These schemes can either be on the books or off, depending on the point of occurrence. Generally, cash schemes are smaller than other fraud schemes because companies tend to have comprehensive internal controls over cash, and those internal controls are adhered to strictly. Fraud schemes perpetrated in other areas, such as the misappropriation of other assets or overbilling, are the result of circumvention of the existing internal control system.

Cash receipts schemes fall into two categories, *skimming* and *larceny*. The difference in the two types of fraud depends completely on when the cash is stolen. Cash larceny is the theft of money that has *already appeared* on a victim organization's books, while skimming is the theft of cash that has *not yet been recorded* in the accounting system. The way in which an employee extracts the cash might be the same for a cash larceny or skimming scheme.

Cash fraud schemes follow general basic patterns, including:

- Skimming
- Voids and under-rings
- Swapping checks for cash
- Alteration of cash receipt documentation
- Fictitious refunds and discounts
- Journal entries
- Kiting

Skimming

Skimming is the process by which cash is removed from a victim entity before the cash is recorded in the accounting system. Employees who skim from their companies steal sales or receivables before they are recorded in the company's books. This is an off-book scheme; receipt of the cash is never reported to the entity. This aspect of a skimming scheme means they leave no direct audit trail. Because the stolen funds are never recorded, the victim organization might not be aware that the cash was ever received. Consequently, it might be very difficult to detect that the money has been stolen. This is the prime advantage skimming schemes offer fraudsters.

Skimming is one of the most common forms of occupational fraud. It can occur at any point where cash enters a business, so almost anyone who deals with the process of receiving cash could be in a position to skim money. This includes salespeople, tellers, waitpersons, and others who receive cash directly from customers.

In addition, many skimming schemes are perpetrated by employees whose duties include receiving and logging payments made by customers through the mail. These employees slip checks out of the incoming mail instead of posting those checks to the proper revenue or receivables accounts. Those who deal directly with customers or who handle customer payments are the most likely candidates to skim funds.

EXAMPLE

Employees of a retail business would close out the cash registers early in the day in order to falsify the cash receipts and keep any cash received in the latter part of the day for themselves. If checks were received in the afternoon, the employees would merely exchange the checks for the cash collected the next morning. The cash receipts were not recorded through a system of consecutively numbered receipts nor on a time-sensitive cash register tape, making it possible for the employees to close out a cash drawer at any time during the day.

The fraud was discovered when revenue for the current period was compared to the revenue in similar prior periods. There was a substantial decline in the current period's revenue.

VOIDS AND UNDER-RINGS

There are three basic void and under-ring schemes. The first is to record a sale or cash receipt, void the same sale, and then remove the cash from the register. The second, and more common, variation is to purchase merchandise at unauthorized discounts. The third, which is a variation of the unauthorized discount, is to sell merchandise to a friend or co-conspirator using the employee's discount. The co-conspirator then returns the merchandise for a full refund, without regard to the original discount.

EXAMPLE

A manager of a recreational facility directed his staff to alert him anytime a customer came in to pay for the monthly rental of the facility. The facility was rented to the public during the daytime on an hourly basis, and to civic groups on a per-evening basis. The pricing for the per-evening groups was somewhat discretionary, and the manager preferred to take care of these customers himself. The groups who rented the facility in the evenings were charged on a monthly basis and the manager maintained the receipts log for these charges. Typically, these customers would pay on account each evening they used the facility.

The manager would charge the customer the full facility rental price, log the charge for less than the full price, and deposit the difference into an account under his control. The amount represented by the difference between the full price and the discounted price recorded in the log was not expended for the benefit of the facility or returned to the customer.

Although this appears to be a skimming scheme, and in a way it is, in his reports to accounting, the manager was under-ringling the payments from the evening customers.

The fraud scheme was discovered when a customer called, questioning the endorsement on her canceled check. She had made a payment on her civic group's account to the recreational facility, and yet the endorsement on the check was the manager's own name and not the name of the recreational facility.

Swapping Checks for Cash

One common method employees use to misappropriate cash is to exchange their own checks for cash in the cash register or cash drawer. Periodically, a new check is written to replace the old check. This process can be continued such that, on any given day, there is a current check for the cash removed. This is a form of unauthorized borrowing from the company. Obviously, if it is company policy that cash drawers or registers are reconciled at the conclusion of each day and turned over to a custodian, then this fraud scheme is less likely to be committed. However, if personnel may keep their cash drawers and only remit the day's receipts, then this method of unauthorized borrowing is allowed to continue.

EXAMPLE

Christina, a retail sales clerk, has a daughter whose birthday is approaching. Christina does not have the money to purchase the new Barbie doll her daughter wants, so she writes a check for \$20, payable to the store, places it in the cash register, and removes \$20 in cash. The next day, Christina replaces the check for \$20 with a new check for \$20, which has a current date. This process of replacing old checks with new checks can go on indefinitely.

Alteration of Cash Receipts Documentation

A lack of segregation of duties can create an opportunity for an employee to misappropriate company funds. For example, if the same person is responsible for both collecting and depositing the cash receipts, then this person has the ability to remove funds from the business for their own personal use and conceal such theft through the deposits. This is often the case in smaller organizations in which there are few personnel among whom to divide the daily operations. A variation of this scheme is to mutilate or destroy the cash receipt documentation such that any attempt to reconcile the cash deposited with the cash receipts is thwarted.

EXAMPLE

An employee in food services received daily receipts from sales, and cash register tapes from other cashiers. Allegedly, this employee mutilated the register tapes, rendering them illegible. She prepared the transmittal documentation that was sent to the controller, but kept the difference between the amount submitted to the controller and the amount submitted by the other cashiers. The mutilated tapes were sent to the controller with the deposit. The controller's office did not compare the deposit with the register tapes.

The fraud was detected when one of the cashiers noticed that the transmittal to the controller was small for a comparatively busy day. When questioned about this difference, the perpetrator could not substantiate the difference between the amount transmitted and the cash register tapes. The 23-year-old female, who had been with the company for two-and-a-half years, was terminated but not prosecuted.

Fictitious Refunds and Discounts

Fictitious refunds are those in which the employee enters a transaction as if a refund were given; however, no merchandise is returned, or no discount is approved that substantiates the refund or discount. The employee misappropriates funds equal to the fictitious refund or discount. This scheme is most prevalent in the retail and merchandise industry.

EXAMPLE

Roger works in a plumbing-supply store as a cashier. There are several cash drawers, one for each cashier. At the end of each day, Roger and the manager reconcile the cash to the cash register tape. A deposit is prepared and submitted to accounting, and a security service picks up the cash for daily deposits to the bank.

Roger knows that some of the contractors in town have discounts on certain items in the store. On occasion, when a customer other than one of the contractors purchases one of the discount items, Roger will fill out a discount form as if the customer were a contractor. The customer, unaware of the discount, pays the full price for the item, and Roger pockets the difference (the amount of the discount).

Journal Entries

Unauthorized journal entries to cash are not as common as the above-mentioned schemes. This type of scheme might be easier to detect because its method of concealment is more obvious. The typical journal entry scheme involves fictitious entries to conceal the theft of cash. If the financial statements are not audited or reviewed, this scheme is relatively easy to employ. However, for larger businesses with limited access to journal entries, this concealment method might be more difficult to use. Generally, fraud schemes that involve journal entries to cash are more likely in financial institutions where there are numerous, daily entries to the cash account.

Kiting

Kiting is the process whereby cash is recorded in more than one bank account, but in reality, the cash is either nonexistent or is in transit. Kiting schemes can be perpetrated using two or more accounts at the same bank or using several banks and several different accounts. Although banks generally have a daily report that indicates potential kiting schemes, experience has shown that banks are somewhat hesitant to report the scheme until customers' account balances are zero.

There is one important element to check kiting schemes: All kiting schemes require that banks pay on unfunded deposits. This is not to say that all payments on unfunded deposits are kiting schemes, but rather that all kiting schemes require that payments be made on unfunded deposits. In other words, if a bank allows its customers to withdraw funds on deposits that the bank has not yet collected the cash to cover, kiting schemes are possible. In today's environment in which customers frequently use wire transfers, kiting schemes can be perpetrated very quickly and in very large numbers.

EXAMPLE

The first deposit for \$100,000 is placed in account X. A check is then written on account X for \$100,000 to open account Y. The records do not reflect that the check has been written on account X, and, therefore, the same \$100,000 appears in both accounts X and Y. Although this sounds like a simple scheme to detect, if the amounts are large and the accounts are numerous, it is very difficult to trace the kiting transactions. Once the kiting cycle has begun, the amounts shown in the various bank accounts have no relationship to the actual cash on hand.

How a Simple Kiting Scheme Works

Start with no money in Bank A and Bank B, and draw \$5,000 in checks on each to deposit in the other:

	Bank A	Bank B	Total
Apparent balances	\$5,000	\$5,000	\$10,000
Actual balances	-0-	-0-	-0-

Do it again with \$8,000 in checks:

	Bank A	Bank B	Total
Apparent balances	\$13,000	\$13,000	\$26,000
Actual balances	-0-	-0-	-0-

Make a \$6,000 down payment on a Mercedes from Bank A:

	Bank A	Bank B	Total
Apparent balances	\$7,000	\$13,000	\$20,000
Actual balances	<\$6,000>	-0-	<\$6,000>

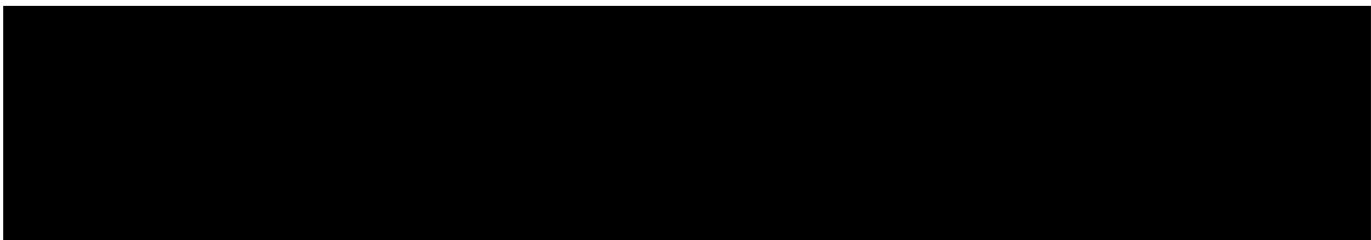
When the first checks clear, write some more, this time for \$9,000 each:

	Bank A	Bank B	Total
Apparent balances	\$11,000	\$17,000	\$28,000
Actual balances	<\$6,000>	-0-	<\$6,000>

Pay the balances to a travel agent and take a long trip:

	Bank A	Bank B	Total
Apparent balances	-0-	-0-	-0-
Actual balances	<\$17,000>	<\$17,000>	<\$34,000>

Remember, not all payments against uncollected funds are check kites, but all check kites require payments against uncollected funds.



Cash Fraud Detection Methods

There are several basic methods to detect cash fraud that generally are included in most cash audit programs. The methods, discussed in more detail throughout this section, are as follows:

- Bank reconciliations
- Cut-off statements
- Surprise cash counts
- Customer complaints
- Altered or missing documentation
- Fictitious refunds or discounts
- Journal entry review
- Review and analyses of decreases in gross sales or increases in returns and allowances
- Analytical review

Bank Reconciliations

The preparation of bank reconciliations by a person not responsible for handling cash frequently turns up discrepancies. These reconciliations should be prepared on a timely basis. Good reconciliation

methods include examining endorsements and dates. When examining the bank reconciliations prepared by company personnel, examine all items that appear to be stale. Obtain satisfactory explanations for the nature of each of the reconciling items.

EXAMPLE

A fraud was made possible because of a lack of policies and procedures and coordination of cash collections and transfers of funds between the cashiers and the accounting department.

The misappropriation of funds was detected by comparing the bank deposits with the collection log that was maintained by the accounting clerk. The review of the collection log took place while the accounting clerk was on sick leave. The accounting clerk was responsible for the preparation of the collection log, the daily cash report, and the daily deposits. Due to the lack of segregation of duties, this accounting clerk was able to alter the computerized accounts and misappropriate a total of \$23,930. She accomplished this by preparing daily cash reports reflecting less cash receipts than were actually collected. The lesser cash amount was deposited into the city's bank account.

After discovery of the missing funds, the accounting clerk was terminated and prosecuted. She ultimately pleaded guilty and was sentenced to ten years' probation. She was 25 years old and had been with the city for three-and-a-half years.

Along with the bank reconciliation, one should prepare a schedule of deposits in transit. This schedule will point out any potential kiting. Deposits in one account should be withdrawals in another account on the same day. There should be no difference between the dates of deposit and the dates of withdrawal.

EXAMPLE

A cashier was able to misappropriate cash receipts totaling \$35,000, and covered the shortage by subsequent receipts. Mail receipts were listed and forwarded to the cashier who prepared the deposits. However, the listed receipts were not compared to the deposits by an independent person. This scheme was discovered as a result of a staff accountant following up on the clearing of deposits in transit listed on the year-end bank reconciliation.

Cut-Off Statements

Cut-off statements are bank statements that show income and expenses in a specific time period, and are often used by auditors to ensure transactions are reported in the proper period. Cut-off statements can also be used to detect unauthorized bank accounts. Additionally, cut-off statements can be used in cases where there are insufficient personnel within the organization to ensure segregation of duties. If the employees know that, at any time, a cut-off statement will be ordered and reviewed independently, the employees are less likely to perpetrate cash fraud.

A cut-off statement is generally ordered from the bank, delivered unopened to the auditor (or outsider), and reconciled. A cut-off statement can be ordered at any time during the accounting cycle; it does not have to be ordered at the end.

Another method related to the cut-off statement is the bank confirmation request. Unlike the cut-off statement, this detection method is merely a report of the balance in the account as of the date requested. When ordering cut-off statements or confirmations, be sure to request the information for all accounts in the company's name.

EXAMPLE

A \$100,000 fraud was uncovered when a bank confirmation was returned indicating that there were other bank accounts than those detailed in the general ledger. Further investigation revealed that the corporate executives had been using an unauthorized bank account for a "slush fund."

Surprise Cash Counts

Sometimes, surprise cash counts can turn up situations of employees "borrowing" or floating small loans (often called swapping). It is critical that these cash counts be done on an irregular and unannounced basis. If employee checks are included in the cash drawer or register, then this could indicate that the employees are swapping checks for cash.

EXAMPLE

Payday was every other Friday at the National Bank of Springsville. Mike, a new teller at the bank, did not have enough money to make his October house payment, which was due on the fifteenth of the month, a Thursday. So, on Thursday, Mike placed a check in his cash drawer for the amount of the shortfall and withdrew the cash. Mike intended to replace the check with cash the following Monday morning, after he had cashed his next paycheck. On Friday morning, the internal auditors performed a surprise cash count and took note of Mike's personal check in his cash drawer.

As luck would have it, Mike got into a fender bender on Friday night while driving home from work. His car had to be towed, and the service charge took the last of Mike's cash reserves.

On the following Monday morning, Mike did not have enough cash to replace his personal check, so he replaced the old check with a new one that had a current date. Much to Mike's surprise, the internal auditors returned on Monday afternoon for a second surprise cash count. They discovered that Mike had replaced the old check with a new one. Mike was terminated.

Customer Complaints

Cash thefts are sometimes reported by customers who have either paid money on an account and have

not received credit, or in some cases, when they notice that the credit they have been given does not agree with the payment they have made.

EXAMPLE

A branch of a large bank received a client complaint that there had been a \$9,900 forged savings withdrawal from her account. The client indicated that she had recently made a \$9,900 deposit at the branch and suspected that the teller who had accepted the deposit could be involved.

The teller was interviewed and admitted to forging and negotiating the savings withdrawal. The teller had obtained the client's mother's maiden name and birth place, had fabricated a duplicate savings receipt book, and, on an unscheduled work day, went to the domiciling branch, posing as the client.

The teller did not have any identification but was persistent enough to remain in the branch for several hours to obtain an approval on the savings withdrawal. The teller who forged the withdrawal was only 17 years old.

Altered or Missing Documents

The cash register tape submitted with the cash receipts should be readable and in good condition at all times. A common method of detecting potential cash fraud is by examining the cash register tape. If it has been altered or is missing, further investigation is warranted.

EXAMPLE

We have all been in a hurry at the check-out line of retail stores when the cashier has entered the data into the register incorrectly. The cashier then must call their supervisor to void the erroneous information and re-enter the correct sale.

In this example, the supervisor is an integral part of the internal control, ensuring that the cashier does not manipulate the register tape by reversing entries or by mutilating the tape. Although the extra time might cause frustration, this store could be trying to avoid mutilated or altered register tapes.

Fictitious Refunds or Discounts

Fictitious refunds or discounts can often be detected when closely examining the documentation submitted with the cash receipts. Another related detection method is to evaluate the discounts given by the cashier or salesperson. This analysis might point out that a single employee or group of employees has a higher incidence rate of discounts than other employees. Further examination is then necessary to determine if the discounts are appropriate and properly documented.

Additionally, if customers are asked to examine their receipts, employees are prevented from making inappropriate refunds or discounts. This method employs the customer as part of the internal control system, to ensure that the cashier or salesperson is properly accounting for the sale.

EXAMPLE

Customers can be given a simple incentive for examining their cash register receipts, such as receiving their purchases for free if the salesperson fails to give receipts. With this policy in place, both customers and employees are integral components of the internal control mechanism for assuring that the register tape and the receipts are equal. In addition, if the register tape must be submitted with the register reconciliation, the issuance of fictitious refunds or discounts can be substantially reduced.

Journal Entry Review

Cash frauds can often be detected by reviewing and analyzing all journal entries made to the cash accounts. This review and analysis should be performed on a regular basis. If an employee is unable to conceal the fraud through altering the source documents, such as the cash register tape, then they might resort to making a journal entry directly to cash. In general, there are very few instances in which a journal entry is necessary for cash. One of these exceptions is the recording of the bank service charge. However, this is an easy journal entry to trace to its source documentation, namely the bank statement. Therefore, all other entries directly to cash are suspect and should be traced to their source documentation or explanation.

EXAMPLE

A cash fraud of approximately \$521,000 was discovered when a computerized review of the journal entries revealed that several entries were made to an income account, and that those entries were unusual in nature.

The employee who perpetrated this fraud had made use of general ledger journal entries to income accounts. He entered fictitious transactions that resulted in a cash increase in his own account. He was caught by means of an automated testing program.

Review and Analysis of Gross Sales and Returns and Allowances

Inappropriate refunds and discounts can also be detected by analyzing the relationship between sales, cost of sales, and the returns and allowances. If a large cash fraud is suspected, a thorough review of these accounts might enlighten the auditor as to the magnitude of the suspected fraud. An analysis of refunds, returns, and allowances with the actual flow of inventory might reveal some fraud schemes. The refund should cause an entry to inventory, even if it is damaged inventory. Likewise, a return causes a corresponding entry to an inventory account. There should be a linear relationship between sales, returns, and allowances over a relevant range. Any change in this relationship could point to a fraud

scheme unless there is another valid explanation, such as a change in the manufacturing process, change in product line, or a similar change.

EXAMPLE

The assistant manager in a retail store periodically removed \$50 to \$100 from the cash register for his own use. At the home office, the auditors discovered that the relationship among sales returns, allowances, and sales for this particular location was inconsistent with all other locations. The auditors monitored the relationship for some time. Rather than improving, the relationship became even worse.

Eventually, it was discovered that the assistant manager was recording the cash thefts as “returns and allowances.” The auditors noticed the red flag because the sales returns and allowances for this location were a larger percentage of sales than at any other location.

Analytical Review

With the aid of a computer, cash frauds might also be detected through analytical reviews. For example, searches can be designed to list the following:

- All voided checks
- Missing checks
- Checks payable to employees (except payroll)
- Deposit dates compared with posting dates of customers’ accounts
- Cash advances
- Voids and refunds by employee ID

Voided Checks

Voided checks might indicate that employees have embezzled cash and charged the embezzlement to expense accounts. When the expense is paid (from accounts payable), the checks are voided and removed from the mail.

Missing Checks

If checks are missing, this might indicate that the control over the physical safekeeping of the checks is somewhat lax. If any checks are found to be missing, this could be a red flag of misappropriation of cash.

Checks Payable to Employees

Any checks payable to employees, except regular payroll, should be examined for appropriateness. Such an examination might indicate other schemes, such as conflicts of interest, fictitious vendors, or duplicate expense reimbursements.

Deposit Dates

If the dates on the deposits do not match the dates the payments are credited to the corresponding customer account, this might be a red flag of a lapping scheme (described in more detail later).

Cash Advances

An examination of all cash advances might reveal that they are not all properly documented and, therefore, inappropriate payments are made to employees. A random review of all cash advances might go a long way to deter employee abuse of an advance system.

VOIDS and Refunds by Employee Identification

By examining the amounts and occurrence rates of voided sales and refunds, sorted by employee ID, one might detect a pattern of unrecorded sales or fictitious refunds.

EXAMPLE

A \$500,000 fraud was discovered through the use of computer matching. The addresses on refund checks were compared with the addresses on the disbursement registers. A fictitious refund claim was uncovered.

Cash Fraud Prevention Methods

Segregation of Duties

The primary prevention to cash fraud is the segregation of duties. Whenever one individual has control over the entire accounting transaction or even multiple parts of it, the opportunity for cash fraud is present. Each of the following duties and responsibilities should be segregated:

- Cash receipts
- Bank deposits
- Bank reconciliation
- Cash disbursements

If any one person can collect the cash, deposit the receipts, record that collection, and disburse company funds, there is a high risk that fraud will occur.

EXAMPLE

This fraud occurred at one of several campus cashiers' offices maintained by the university for the collection and processing of student tuition bills and other related charges.

The perpetrator was employed as a teller for approximately five years before she was promoted to head cashier. The head cashier was responsible for the reconciliation of the daily cash receipts to the cash

transmittal and bank deposits. The head cashier also prepared the deposits of funds received from outside departments, such as the bookstore and the dining operations. The deposits from the outside departments involved substantial amounts of cash. As head cashier, she also prepared the initial documentation that served as the input for the various general ledger accounts, including accounts receivable.

The perpetrator's extensive knowledge and experience, coupled with the trust placed in her by the manager, resulted in a diminishing review of her work, particularly her cash register reconciliations. She soon was able to manipulate the documentation and control procedures necessary to conceal the embezzlement of funds. The 29-year-old head cashier stole an estimated \$66,000. She was fired and prosecuted, but the grand jury failed to indict her.

EXAMPLE

Karina was the sole bookkeeper in a family-owned flooring-supply store in San Diego. Because of the lack of internal control, specifically the lack of segregation of duties, Karina was able to embezzle approximately \$550,000 from her employer. In her position as bookkeeper, she was responsible for writing the checks and reconciling the bank account. Her scheme was very simple—she wrote checks to herself, made notations in the check register that the checks had been voided, and then destroyed the canceled checks when they were returned with the bank statement. Karina concealed her scheme by decreasing inventory accounts in lieu of the cash accounts. The fraud was discovered when the store owner learned that a company check had bounced and began looking at the bank statements to see why there was not sufficient funds in the account to cover that payment. Karina was subsequently prosecuted, convicted, and spent eight months in prison.

Assignment Rotation and Mandatory Vacations

Mandatory job rotation is an excellent method of detecting cash fraud. To sustain a fraud, one must continually conceal it. By establishing a mandatory job or assignment rotation, the concealment element is interrupted. If mandatory vacations are within the company's policies, it is also important to remember that during the employee's absence, the normal workload of that employee should be performed by another individual. The purpose of mandatory vacation is lost if the work is allowed to remain undone during the employee's time off.

EXAMPLE

A \$1.1-million fraud was uncovered when a new loan officer was routinely transferred. The previous loan officer had been in collusion with a borrower in a loan insurance scam. The borrower approached the new loan officer, who had the good sense to report the bribery attempt to authorities.

Surprise Cash Counts

Surprise cash counts are a useful fraud prevention method if properly used. It is important that employees know the cash will be counted on an irregular basis; but they should not be advised in advance of an impending cash count.

EXAMPLE

Petra, a high-school graduate, was employed by a photo-processing store. It was her first job and she was happy in her employment. She had peer recognition and everyone liked and respected her. Petra did not know about the company's internal control system; that is, she did not know that her cash drawer was subject to surprise cash counts. When her drawer was selected for a cash count, management discovered that Petra had undertaken a skimming operation wherein she stole approximately \$800 from her employer. Although Petra did not take much money, she was still terminated from her employment.

EXAMPLE

A hoard of cash was discovered in a fast-food retail outlet when the external auditors included a surprise cash count as one of their audit steps. When the auditors couldn't reconcile the cash in the registers with the register tapes, they discovered that the employees had hidden cash throughout the store. They found caches in the ceiling, taped to the bottom of the portable ovens, and even inside toilet tanks. Apparently, cash receipts were deposited directly to the bank and the register tapes were mailed to centralized accounting. There was no reconciliation of the deposits with the register tapes.