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Fraud in Local Government

September 2019

Missouri Municipal League
Growing Our Communities Together

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Learning Objectives

- Occupational Fraud Categories & Schemes
- Findings from the ACFE 2018 Report to the Nations on Fraud
- Keys to Fraud Prevention and Detection
- How to Conduct a Fraud Risk Assessment in Local Government

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Occupational Fraud Categories and Schemes

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What is Occupational Fraud?

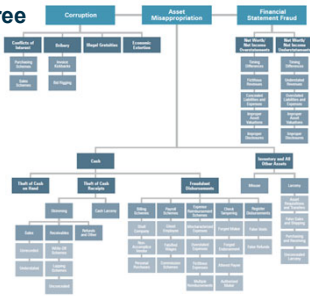
Use of one's occupation for personal enrichment through the deliberate misuse or application of the employing organization's resources/assets.

Three general categories:

1. **Asset misappropriation** - Employee steals or misuses an organization's resources.
2. **Corruption** - Employee's use of influence in business transactions in a way that violates duty to the employer for the purpose of obtaining benefit for self or someone else.
3. **Financial statement fraud** - Intentional misstatement or omission of material information in the organization's financial reports.

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ACFE Fraud Tree



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Examples

- Director of Finance embezzled over \$4 million through wire transfers to personal bank accounts.
- Director of Procurement reaped nearly \$1.3 million from services that were never provided by her company by falsifying records.
- The CEO of a nonprofit focused on "at risk" children from low-income households received federal grant funding and electronically submitted fraudulent claims (over \$250k) for reimbursement based on inflated attendance figures.
- Former deputy used some of the police-dog nonprofit group's funds between 2010 and 2015 to make payments on his personal credit card, to pay cable and cellphone bills, and make purchases at stores and restaurants.
- Technology Director defrauded organization of more than \$1 million by accepting kickbacks from vendors.

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Findings from the ACFE 2018 Report to the Nations on Fraud

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2018 ACFE Fraud Study – Key Findings

- Estimated organizations lose 5% of annual revenue to fraud.
- Asset misappropriation was most common, occurring in 89% of cases with median loss of \$114,000.
- Financial statement fraud was least common, but most costly with median loss of \$800,000.
- Fraud lasted a median of 16 months.
- Occupational frauds are most likely to be detected by tips (40%).
- Fraud perpetrators often display warning signs.
- Organizations that implanted anti-fraud controls realized lower fraud losses.
- Data monitoring/analysis and surprise audits were correlated with the largest reduction in fraud loss.

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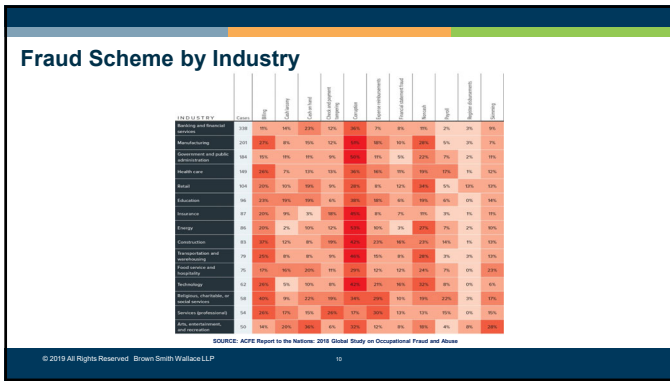
How Does Fraud Affect Industries?

Banking and financial services 36% MEDIAN LOSS: \$110,000	Manufacturing 21% MEDIAN LOSS: \$240,000	Government and public administration 20% MEDIAN LOSS: \$125,000	Health care 19% MEDIAN LOSS: \$100,000	Retail 18% MEDIAN LOSS: \$50,000	Real estate, construction, and insurance 17% MEDIAN LOSS: \$88,000	Nonprofit 16% MEDIAN LOSS: \$100,000	Education 15% MEDIAN LOSS: \$180,000
Business 14% MEDIAN LOSS: \$153,000	Transportation and logistics 13% MEDIAN LOSS: \$140,000	Energy 12% MEDIAN LOSS: \$300,000	Construction 11% MEDIAN LOSS: \$227,000	Food service and hospitality 10% MEDIAN LOSS: \$90,000	Telecommunications 9% MEDIAN LOSS: \$150,000	Religious, nonprofit, or social services 8% MEDIAN LOSS: \$90,000	Service (professional) 7% MEDIAN LOSS: \$258,000
Transportation and logistics 6% MEDIAN LOSS: \$140,000	Food service and hospitality 5% MEDIAN LOSS: \$90,000	Technology 4% MEDIAN LOSS: \$150,000	Religious, nonprofit, or social services 3% MEDIAN LOSS: \$90,000	Service (professional) 2% MEDIAN LOSS: \$258,000	Agriculture, forestry, fishing, and hunting 1% MEDIAN LOSS: \$136,000	Utilities 1% MEDIAN LOSS: \$150,000	Wholesale trade 1% MEDIAN LOSS: \$110,000

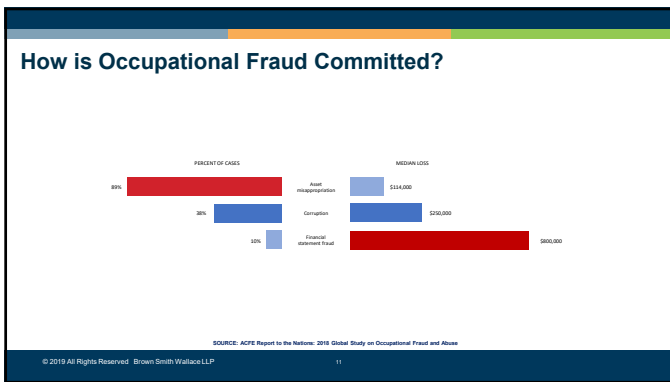
SOURCE: ACFE Report to the Nations 2018 Global Study on Occupational Fraud and Abuse

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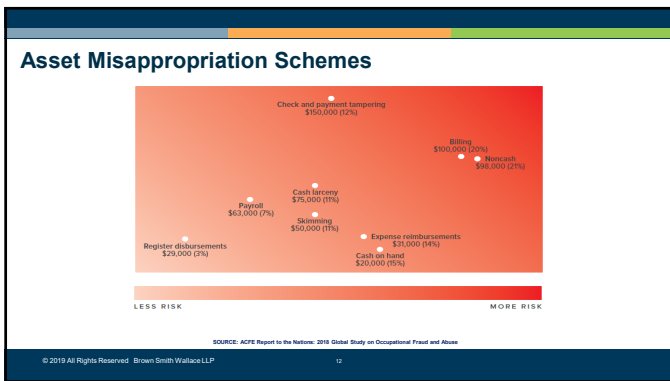
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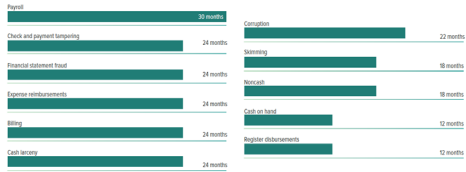


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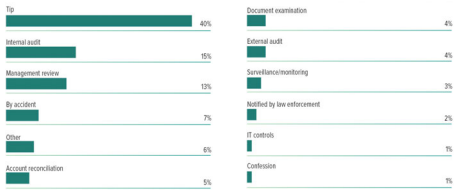
How Long Do Different Schemes Last?



SOURCE: ACFE Report to the Nations: 2018 Global Study on Occupational Fraud and Abuse

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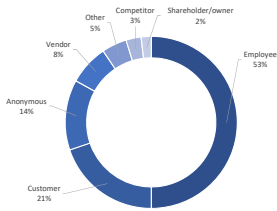
How is Operational Fraud Detected?



SOURCE: ACFE Report to the Nations: 2018 Global Study on Occupational Fraud and Abuse

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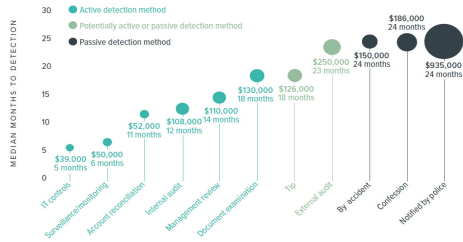
Who Reports Operational Fraud?



SOURCE: ACFE Report to the Nations: 2018 Global Study on Occupational Fraud and Abuse

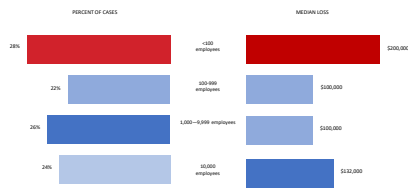
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How Does Detection Method Relate to Loss?



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How Does Size Relate to Fraud Risk?



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How Do Anti-Fraud Controls Relate to Loss?

Control	Percent of cases	Control in place	Control not in place	Percent reduction
Code of conduct	80%	\$180,000	\$250,000	56%
Proactive data monitoring/analysis	37%	\$ 80,000	\$185,000	52%
Surprise audits	37%	\$ 75,000	\$182,000	51%
External audit of internal controls over financial reporting	67%	\$100,000	\$200,000	50%
Management review	66%	\$100,000	\$200,000	50%
Hotline	63%	\$100,000	\$200,000	50%
Anti-fraud policy	54%	\$100,000	\$180,000	47%
Internal audit department	73%	\$108,000	\$200,000	46%
Management certification of financial statements	72%	\$100,000	\$192,000	47%
Fraud training for employees	53%	\$100,000	\$189,000	47%
Formal fraud risk assessments	47%	\$100,000	\$182,000	38%
Employee support programs	54%	\$100,000	\$180,000	38%
Fraud training for managers/supervisors	52%	\$100,000	\$183,000	36%
Dedicated fraud department, function, or team	47%	\$100,000	\$180,000	33%
External audit of financial statements	30%	\$100,000	\$170,000	29%
Job rotation/mandatory vacation	39%	\$100,000	\$158,000	23%
Independent audit committee	61%	\$120,000	\$150,000	20%
Rewards for whistleblowers	12%	\$110,000	\$125,000	12%

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How Does Level of Authority Relate to Fraud?



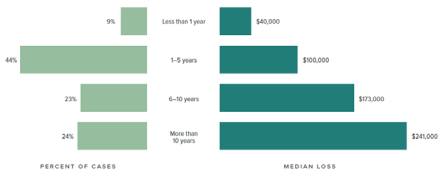
SOURCE: ACFE Report to the Nations: 2018 Global Study on Occupational Fraud and Abuse

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How Does Tenure Relate to Fraud?



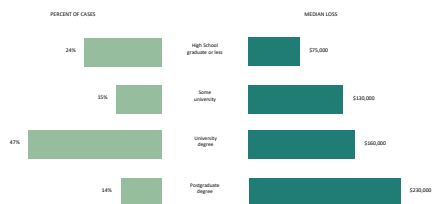
SOURCE: ACFE Report to the Nations: 2018 Global Study on Occupational Fraud and Abuse

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How Does Education Level Relate to Fraud?

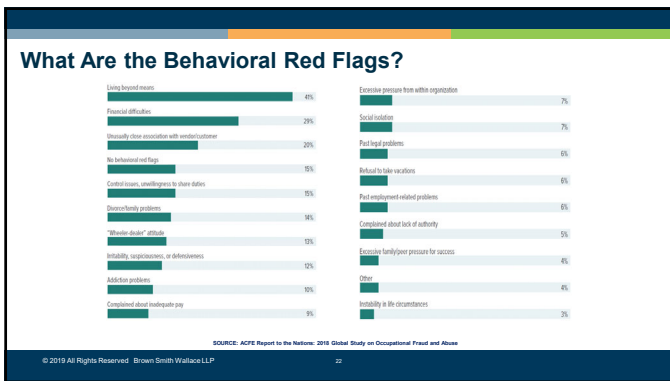


SOURCE: ACFE Report to the Nations: 2018 Global Study on Occupational Fraud and Abuse

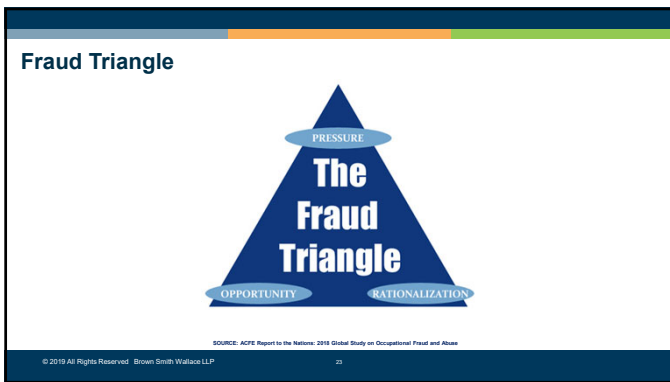
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Keys to Fraud Prevention and Detection

SOURCE: ACFE Report to the Nations 2018 Global Study on Occupational Fraud and Abuse

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#1 – Establish a Fraud Risk Governance Program

- Make an organizational commitment to fraud risk management.
- Establish a comprehensive fraud risk management policy.
- Establish fraud risk governance roles and responsibilities.
- Document the fraud risk management program.
- Communicate fraud risk at all organizational levels and train.
- Implement a Fraud Hotline.

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#2 – Conduct a Fraud Risk Assessment

- To Be Discussed in our next section

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#3 – Implement Fraud Prevention and Detection

- Promote fraud deterrence through preventative and detective control activities.
- Integrate with the fraud risk assessment.
- Consider organization-specific factors and relevant business processes.
- Consider the application of control activities to different levels of the organization.

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#3 – Implement Fraud Prevention and Detection

- Utilize a combination of fraud control activities.
 - Preventative controls (e.g., Segregation of duties, limited system access, etc.)
 - Detective controls (e.g., Bank reconciliations, surprise cash counts, etc.)
 - Human Resource Procedures (e.g., Background investigations, segregation of duties, Whistleblower System, etc.)
- Consider management override of controls.
- Use proactive data analytic procedures.
- Deploy control activities through policies and procedures.

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#4 – Conduct Fraud Investigations & Take Corrective Action

- Establish fraud investigation and response protocols
- Conduct investigations
- Communicate investigation results
- Take corrective action
- Evaluate investigation performance

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#5 – Monitor Fraud Risk Management

- Consider a mix of ongoing and separate evaluations.
- Consider factors for setting scope and frequency of evaluations.
- Establish appropriate measurement criteria.
- Consider known fraud schemes and new fraud cases.
- Evaluate, communicate, and remediate deficiencies.

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How to Conduct a Fraud Risk Assessment in Local Government

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Fraud Risk Assessment

- Include elected offices, departments/divisions, operating units, and functional levels.
- Analyze internal and external factors related to ACFE Fraud categories and schemes.
- Consider using a survey tool or questionnaire.
- Consider various types of fraud.
- Consider the risk of management override of controls.
- Estimate the likelihood and significance of risks identified.

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Fraud Risk Assessment

- Assess personnel/departments involved and the fraud triangle.
- Identify existing fraud control activities and assess their effectiveness.
- Determine how to respond to risks.
- Perform periodic reassessments and assess changes to fraud risk.
- Document the risk assessment.
- Consider risk assessment when planning your audits.

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Examples of Fraud Risk Assessment General Survey Questions

- Does City management exhibit and encourage ethical behavior?
- Does City management educate employees about the importance of ethics and anti-fraud programs?
- Does City management provide an anonymous way to report suspected fraud and ethics violations?
- Do any key employees have an unusually close association with vendors or contractors?
- Do any key employees have outside business interests that might conflict with their duties?

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Examples of Fraud Risk Assessment General Survey Questions

- Are any key employees experiencing financial pressures, such as debts, gambling, medical, or divorce?
- Do any key employees appear to be living beyond their means?
- Do any key employees have a criminal conviction?
- Do any key employees have friends/relatives reporting directly to them?
- Has any key employee failed to take vacation?
- Does the City lack an internal control system to prevent or detect fraud?
- Does the City fail to enforce the existing internal controls?

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Examples of Fraud Risk Assessment General Survey Questions

- Does the City adequately restrict employee access to high value assets, such as: cash, equipment, vehicles, tools, supplies, etc.?
- Does the City adequately restrict employee access to computer systems with sensitive information?
- Do you have any concerns related to ethics or fraud at the City?
- Any other comments you would like to make concerning fraud risks at the City?

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Example of Fraud Risk Assessment Tool

Issue Area	Risk Likelihood Low: 1 Med: 2 High: 3	Risk Magnitude Low: 1 Med: 2 High: 3	Inherent Risk Assessment	Control Activity	Control Assessment/Deficiency		Overall Risk Assessment	Risk Priority	Deficiency	Recommendation
					Low: 1 Med: 2 High: 3	Low: 1 Med: 2 High: 3				
Asset Misappropriation - Theft of Cash on Hand										
Asset Misappropriation - Theft of Cash Receipts - Skimming (Cash stolen before recording in books - sales, invoices, refunds/credits)										
Asset Misappropriation - Theft of Cash Receipts - Cash Larceny (Cash stolen after recording in books)										
Asset Misappropriation - Fraudulent Disbursements - Check Tampering (Cash employer funds by intercepting, forging or altering a check drawn on the organization's bank account.)										
Asset Misappropriation - Fraudulent Disbursements - Cash Register (Employee makes false entries on cash register to conceal the fraudulent removal of cash.)										

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Example of Fraud Risk Assessment Summary

Potential Occupational Fraud Scheme	Occupational Fraud Risk								
	DEPT A	DEPT B	DEPT C	DEPT D	DEPT E	DEPT F	DEPT G	DEPT H	DEPT I
Asset Misappropriation - Theft of Cash on Hand	High	High	Low	Low	Low	High	Moderate	Low	Low
Asset Misappropriation - Skimming (Employee steals before recording in books - sales, invoices, refunds/credits)	High	High	Low	Low	Low	High	Low	Low	Low
Asset Misappropriation - Cash Larceny (Employee steals cash after recording in books)	High	High	Low	Low	Low	High	Low	Low	Low
Asset Misappropriation - Check Tampering (Intercept, forge or alter a check drawn on the organization's bank account.)	Low	Low	Low	Low	Low	Low	Low	Low	Low
Asset Misappropriation - Cash Register (Employee makes false entries on cash register to conceal the fraudulent removal of cash.)	High	High	Low	Low	Low	High	Low	Low	Low
Asset Misappropriation - Purchasing/Billing (Invoices for fictitious goods or services, inflated quantities or prices)	Moderate	Moderate	Low	Moderate	Moderate	Moderate	Low	Low	Low
Asset Misappropriation - Payroll (False time, inflated wages)	Moderate	Moderate	Low	Moderate	Moderate	Moderate	Low	Low	Low
Asset Misappropriation - Expense Reimbursements (Fictitious or inflated receipts)	Low	Low	Low	Low	Moderate	Moderate	Low	Low	Low
Asset Misappropriation - Inventory (False counts, theft)	High	High	Low	Low	Moderate	Low	Low	Low	Low
Asset Misappropriation - Fraud (Employee uses their position of organization to commit a crime)	High	Moderate	Low	Moderate	High	Low	Moderate	Low	Low
Asset Misappropriation - Supplier (Employee uses their position of organization to commit a crime)	Low	Low	Low	Low	Low	Moderate	Low	Low	Low
Corruption - Bribery	Low	Low	Low	Low	Low	Moderate	Low	Low	Low
Financial Statement Fraud -	Low	Low	Low	Low	Low	Moderate	Low	Low	Low
Financial Statement Fraud -	Low	Low	Low	Low	Low	Moderate	Low	Low	Low
Asset Misappropriation -	Low	Low	Low	Low	Low	Moderate	Low	Low	Low

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Speaker Bio and Contact Information



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Ron is a Partner in the Advisory Services group of Brown Smith Wallace and leads the Public Sector Industry Group. With over 20 years of experience, he focuses on internal controls, internal audit, business process improvement, enterprise risk management, fraud and forensic prevention and detection and investigation, and Sarbanes-Oxley compliance. His expertise spans a variety of industries, including government, manufacturing, retail, telecommunications, and construction.

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