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Research series ... 2

सत्यमेव जयते

Red flags & Anti-fraud measures in Accounts Payable Process

A Research Paper

Indian Audit & Accounts Department

Regional Training Institute

26/1, Civil Lines, Nagpur

Preface

Fraud is a barrier to growth and a threat to corporate well being so organizations have to devote significant resources to prevent and detect fraudulent activities. But with ever changing tactics/techniques of fraud, heavy dependence on technology anti-fraud professionals that include auditors have to keep themselves abreast with the best professional practices and the latest in combating frauds to stay ahead of fraudsters.

As a centre of excellence in the area of *'Audit of Fraud, Fraud Detection Techniques, and Forensic Audit'*, it has been our endeavour to develop a bank of anti-fraud measures for different scenarios. The institute's maiden research paper titled, *'Red flags and Anti-fraud measures in Public Works'* released in October 2007 has been well received and found to be quite useful in PWD auditing.

This paper is one in such series that focuses on key best practices for improving financial effectiveness through developing anti-fraud measures. The paper presents various accounts payable fraud scenarios and relevant anti-fraud measures.

I hope that the readers would find this paper too interesting and useful.

RTI, Nagpur
June 2008

Dr. Sadu Israel
Principal Director

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1. Introduction

Accounts payable

Accounts Payable (A/P) is a file or account that contains money that a person or company owes to suppliers, but hasn't paid yet (a form of debt). When you receive an invoice you add it to the file, and then you remove it when you pay. Thus, the *A/P* is a form of credit that suppliers offer to their purchasers by allowing them to pay for a product or service after it has already been received. Many, but not all, executives think that accounts payable simply gets bills and pays them. They do not realize that when handled incorrectly the impact to the bottom line can be significant and not in a good way.

Auditors often focus on the existence of approved invoices, expense reports, and other supporting documentation to support cheques that were cut. The presence of a confirmation or statement from the supplier is reasonable proof of the existence of the account. It is not uncommon for some of this documentation to be lost or misfiled by the time the audit rolls around. An auditor may decide to expand the sample size in such situations.

Auditors typically prepare an aging structure of accounts payable for a better understanding of outstanding debts over certain periods (30, 60, 90 days, etc.) Such structures are helpful in the correct presentation of the balance sheet as of year end.

Risks & magnitude of losses

A/P for obvious reasons is susceptible to fraud which might include the fraudulent procurement of supplies and materials and other general expenses. *A/P* can be manipulated in several ways, and paying attention to the purchaser is as important as keeping an eye on

the actual purchase.

The procurement and accounts payable processes are so closely integrated, and the controls so overlapping, that they must be dealt with together. For a purchasing fraud to be successful, the perpetrator must know the checks and balances and weaknesses in both the purchasing system and the accounts payable systems in order for the fraud to succeed. Consequently, the discussion of fraud in these two areas will be dealt with under the more generic term 'procurement and accounts payable fraud' in the paper.

According to the 2006 “Report to the Nation on Occupational Fraud and Abuse” published by the Certified Fraud Examiners Association, billing schemes are the most common of the fraudulent disbursement schemes. These cases made up 28.3% of all cases identified at the time of their survey. Such schemes are highly profitable for the perpetrator, with a median loss of $130,000, making them the second most expensive form of fraudulent disbursement behind wire transfers, which have a median loss of $500,000.1

Role of Technology

In recent years, *A/P* operations have automated and streamlined their processes. New technology, such as electronic invoice presentment and payment (EIPP) and electronic funds transfer (EFT), has enabled automation of many *A/P* transactions. Without a doubt technology plays a huge role in preventing accounts payable fraud. Leading companies use a variety of EFT tools to make payments electronically and rely on computer-assisted audit techniques (CAATs) and other technology-based antifraud procedures to monitor and stop illegal *A/P* transactions. Many companies also seek to streamline or eliminate steps in *A/P* transactions, such as invoice processing.

Despite this push toward automation, companies still strive to maintain a strong relationship-based focus. They seek progressive approaches to supplier communications, payment timing, and fraud prevention. They also leverage other organizational initiatives, such as regulatory compliance and internal control efforts, to achieve better *A/P* efficiency.

2. Best practices for Procurement/Accounts Payable Management and Controls

1. A request is initiated by an authorized purchasing agent to add a vendor to the "Master Vendor List." The request is sent to the designated person in the Finance Department.

2. A "due diligence" investigation is conducted and documented by the Finance Department regarding the vendor (company or person). This investigation should include, but not be limited to, the following:

   - *Verification of the PAN number*
   - *Verification of incorporation status*
   - *Fictitious name filing*
   - *Business license verification*
   - *Verification of address and telephone number through database/Internet sources*

3. Purchase request initiated and approved by authorized individual.

4. Purchase order completed, purchase order number assigned, and purchase of goods or services made. Purchase order number is given to vendor and should be included on the invoice from the vendor.

5. Goods are received or service completed.

6. If physical item, goods received are matched to the shipping document (Bill of Lading) and the purchase order.
   - *If item is a physical asset, the asset department is notified and the item is assigned an inventory number, tagged and*

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5. Goods are received or service completed.

6. If physical item, goods received are matched to the shipping document (Bill of Lading) and the purchase order.
   If item is a physical asset, the asset department is notified and the item is assigned an inventory number, tagged and

added to the inventory record before release to the requestor.
If item is supply or production inventory, inventory levels are adjusted accordingly.

7. Verified shipping document is sent to accounts payable by the Receiving Department.

8. Invoice for payment of shipped goods is received by accounts payable from the vendor.

9. Vendor is verified by accounts payable against the Master Vendor List. The invoice and shipping document are compared to the purchase order.

10. Cheque to the vendor is created by accounts payable clerk.

11. Cheque, invoice, shipping document, and purchase order are provided to the authorized cheque signer for review prior to cheque signing.

12. The cheque run is reconciled daily by someone other than the accounts payable clerk who produced the cheques. All cheques issued or voided are accounted for and compared to the purchase order and the shipping and receiving documentation. In addition, a physical inventory is conducted daily of all blank cheques.

Segregation of duties

13. A fundamental element of internal control is the segregation of certain key duties. The basic idea underlying segregation of duties is that no employee or group should be in a position both to perpetrate and to conceal errors or fraud in the normal course

of their duties. In general, the principal incompatible duties to be segregated include:

- *Custody of assets*
- *Authorization or approval of related transactions affecting those assets*
- *Recording or reporting of related transactions*
- *Execution of the transaction or transaction activity*

An essential feature of segregation of duties/responsibilities within an organization is that no one employee or group of employees has exclusive control over any transaction or group of transactions.

Based on the above criteria, a matrix indicated at annexure (i) has been designed to highlight conflicting duties performed by one individual or group of individuals (potential lack of proper segregation of duties). Audit teams can use this form to review the segregation duties of key employees in order to help identify potentially conflicting duties within accounting processes that may constitute a control weakness.

Instructions to use the matrix

1) The auditor should inquire to determine which individuals are responsible for certain duties within the company/location.
2) The matrix should be used to determine if there is potential for a segregation of duties conflict. Use the following keys to identify the potential financial risk and segregation of duties conflicts:

X - Segregation of duties conflict
H - High financial risk
M - Medium financial risk
L - Low financial risk

3) The potential issues should be investigated to ensure a mitigating/compensating control prevents the individuals from performing both tasks.

The Famous Three-way matching

Technology allows automation of the proverbial three-way match (invoices against purchase orders and goods/services receiving documents). All invoices that do not have the corresponding documents are kicked out for manual processing. Thus the automation handles the bulk of the transactions leaving humans to focus their attention on the remaining. This will help identify fraudulent transactions. The automation of the three-way match allows for detailed checking that is more difficult in a manual process. Nowadays most of the software used for handling these functions.

A word of caution!!

Sometimes the built in control in the IT system could be over ridden by the users using their access privileges. One such case handled while auditing IT security in SAP system of one of the UN organisations in October 2006 is given below.

Audit Observation

The main control feature in SAP in procurement function is linkage between Invoice, Goods receipt and Purchase Order before the payment is released. A review of a sample of procurements made during the period of audit revealed a case where this control was bypassed resulting in over-payment. The case details are as under.

A purchase order (No 4500004468 line item 00010 Renewal Blackberry) dated 24.4.2006 with Goods Receipt(GR) No. 5000008608 for GBP 1800 was cleared against 2 invoices No. 5105610645 for GBP 933.23 and No. 5105610956 for GBP 900.00, for payment, adding up to an excess of 33.23 GBP over the GR.

Management's response

"There appear to be an error in splitting the invoice and resultant overcharge. While the global position remained within bounds, the matching against the first GR was not correct. The system would have blocked this item for payment pending manual release, which would have been made following a review of the overall position on the Purchase Order and that this was clearly an exception to the normal pattern of matching, and would be reviewed with the staff involved to determine how the controls may be further enhanced."

4) If a control is not present, a conflict of duties may be present.

Likely Risks/Vulnerabilities

1. Controls over additions and changes to the Master Vendor List are often weak. In some cases a phone call from a department manager is all that's required. In other cases, the purchasing agent is able to add names to the vendor list. Such changes in the Master Vendor List rarely produce an exception report. See the flow chart given at annexure (iii) for understanding the methodology of purchase agent (employee) fraud.

2. Due diligence on new vendors is often minimal.

3. Auditing controls surrounding vendors who supply "consulting" services or advertising services are often weak.

4. Cost considerations have resulted in lower staffing levels, decreased separation of duties, over-reliance upon computerized systems, and increased volume of transactions.

5. In order to reduce costs, companies often forego costly pre-employment screening. As a result, individuals might be hired who have less than desirable backgrounds.

6. Most *A/P* and Purchasing systems do not produce automatic exception reports that result in "red flag" notifications to auditors and managers. Instead, the variance reports that are available must be requested and then analyzed.

7. Computer access controls and user right and responsibilities are often weak, thereby permitting compromise of the systems. See the following box for more information.

8. With the increase in computerization and integration of systems, Receiving personnel often have access to the computerized purchase order and can view it on line. In such instances, Receiving personnel can record receipt of items that

matches the purchase order, rather than having to conduct a "blind count" and merely documenting the results. This increases the risk of counts not being made, or theft of overages in shipments.

9. In almost all systems procedures exist for issuing cheques in an emergency that allow controls to be by-passed.

10. Most computerized purchasing systems allow critical information to be changed after a purchase order is written without producing an audit trail or exception report, e.g., unit price, quantity.

11. Collusion between employees and vendors, with the vendor giving kickbacks to the employee, is a frequent event and often difficult to detect if the employee is in a key position.

Controls required

a) PURCHASING:

1. Purchasing policies and procedures have been incorporated into a written document.

2. Levels of authority have been published throughout the organization that specify who is permitted to approve purchases, for what items, and for what amount.

3. Approved purchase requests are required for all purchases over a specified rupee amount.

4. A numbered purchase order system has been implemented and is followed. The numbers are secured against unauthorized access and use.

5. An approved vendor list has been established and only authorised individuals are permitted to edit the Vendor Master database.

6. Persons authorized to approve purchases or issue purchase order numbers should not able to make changes to the approved vendor list.

7. Competitive bids are required for all purchases over a specified rupee amount.

8. Purchasing personnel may only offer or accept nominal gratuities.

9. Purchasing databases and/or bills of lading are immediately documented with the details of all goods received.

10. Received property is added to inventory records as soon as possible.

11. Bills of lading and signed receipts for goods are forwarded to Accounts Payable within one business day.

b) ACCOUNTS PAYABLE

A variety of checks against abuse are usually present to prevent embezzlement by Accounts Payable personnel. Separation of duties is a common control. Nearly all companies have a junior employee process and print the cheque and a senior employee review and sign the cheque. Often, the accounting software will limit each employee to performing only the functions assigned to them, so that there is no way any one employee, even the controller, can single handedly make a payment.

A segregation of duties chart given at annexure (i) may be seen for

more information.

1. Accounts Payable policies and procedures have been incorporated into a written document. The document is current and contains all essential control elements contained herein.

2. Bills of lading for goods received are matched against the invoice and the approved purchase order.

3. Invoices are not paid for partial shipments. Adequate controls are in place to ensure partial shipments are not paid.

4. Accounts payable staff members have "read only" capability on purchase order screens for on-line systems. They cannot modify vendor name, payment address, item, quantity, price, or

Tips for detecting signs of frauds committed by the Accounts Payable wing

Step one

Look for transactions that are out of the ordinary. These would include transactions that take place in the middle of the night, a point of sales transactions.

Step two

Note any accounting discrepancies. At the end of the month, check for overstated or understated account balances. Examine any out of place entries such as last minute adjustments to vendor accounts. Finally look for records and transactions that aren't supported with a receipts or an explanation.

Step Three

Uncover suspicious activity in your accounts receivable ledger. Note the number of voids and credits made. Excessive voids can indicate fraud. Also examine the check record for gaps in your check registry. Review your bank statement for gaps, duplicate check numbers and other suspicious activity.

Step Four

Evaluate the behavior of your accounts payable employees. Employees quitting suddenly without reason can be a red flag for fraud.

specifications.

5. Accounts payable staff has no capability to modify approved vendor lists.

6. Procedures are in place to follow-up on unmatched open purchase orders, receiving reports, and invoices; and to resolve missing, duplicate, or unmatched items.

7. Cheques used by *A/P* staff are adequately secured and under dual control. Keys to the cheque storage area are not kept on the premise.

8. All boxes of blank cheques remain sealed until required to be open for daily use.

9. All cheques used by the *A/P* department are consecutively numbered.

10. A perpetual inventory is kept of all blank cheques stored and used by the *A/P* department. Unused cheques from the daily supply are returned to the inventory and accounted for.

11. Adequate controls are in place to prohibit the payment of duplicate invoices.

.

12 Monthly inventories of blank cheques are conducted under dual control. The results of the physical inventory are reconciled with the perpetual inventory.

13. Levels of authority have been established for cheque signing, including when dual signatures are required; the established levels appear reasonable for the type of business.

14. Persons signing cheques are presented with the documentation to support the cheques (i.e., bill of lading, invoice, or statement).

15. Daily reconciliation is made between the cheques written, cheques voided, the cheque inventory, and (where possible) the computer record of all cheques issued. A supervisor or manager that is independent of the *A/P* staff member(s) who processes invoices for payment performs the reconciliation.

16. If mechanical cheque signers or signature plates are used, the equipment is properly secured under dual control when not in use.

17. Access to the Accounts Payable software program is properly restricted and controlled.

18. Emergency payments requiring handwritten cheques are not processed by Accounts Payable personnel. Supervisory personnel must be involved and the process should be fully supported with adequate documentation.

19. A monthly reconciliation of the cheques account used by Accounts Payables is performed; a person who has no access to cheques, signature plates, or Accounts Payable software programs conducts the reconciliation.

20. The perpetual inventory should be designed and documented so that at any point in time a physical inventory can be easily conducted and all blank cheques, including working stock, can be accounted for readily.

21. It is essential that the daily reconciliation be performed and that it is independent. A common weakness is the relegation of the

reconciliation function to the same person who writes the cheques.

Some Compensatory Controls

1. If a master vendor list is developed and maintained outside an automated system, access to the list must be extremely limited and tightly controlled. If the list is kept on a PC hard drive or a network file server, the file should be password protected and encrypted if possible. Any hard copies of the list should be kept in a burglary resistant storage container that is locked at all times. Similarly, documentation supporting changes to the master vendor list (i.e. the due diligence results, etc.) should be comparably protected. This list should be subject to scheduled and unannounced audits by management and the auditing department.

2. If purchase order numbers are developed and maintained outside an automated system, access to the numbers should be controlled the same as the master vendor list and the issuance of the numbers subject to similar audit procedures.

3. Where purchasing authority is not centralized, some of the compensatory measures are as follows:

   Policies and procedures must be developed from a centralized source, e.g., Finance Department. The policies must contain direction on the following as a minimum: levels of purchasing authority, who must approve what types of contracts for goods and services and at what rupee level, procedures for

3. Common Red flags & Anti-fraud measures in Procurement and Accounts Payable process[1]

Sr No.	Red flags (Fraud indicators)	Anti-fraud measures	
		Preventive	Detective
1.	An employee has set a fictitious vendor.	Restrict Vendor creation role to a selected few. See annexure (iii) to understand the methodology followed in a typical case.	Merge vendor file & employee file by the following variables to identify fictitious vendors. • Address • PAN No. • Phone No. • Bank Account No.
2.	Multiple Vendors and remittance addresses for the same vendor.	Reduce the number of suppliers to only key strategic sourcing partnerships to negotiate better payment terms while decreasing the risk of frauds. Maintain vendor database integrity in computerized systems. Naming conventions must be followed to avoid redundancy.	Marge the database containing PAN with the Names & addresses. This leaves redundant addresses.
3.	Sequential invoice numbers from the same vendor or invoice numbers with an alpha suffix.	While processing, check sales tax numbers, PAN No. etc., given by vendors & check those numbers on those invoices which are of doubtful nature.	Check address of office and telephone Nos (residential & official) on all such invoices. When payments were made by cheques verify address at which cheques were sent and whether any letters were received from such vendors and if so examine those letters to detect any mischief.

1 See annexure (ii) for red flags of other areas.

4.	Payments to vendor have increased dramatically for no apparent reason.	Implement Payment Budget for each function and review it periodically.	Check whether receipt of material was checked for quantity and quality independently. Verify its entry in the stock register, bin card & issue, if any.
5.	Lack of segregation of duties between the following: • Processing of accounts payable invoice and updates • Creation of vendor master files • Cheque preparation and posting to vendor account • Cheque preparation and mailing of signed cheques	Ensure that appropriate segregation of duties exit between th personnel performing the roles of placing purchase order, invoice receipt, goods receipt and releasing payments. In case of smaller organizations, built appropriate compensating controls in the form of checking by an independent person at periodical intervals. Management must play a pro-creative role in setting these controls. See annexure (i) for additional information.	Tabulate the role-wise functions being performed by various functionaries using with the help of MS Access or any RDBMS software and bring out conflict, if any, using 'set relation to' function available in this reference.
6.	No documentation of additions, charges, or deletions to vendor master file.	As far as possible, the functions of creation of vendor master database and changes thereof is done centrally or restricted to a chosen few and appropriate documentation is maintained. Whenever vendor master list is edited, it has to have explicit approval of the component authority.	In computerized systems, generate a list of the most recent additions or deletions to the vendor master database and look for relevant authorizations.

7.	Excessive credit adjustments to a particular vendor and/or credit issued by unauthorized department (credits involving quantities and price.)	Credit adjustments are allowed to be carried out by authorized departments only and wherever they are carried out appropriate documentation is maintained.	Trace back to relevant authorizations and authenticity of the vendors and the departments that carried out the adjustments.
8.	Systematic pattern of adjustments to accounts payable for goods returned.	Document reasons for return. If the goods were below the set standard, mention should be made in the Sales Return Book, Stock Register, and Bin Card.	Verify whether payments made were genuine and goods were actually received.
9.	No reconciliation performed of accounts payable sub ledger to general ledger control accounts. Lack of documentation for payment of invoices.	Periodical reconciliation by authorized individuals and verification of discrepancies.	Trace the items to general ledger control account to identify discrepancies, if any.
10.	Lack of documentation for payment of invoices.	Keep Payment Advice as a separate document from the Invoices, which gives all the payment validation.	Select payment advices to trace them to the concerned invoices, goods receipts and purchase orders
11.	Payments made on copies of invoices, not originals.	Payment on Duplicate Invoices to be allowed only by competent authorities. Check in cash book to ensure that the same amount has not appeared in payment side of cash.	Check the sources of duplicate invoices. Check whether material mentioned therein was entered in stores/stock register & certificate to that order made by Accounts & Finance Department. Mathematical algorithms using vendor number, invoice number, invoice date, and invoice amount could be used to extract duplicates.

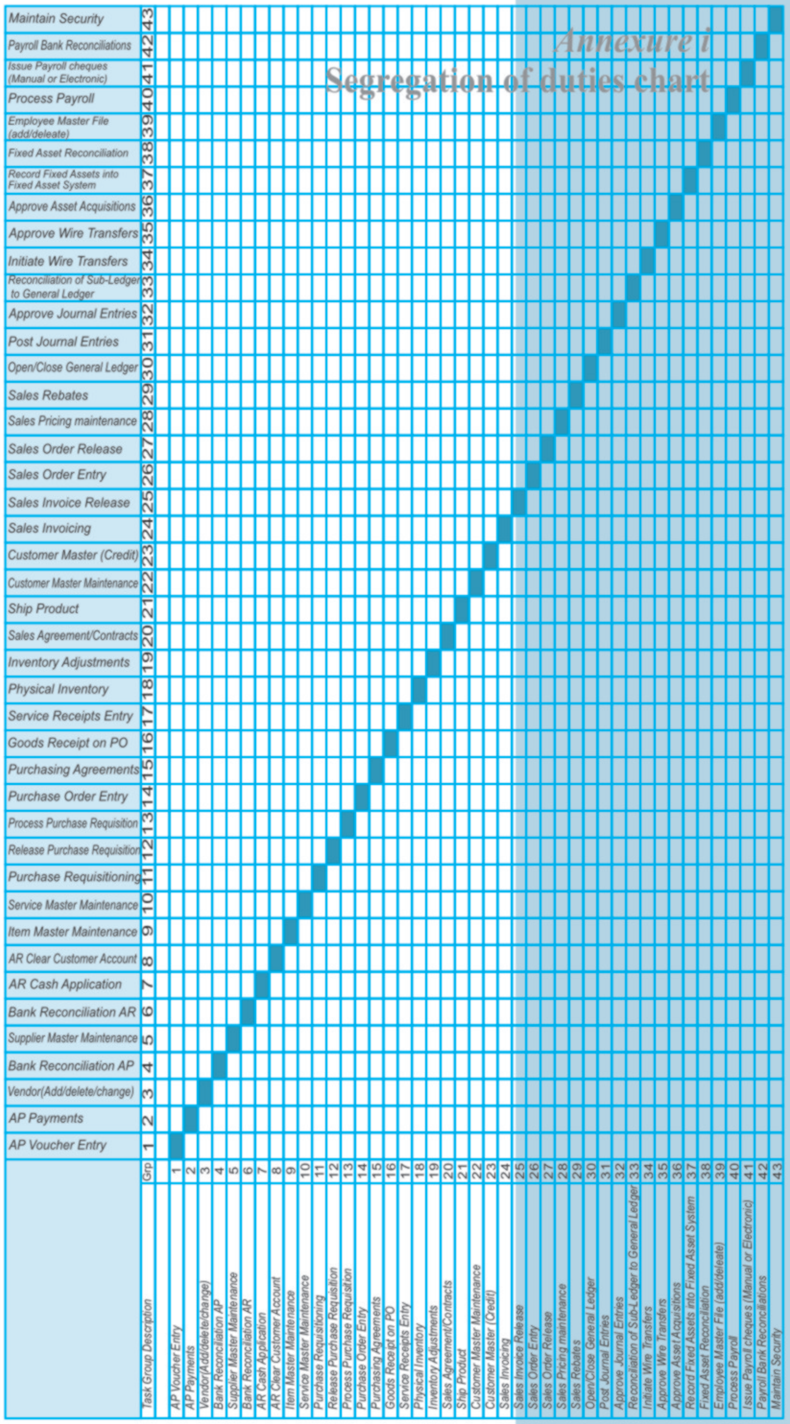
12.	Paid invoices not properly cancelled, allowing for reprocessing.	Paying authority must ensure defacing the invoice before signing the payment advice.	Select the paid invoices to look for appropriate defacing as a mark of payment made.
13.	High volume of manually prepared disbursement cheques.	Restrict the process of manual preparation of disbursement for contingent situations only. Build in appropriate compensating control for verification by personnel other than those who were involved in the process .	Select manually prepared cheques to trace relevant authorisations.
14.	Missing or easy access to blank cheques, facsimile and manual cheque preparation machines.	Every cheque book should be issued to competent authority & acknowledgement taken. No fresh cheque book should be issued unless old one is fully used. All these cheque books should be kept under lock & key. Signature plates & cheque signing equipment should be kept in the custody of competent authority & immediately after its use it should be returned for safe custody.	Compare the cheque numbers & cheque book number of the last cheque issued with reference to counterfoil of cheque & concerned voucher & ensure that blank cheques beyond that number were in the cheque book.
15.	Invoices with rounded off amounts.	In case of computerized systems, build in appropriate input controls to prevent rounding off. In cases where rounding off is authorised, generate exception reports through Reports module to verify the circumstances and the impact.	Calculate each vendor's number of rounded-amount invoices and divide it by the total no of invoices for that vendor, obtaining the percentage. Then rank by descending percentage to review the most suspicious vendors first.

16.	Invoices just below approval amounts	Set a limit (no. of occasions) upto which such limits are allowed in a day/ week/ month and the system should generate exception reports automatically for further scrutiny	Identify invoices that are 3% (or less) LESS THAN the approval amount. For example; if the Manager's approval amount is Rs.10,000/- then any invoices that is between Rs.9700 and Rs.9999 would be flagged as suspicious.
17.	Abnormal invoices volume activity	Set a threshold percentage (200% or 300% etc.) setting minimum number of records that you are interested in.	To calculate percent increase invoices from month to next month, find the difference in the number of invoices and then divide by the number of invoices in the first month. For ex: In case of invoices going from 2 to 7 in case of vendor, the difference (68) divided by the number of invoices in the first month (2) represents a 3,400% increase. Setting the threshold at 300% will catch the increases.
18.	Vendors with cancelled or returned cheques.	Cancelled cheques are usually legitimate transactions; however, a cancelled cheque can be returned to wrong hands and re-written to the fraudster. Build in a control mechanism for their accounting and custody.	Calculate the number of cancelled or returned cheques for each vendor and divide by the total number of cheques for that vendor. Then, sort this list by descending percent so that your most suspicious vendors are at the top of the report.
19.	Employees never proceeded on leave/ training or never transferred.	Set appropriate policies to encourage staff holding sensitive posts to proceed on vacation. Ensure that certain % of the staff (may be 1/3rd) is trained on the areas of their working annually.	Generate a report from the HR module of the system to get a list of employees who were never transferred from their seats or proceeded on leave over a period of time say 3 years or 5 years based on the nature of risk involved.

<table>
<tr>
<td>20.</td>
<td>Duplicate payments</td>
<td>Weed out duplicate vendors from the vendors master data which is the number one cause for duplicate payments.
Set appropriate input controls in the software used for processing payments.
Set a policy to discourage payments based on duplicate invoices.</td>
<td>Develop an accurate & comprehensive duplicate payments report.
Implement the 5 basic dupe searches.
<table>
<tr><th>Report</th><th>Vendor</th><th>Invoice</th><th>Invoice Date</th><th>Invoice Amount</th></tr>
<tr><td>EEEE</td><td>Exact</td><td>Exact</td><td>Exact</td><td>Exact</td></tr>
<tr><td>EEED</td><td>Exact</td><td>Exact</td><td>Exact</td><td>Different</td></tr>
<tr><td>EEDE</td><td>Exact</td><td>Exact</td><td>Different</td><td>Exact</td></tr>
<tr><td>EDEE</td><td>Exact</td><td>Different</td><td>Exact</td><td>Exact</td></tr>
<tr><td>DEEE</td><td>Different</td><td>Exact</td><td>Exact</td><td>Exact</td></tr>
</table>
A programme in your IT department will be able to help you with the SQL code for these joins. The SQL code will look something like this to create the first report “EEEE”.
CREATE TABLE DUPES_EEEE AS
SELECT A.*
FROM INVOICES A, INVOICES B
WHERE A.VENDORID=B.VENDORID AND
A.INVOICENUM=B.INVOICENUM AND
A.INVOICEDATE=B.INVOICEDATE AND
A.INVOICEAMT=B.INVOICEAMT AND
A.ID<>B.ID
The ID should be a unique record identifier to distinguish one record from another. In Microsoft Access, these fields are usually created by using the data type “AutoNumber”. In open code, a field such as this can be easily created using a counter and incrementing it by 1 for every record (COUNTER = COUNTER +1).</td>
</tr>
</table>

Annexure i

Segregation of duties chart



Annexure ii

Representative examples of symptoms or red flags

Payroll Process

- Dramatic increase in labor force or overtime not justified by production or sales volume.
- Turnover within the payroll department significantly exceeds attrition rates throughout the organization.
- Missing or easy access to blank cheques, facsimile, and manual cheque preparation machine.
- Tax deposits are substantially less than those required by current payroll expenses.
- High volume of manually prepared payroll cheques.

Cash Receipts Process

- Improper safeguarding of cash under lock and key.
- No segregation of duties between the following:
- *Receiving cash and posting to customer accounts*
- *Issuing receipts and deposit preparation*
- Infrequent bank deposits, allowing cash to accumulate.
- Consistent shortages in cash on hand.
- Consistent fluctuations in bank account balances.
- "Closing out" cash drawer before end of shift.
- Excessive number of voided transactions on a regular basis without proper explanation.
- Missing copies of pre-numbered receipts.
- Not balancing cash to accounts receivable subledger.
- Insufficient supervisory review of cashier's daily activity.

Accounts Receivable Process

- Lack of accountability for invoice numbers issued.
- Lack of segregation of duties between the following:
- *Processing of accounts receivable invoices and posting to subledger*

- *Posting to accounts receivable subledger and cash receipts.*
- Lack of policies and procedures regarding write-offs to satisfy industry standards.
- Frequent undocumented and/or unapproved adjustments, credits, and write-offs to accounts receivable subledger.
- Low turnover or slow collection cycle for accounts receivable.
- Dramatic increase in allowance for doubtful accounts in view of positive economic events and stringent credit policies.
- No reconciliation of accounts receivable subledger to general ledger control account.
- Insufficient supervisory review of accounts receivable activity as well as customer account aging schedule.
- Unrestricted access to subledgers and general ledger.

Inventory/Production Process

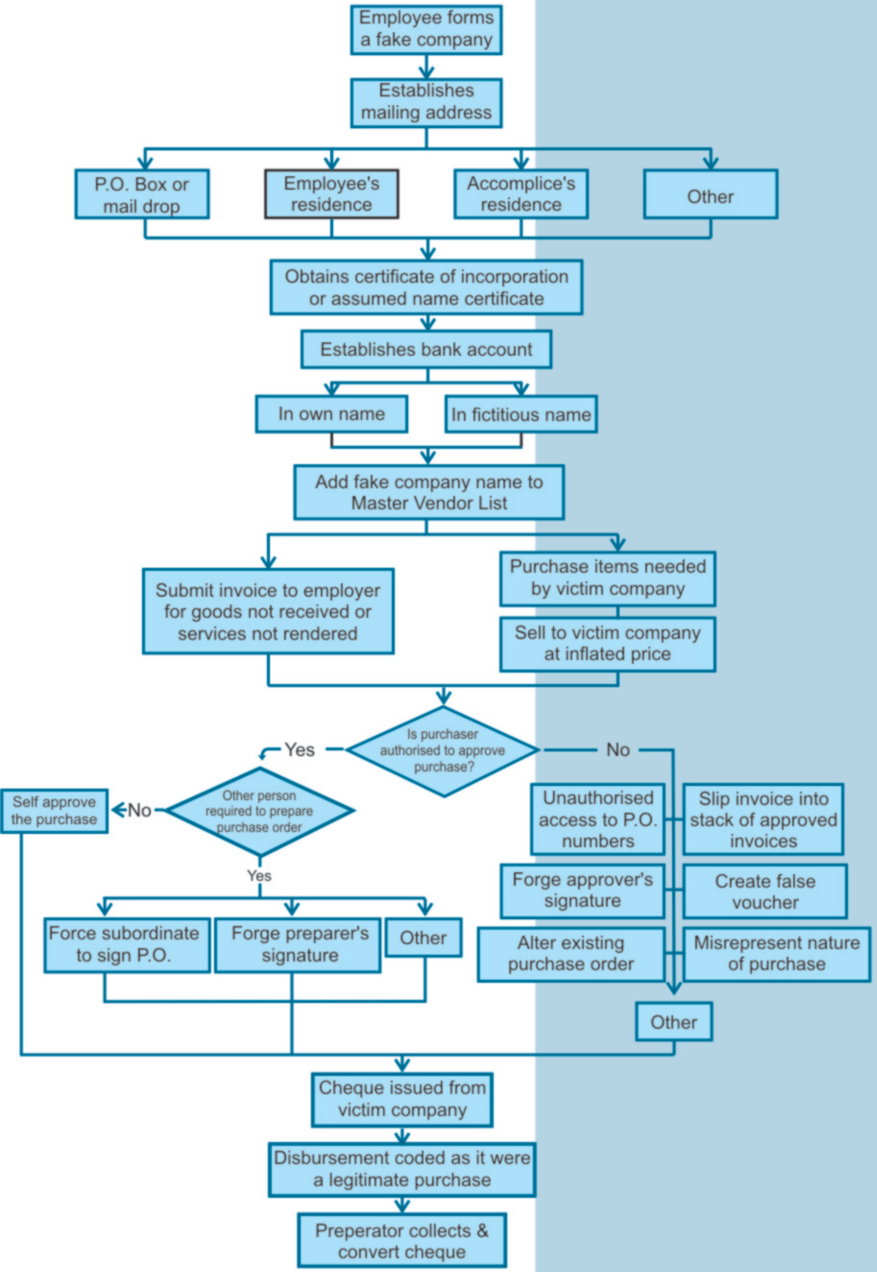
- Credit balances in inventory accounts.
- Consistent fluctuations in inventory accounts between months (e.g. debit balance one month, credit balance the next).
- Excessive inventory write-offs without documentation or approvals.
- Unusual volume of adjustments, write-offs, and disposal of material, inventory, or fixed assets.
- Unrestricted access to inventory storage areas by non-responsible employees and/or vendors.
- Significant weaknesses in inventory cut-off procedures.
- No policy regarding identification, sale, and disposal of obsolete and surplus materials.
- Finished goods inventory turnover rate does not correlate with operating cycle.
- No segregation of duties between:
- *Receipt of inventory and issuing of materials*
- *Recording of inventory accounts and ordering materials*
- *Identification of obsolete and surplus materials and sale and disposal of such materials.*
- There is no policy regarding inventory levels to be
- maintained (i.e., minimums, maximums, reorder points).

- Systematic pattern of improperly labeled inventory and raw materials.
- Poor review of inventory accounts, write-offs, and physical access to storage areas.
- Lack of regular physical inventories carried out by independent personnel.
- Consistent production overruns beyond sales demand and backlog orders.
- Excessive production waste, spoilage, or other loss of raw materials.
- Physical replacement of finished goods within production area beyond a reasonable period of time.
- Abnormal expenditures for external maintenance services beyond normal repairs and capability of internal repair service personnel.
- Extended delay of goods marked "for shipment" maintained within shipping area.

Finance Process

- Significant adjustments to accrued liabilities, accounts receivable, contingencies, and other accounts prior to acquisition of new financing.
- Dramatic change in key leverage, operating, and profitability ratios prior to obtaining financing.
- Adopting a change in accounting principle or revising an accounting estimate prior to obtaining financing.
- Increase in short-term cash and a decrease in receivables while sales are increasing prior to seeking new financing.
- A change in external activities, legal counsel, or treasury department head prior to obtaining new financing.
- A delay in issuance of monthly, quarterly, or annual financial reports prior to seeking new financing.

Annexure iii
Methodology of employee fraud



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