Fraud Issues in Local Government

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In normal circumstances, all three factors must be present

- Pressures
- Opportunity
- Rationalization
Internal control is a process, effected by an entity’s board of directors, management, and other personnel, designed to provide REASONABLE ASSURANCE regarding the achievement of objectives of operations, financial reporting, and compliance.
Inherent Limitations

- Human judgment can be faulty
- Internal control designers consider cost and benefits
- Human failures
- Circumvented by collusion
- Management override of controls
- No Guarantees, only reasonable assurance
# Risk Assessment

## Risk Assessment Matrix 1. Risk Identification and Analysis by Account and Disclosure

<table>
<thead>
<tr>
<th>Financial Statement Account/ Disclosure</th>
<th>As % of Total</th>
<th>Impact on F/S</th>
<th>Account Characteristics</th>
<th>Business Process Characteristics</th>
<th>Fraud Risk</th>
<th>Entity-wide Factors</th>
<th>Overall Rating</th>
<th>Significant Assertions³</th>
</tr>
</thead>
<tbody>
<tr>
<td>BALANCE SHEET</td>
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<td></td>
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<tr>
<td>Assets</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash &amp; Cash Equivalents</td>
<td>6%</td>
<td>M</td>
<td>H</td>
<td>M</td>
<td>H</td>
<td>M</td>
<td>H</td>
<td>✓</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td>30%</td>
<td>H</td>
<td>H</td>
<td>H</td>
<td>L</td>
<td>H</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Prepaid Expenses</td>
<td>4%</td>
<td>L</td>
<td>M</td>
<td>L</td>
<td>L</td>
<td>L</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Inventory</td>
<td>35%</td>
<td>H</td>
<td>M</td>
<td>M</td>
<td>M</td>
<td>L</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Property &amp; Equipment</td>
<td>15%</td>
<td>H</td>
<td>L</td>
<td>L</td>
<td>L</td>
<td>L</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Intangible Assets</td>
<td>10%</td>
<td>H</td>
<td>M</td>
<td>M</td>
<td>M</td>
<td>M</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Total Assets</td>
<td>100%</td>
<td></td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounts Payable</td>
<td>25%</td>
<td>H</td>
<td>H</td>
<td>L</td>
<td>M</td>
<td>L</td>
<td>M</td>
<td>✓</td>
</tr>
<tr>
<td>Accrued Expenses</td>
<td>15%</td>
<td>H</td>
<td>M</td>
<td>M</td>
<td>H</td>
<td>L</td>
<td>H</td>
<td>✓</td>
</tr>
<tr>
<td>Warranty</td>
<td>15%</td>
<td>H</td>
<td>M</td>
<td>M</td>
<td>M</td>
<td>L</td>
<td>M</td>
<td>✓</td>
</tr>
<tr>
<td>Long-Term Debt</td>
<td>10%</td>
<td>H</td>
<td>L</td>
<td>L</td>
<td>L</td>
<td>L</td>
<td>M</td>
<td>✓</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>65%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholders' Equity</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Common Stock</td>
<td>5%</td>
<td>M</td>
<td>M</td>
<td>M</td>
<td>L</td>
<td>L</td>
<td>L</td>
<td>✓</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td>30%</td>
<td>H</td>
<td>L</td>
<td>L</td>
<td>L</td>
<td>L</td>
<td>M</td>
<td>✓</td>
</tr>
<tr>
<td>Total Liabilities and Equity</td>
<td>100%</td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

ACFE Report to the Nation on Occupational Fraud & Abuse (2008)

- Median loss $175,000
- Median length of the scheme was 24 months
- Occupational frauds are more likely to be detected by a tip than other means such as internal audits, external audits or internal controls
- In organizations with hotlines median loss was $100,000 versus median loss of $200,000 for organizations without hotlines
- Industries with the highest median loss
  - Telecommunications $800,000
  - Agricultural, Forestry, Fishing & Hunting $450,000
  - Manufacturing $441,000
  - Retail $153,000
  - Government organizations $93,000
Organizations with less than 100 employees suffered median loss of $200,000

- Less than 10% of these organizations had hotlines and less than 20% had audits or fraud training for employees or managers
Size of loss depends on tenure of perpetrator
The Effect of Education

As employees’ education levels rose, so did the losses from their frauds. The median loss in schemes committed by those with a college degree was $210,000, more than twice as much as individuals with only a high school education. The median loss caused by employees with a postgraduate education was $425,000.

This trend was to be expected given that those with higher education levels will tend to occupy positions with higher levels of authority.
Occupational Frauds

- 29% occurred in the accounting department

- 18% were committed by upper management

<table>
<thead>
<tr>
<th>Department</th>
<th># of Cases</th>
<th>Pct. of Cases</th>
<th>Median Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting</td>
<td>231</td>
<td>28.9%</td>
<td>$200,000</td>
</tr>
<tr>
<td>Executive / Upper Management</td>
<td>142</td>
<td>17.8%</td>
<td>$853,000</td>
</tr>
<tr>
<td>Operations</td>
<td>129</td>
<td>16.1%</td>
<td>$80,000</td>
</tr>
<tr>
<td>Sales</td>
<td>93</td>
<td>11.6%</td>
<td>$106,000</td>
</tr>
<tr>
<td>Customer Service</td>
<td>49</td>
<td>6.1%</td>
<td>$45,000</td>
</tr>
<tr>
<td>Finance</td>
<td>31</td>
<td>3.9%</td>
<td>$252,000</td>
</tr>
<tr>
<td>Warehousing / Inventory</td>
<td>24</td>
<td>3.0%</td>
<td>$100,000</td>
</tr>
<tr>
<td>Purchasing</td>
<td>22</td>
<td>2.8%</td>
<td>$600,000</td>
</tr>
<tr>
<td>Manufacturing and Production</td>
<td>19</td>
<td>2.4%</td>
<td>$100,000</td>
</tr>
<tr>
<td>Information Technology</td>
<td>16</td>
<td>2.0%</td>
<td>$93,000</td>
</tr>
<tr>
<td>Marketing / Public Relations</td>
<td>8</td>
<td>1.0%</td>
<td>$80,000</td>
</tr>
<tr>
<td>Legal</td>
<td>8</td>
<td>1.0%</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>Board of Directors</td>
<td>8</td>
<td>1.0%</td>
<td>$93,000</td>
</tr>
<tr>
<td>Human Resources</td>
<td>7</td>
<td>0.9%</td>
<td>$325,000</td>
</tr>
<tr>
<td>Research and Development</td>
<td>7</td>
<td>0.9%</td>
<td>$562,000</td>
</tr>
<tr>
<td>Internal Audit</td>
<td>6</td>
<td>0.8%</td>
<td>$93,000</td>
</tr>
</tbody>
</table>
More on Occupational Fraud

- More than half of the organizations did background checks
- Fraud training, surprise audits, and hotlines have more of an impact on detecting fraud
- 87% of perpetrators never had prior convictions of a fraud-related offense

![Perpetrator’s Criminal History Pie Chart]

- Never Charged or Convicted: 87.4%
- Charged but not Convicted: 6.8%
- Prior Convictions: 5.7%
Common Anti-Fraud Measures for Governments

#1 External Audits

#2 Hotlines

#3 Management Certification

#4 Independent Audit Committee

#5 Management Review of IC
Detecting Fraud in Government Agencies

- Generally speaking, organizations were much less likely to rely on detection of fraud from external audits or notification by law enforcement, whereas their rates of detection through tips, internal audits, and internal controls were much higher.
Billing schemes were the most commonly reported form of asset misappropriation, while check tampering and expense reimbursement fraud were each reported in over 100 cases.*

Source: 2008 Report to the Nation on Occupational Fraud and Abuse. Copyright 2008 by the Association of Certified Fraud Examiners, Inc.

The sum of percentages in this table exceeds 100 percent because several cases involved multiple asset misappropriation schemes for more than one category.

<table>
<thead>
<tr>
<th>Category</th>
<th>Description</th>
<th>Examples</th>
<th>Cases Reported</th>
<th>Percent of all cases</th>
<th>Median Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Schemes Involving Cash Receipts</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Skimming</td>
<td>Any scheme in which cash is stolen from an organization before it is recorded on the organization’s books and records.</td>
<td>• Employee accepts payment from a customer but does not record the sale</td>
<td>159</td>
<td>16.6%</td>
<td>$80,000</td>
</tr>
<tr>
<td>Cash Larceny</td>
<td>Any scheme in which cash receipts are stolen from an organization after they have been recorded on the organization’s books and records.</td>
<td>• Employee steals cash and checks from daily receipts before they can be deposited in the bank</td>
<td>99</td>
<td>10.3%</td>
<td>$75,000</td>
</tr>
<tr>
<td>Schemes Involving Fraudulent Disbursements of Cash</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Billing                          | Any scheme in which a person causes his or her employer to issue a payment by submitting invoices for fictitious goods or services, inflated invoices, or invoices for personal purchases. | • Employee creates a shell company and bills employer for nonexistent services  
• Employee purchases personal items, submits invoice to employer for payment | 229            | 23.9%                | $100,000     |
| Check Tampering                  | Any scheme in which a person steals his or her employer’s funds by forging or altering a check on one of the organization’s bank accounts, or steals a check the organization has legitimately issued to another payee. | • Employee steals blank company checks, makes them out to himself or an accomplice  
• Employee steals outgoing check to a vendor, deposits it into his own bank account | 141            | 14.7%                | $138,000     |
| Expense Reimbursements           | Any scheme in which an employee makes a claim for reimbursement of fictitious or inflated business expenses. | • Employee files fraudulent expense report, claiming personal travel, nonexistent meals, etc. | 127            | 13.2%                | $25,000     |
| Payroll                          | Any scheme in which an employee causes his or her employer to issue a payment by making false claims for compensation. | • Employee claims overtime for hours not worked  
• Employee adds ghost employees to the payroll | 89             | 9.3%                 | $49,000      |
| Cash Register Disbursements      | Any scheme in which an employee makes false entries on a cash register to conceal the fraudulent removal of cash. | • Employee fraudulently voids a sale on his cash register and steals the cash | 27             | 2.8%                 | $25,000     |
| Cash on Hand Misappropriations   | Any scheme in which the perpetrator misappropriates cash kept on hand at the victim organization’s premises. | • Employee steals cash from a company vault | 121            | 12.6%                | $35,000     |
| Non-Cash Misappropriations       | Any scheme in which an employee steals or misuses non-cash assets of the victim organization. | • Employee steals inventory from a warehouse or storeroom  
• Employee steals or misuses confidential customer financial information | 156            | 16.3%                | $100,000    |
Common Schemes and Related Controls

**Billing**
- Review vendor lists/ invoices
- Vouching and tracing
- Budget review
- Approval process for new vendors
- Segregation of duties

**Payroll**
- Segregation of duties between HR and payroll
- Review payroll registers/ change reports
- Social Security number review
- Budget by position

**Inventory**
- Physical count
- Surveillance
- Review of journal entries
- Agreed upon procedures

**Expense Reimbursements**
- Review of supporting documentation
- Approval before allowable travel, meals, classes etc.
- Credit card limits
- Original invoices only
Common Schemes and Related Controls

- Skimming
  - Surveillance
  - Alternative party to perform procedures
  - Segregation of duties
  - Numbered receipts
  - Sign on register requiring receipt
  - Phone number to call if amount is different

- Check Tampering
  - Segregation of duties
  - Timely bank reconciliation
  - Positive pay
Common Schemes and Related Controls

Contracting/Bidding process

- Review contracts
- Review process
- Who approves
Outside Fraud

- Reproduction of check stock/check tampering
  - Use positive pay

- IT issues
  - Make sure you have adequate safeguards
  - Outside review periodically

- Change in check signers
  - Change authorizations

- Outside Consultants monitoring
You’ve Found Fraud - Now What?

- Inform appropriate level of management
- Inform police department
- Inform external auditors
  - External auditor can help with the documentation of the fraud
  - Work together
  - Remember internal controls and external audits are not guarantees, it is only reasonable assurance that fraud would be detected.
End of Presentation
Other Information
Background. Statement on Auditing Standards (SAS) No. 112, Communicating Internal Control Related Matters Identified in an Audit, emphasizes the need for governments to have a financial reporting system in place that is sufficient to provide reasonable assurance that management can prepare financial statements in conformity with generally accepted accounting principles (GAAP). To meet that objective, a financial reporting system must be designed to detect not only material fraud or abuse, but also any questionable accounting or auditing practices that could jeopardize the integrity of financial reporting. SAS No. 112 instructs independent auditors that inadequate “anti-fraud programs and controls” constitute, at a minimum, a significant deficiency that would need to be reported.

In most cases, potential instances of fraud or abuse and questionable accounting or auditing practices come to the attention of responsible parties thanks to employees or citizens who become aware of such practices. Governments can and should take practical steps to encourage and facilitate such reporting.
**Recommendation.** The Government Finance Officers Association recommends that every government establish policies and procedures to encourage and facilitate the reporting of fraud or abuse and questionable accounting or auditing practices. At a minimum, a government should do all of the following:

- Formally approve, and widely distribute and publicize an ethics policy that can serve as a practical basis for identifying potential instances of fraud or abuse and questionable accounting or auditing practices.

- Establish practical mechanisms (e.g., hot line) to permit the confidential, anonymous reporting of concerns about fraud or abuse and questionable accounting or auditing practices to the appropriate responsible parties.\(^1\) A government should regularly publicize the availability of these mechanisms and encourage individuals who may have relevant information to provide it to the government.
• Since ensuring or enhancing confidentiality can significantly increase costs, consider minimizing those costs by providing a separate reporting mechanism for employees, who typically desire greater assurance of confidentiality than do outside parties. In this regard, a government may wish to explore the possibility of engaging the services of an outside vendor to receive complaints from employees. The use of an outside vendor offers a number of potential advantages, including the following:

- Employees may be more readily persuaded of the confidentiality of their calls if they are made directly to a party outside the government.

- Vendors may be able to provide extended hours of service, thus avoiding the need to place a call during regular working hours (i.e., while the employee is still at work).

1 While providing mechanisms to promote the reporting of fraud is an important element of an overall fraud prevention program there are other elements necessary for a complete program that are outside the scope of this recommended practice.
• Train those answering calls from the general public to recognize calls that are reporting fraud or abuse and direct them appropriately to ensure that reports of instances of fraud or abuse by outside parties receive the appropriate disposition even when they are not made through the mechanism established for that purpose.

• Make internal auditors (or their equivalent) responsible for the mechanisms used to report instances of potential fraud or abuse and questionable accounting or auditing practices. Emphasize that they should take whatever steps are necessary to satisfy themselves that a given complaint is without merit before disposing of it. Further, they also should document the disposition of each complaint received so it can be reviewed by the audit committee.

• Have the audit committee, as part of its evaluation of the government’s internal control framework, examine the documentation of how complaints were handled to satisfy itself that the mechanisms for reporting instances of potential fraud or abuse, and questionable accounting or auditing practices are in place and working satisfactorily.

Approved by the GFOA's Executive Board, October 19, 2007.
Mission Statement

To provide responsive, innovative services of the highest quality to our clients; and to provide a positive, rewarding environment encouraging our employees to fulfill their professional and personal goals.

Presenter

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