

DETECTING AND DETERRING FRAUD IN LOCAL GOVERNMENTS

NADO
2014 Annual Training Conference

Cam Matheny, CPA, CGMA
RCM Consulting, LLC
cmathenycpa@gmail.com

THIS DISCUSSION HIGHLIGHTS STEPS YOU CAN TO TAKE TO DETECT AND DETER FRAUD IN YOUR ORGANIZATION

- Recognize that fraud can occur in any organization
- Understand the importance of hiring ethical employees
- Understand the importance of creating a culture of honesty
- Become familiar with ways to eliminate fraud opportunities
- Discussion of techniques to detect common fraud techniques
- What to do if you suspect fraud

WHAT IS FRAUD?

Fraud is a deception deliberately practiced in order to secure unfair or unlawful gain.

FRAUD CAN OCCUR IN ANY ORGANIZATION

Small government entities and nonprofits are more susceptible to theft and fraud than any other type of business.

That's because most have less money to invest in the right kinds of internal controls and qualified financial people to implement those controls.

FRAUD CAN OCCUR IN ANY ORGANIZATION (CONT.)

- Former food bank director arrested for embezzlement –
Huntington, WV
 - The 17-count indictment identifies the defendant as Leigh Anne Zappin, the agency's former executive director. She had worked there since 2008, first under a community service program for a prior embezzlement conviction and then as its leader from fall 2010 to Oct. 3, 2012.
 - Embezzled over \$23,000.

FRAUD CAN OCCUR IN ANY ORGANIZATION (CONT.)

- Woman who touted her charity work sentenced in \$5.1 million embezzlement – Washington, DC
 - Administrative Assistant embezzled \$5.1 million from a DC based non-profit beginning in 2000. The scheme started small but dramatically increased. Phony invoices were created in names of companies that closely resembled legitimate vendors that did business with the non-profit. Brookings Institute vs Brookings Institution.

FRAUD CAN OCCUR IN ANY ORGANIZATION (CONT.)

- Chapin accountant pleads guilty to \$1.9 million embezzlement fraud – Columbia, SC.
 - Chandra Padgett was the trusted accountant for a medical practice. She created a fraudulent shell company called Padgett Specialty Scrapbook Service (PSS). She created checks made payable to her company to her company PSS and hid them among the legitimate invoices. These payments were disguised as payments to Physicians Sales & Services (PSS), a legitimate company utilized by the practice.
 - The fraud was only discovered after liquidity issues became apparent.

UNDERSTANDING THE IMPORTANCE OF HIRING ETHICAL EMPLOYEES

- Not all people are equally honest or have equally well-developed personal codes of conduct
- In fact, research results indicate that many people, when faced with significant pressure and opportunity, will behave dishonestly rather than face the "certain negative consequences" of honest behavior.
- Specifically, studies have indicated that nearly 30 percent of Americans are dishonest, 40 percent are situationally honest, and only about 30 percent are honest all the time.

UNDERSTANDING THE IMPORTANCE OF HIRING ETHICAL EMPLOYEES (CONT.)

- This means that 70 percent of Americans can be enticed by the right mix of pressures, opportunity, and justification to commit fraud.
- If an organization is to be successful in preventing fraud, it must have effective hiring policies that discriminate between marginal and high ethics individuals, especially when recruiting for key positions.

UNDERSTANDING THE IMPORTANCE OF HIRING ETHICAL EMPLOYEES (CONT.)

Hiring people of integrity is key to preventing fraud. Preventative hiring procedures include the following:

- Conducting criminal background investigations on individuals being considered for employment - something that is increasingly easy and inexpensive to do with technology.
- Conducting credit checks on individuals being considered for employment, again, something that is very easy.

UNDERSTANDING THE IMPORTANCE OF HIRING ETHICAL EMPLOYEES (CONT.)

- Thoroughly checking references that are provided by candidates - remembering that no gratuitous positive information about a candidate usually means negative information.

UNDERSTANDING THE IMPORTANCE OF HIRING ETHICAL EMPLOYEES (CONT.)

- Learning how to interpret responses to inquiries asked of and about candidates.
 - In this regard, it is usually helpful to centralize the hiring and screening function with experts who understand how to interview and read verbal and nonverbal cues, as well as ensuring that relevant laws are followed when considering candidates for employment.

UNDERSTANDING THE IMPORTANCE OF CREATING A CULTURE OF HONESTY

Creating a culture of honesty involves four steps:

1. Having top executives model appropriate behavior.
2. Communicating expectations throughout the organization.
3. Requiring periodic written confirmation of acceptance of expectations.
4. Creating a positive work environment.

UNDERSTANDING THE IMPORTANCE OF CREATING A CULTURE OF HONESTY (CONT.)

Appropriate Modeling by Top Management

- First and foremost, the highest priority is for management to set a good “Tone at the Top.”
- “Tone at the Top” is a term used to describe an organizations general ethical climate as established by its board of directors, audit committee, and/or senior management.

UNDERSTANDING THE IMPORTANCE OF CREATING A CULTURE OF HONESTY (CONT.)

Appropriate Modeling by Top Management

- The concept of tone at the top originated in audit firms, where it referred fairly narrowly to the attitude of an organization's senior leadership towards internal financial controls.

UNDERSTANDING THE IMPORTANCE OF CREATING A CULTURE OF HONESTY (CONT.)

Appropriate Modeling by Top Management

A "code of ethics" should be designed to deter wrongdoing and to promote the following:

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships.

UNDERSTANDING THE IMPORTANCE OF CREATING A CULTURE OF HONESTY (CONT.)

Appropriate Modeling by Top Management

A "code of ethics" should be designed to deter wrongdoing and to promote the following (Cont.):

- Compliance with applicable governmental laws, rules and regulations.
- The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code.

UNDERSTANDING THE IMPORTANCE OF CREATING A CULTURE OF HONESTY (CONT.)

Communicating Expectations Throughout the Organization

Communicating expectations involves three steps:

1. Identifying what is, and is not, appropriate behavior through written *codes of conduct* for employees.
2. Having fraud awareness training that helps employees understand potential problems they may encounter and how to resolve them.
3. Communicating consistent expectations of punishment for violators.

UNDERSTANDING THE IMPORTANCE OF CREATING A CULTURE OF HONESTY (CONT.)

Communicating Expectations Throughout the Organization

Organizations that are successful in communicating expectations often combine misappropriation of assets and fraudulent financial reporting with other intolerable actions such as discrimination, drug and substance abuse, violations of safety, and harassment, and develop extensive awareness materials which are communicated forcefully and frequently to all employees.

UNDERSTANDING THE IMPORTANCE OF CREATING A CULTURE OF HONESTY (CONT.)

Communicating Expectations Throughout the Organization

Some of the common elements covered in an ethics or conduct code include:

- Policies for fairness in purchasing and selling products and services.
- Prohibitions on espionage and bribery activities.
- Compliance with laws and regulatory orders.

UNDERSTANDING THE IMPORTANCE OF CREATING A CULTURE OF HONESTY (CONT.)

Communicating Expectations Throughout the Organization

Some of the common elements covered in an ethics or conduct code include
(Cont.):

- Gifts and entertainment issues with suppliers and customers.
- Policies relating to proprietary and confidential information.
- Assurances regarding the privacy of communication.

UNDERSTANDING THE IMPORTANCE OF CREATING A CULTURE OF HONESTY (CONT.)

Communicating Expectations Throughout the Organization

Some of the common elements covered in an ethics or conduct code include
(Cont.):

- Specifications of conflicts of interest.
- Employment of relatives.
- Responsibility for company assets.

UNDERSTANDING THE IMPORTANCE OF CREATING A CULTURE OF HONESTY (CONT.)

Communicating Expectations Throughout the Organization

Some of the common elements covered in an ethics or conduct code include
(Cont.):

- Political contributions.
- Use of controlled substances.

UNDERSTANDING THE IMPORTANCE OF CREATING A CULTURE OF HONESTY (CONT.)

Requiring Written Confirmation of Acceptance of Expectations

The third element in creating a culture of honesty is requiring periodic written confirmation by employees so that they understand the organization's expectations. If employees are not required to assess their commitment and understanding of expectations, the expectations are not likely to be followed. Successful organizations have found that annual written confirmation is appropriate and often deters, and even detects, problems before they become significant.

UNDERSTANDING THE IMPORTANCE OF CREATING A CULTURE OF HONESTY (CONT.)

Creating a Positive Work Environment

The final element in creating a culture of honesty includes developing a positive work environment.

Research shows that fraud occurs less frequently when employees feel ownership and have positive feelings about an organization than when they feel abused, threatened, or ignored.

BECOMING FAMILIAR WITH WAYS TO ELIMINATE FRAUD OPPORTUNITIES

Identifying Fraud Risks

Identifying and measuring fraud risk means that organizations should have an antifraud program in place that both defines where the greatest risks are and evaluates and tests processes that tend to mitigate those risks.

BECOMING FAMILIAR WITH WAYS TO ELIMINATE FRAUD OPPORTUNITIES (CONT.)

Identifying Fraud Risks

The employee code of conduct, and other business ethics programs and documents, should direct employee's attention to those risks, identify what is and is not appropriate behavior, what to do if violations are observed, and provide examples of acceptable and unacceptable behavior.

BECOMING FAMILIAR WITH WAYS TO ELIMINATE FRAUD OPPORTUNITIES (CONT.)

Implementing a Proper Control Structure

Once risk assessment has taken place, the organization can identify the processes, controls, and other procedures that are needed to mitigate the identified risks.

Management should put in place a control structure that will protect stakeholders and creditors, and even help management in their efforts to run their organizations as effectively and efficiently as possible.

BECOMING FAMILIAR WITH WAYS TO ELIMINATE FRAUD OPPORTUNITIES (CONT.)

Implementing a Proper Control Structure

According to the Committee of Sponsoring Organizations of the Treadway Commission, the National Commission of Fraudulent Financial Reporting, sponsored jointly by the AICPA, the American Accounting Association, Financial Executives Institute, Institute of Internal Auditors, and Institute of Management Accountants (COSO's) framework for internal control, a company's control structure can be divided into five basic categories.

BECOMING FAMILIAR WITH WAYS TO ELIMINATE FRAUD OPPORTUNITIES (CONT.)

Implementing a Proper Control Structure

1. The control environment
2. Risk assessment
3. Control activities
4. Information and communication
5. Monitoring

BECOMING FAMILIAR WITH WAYS TO ELIMINATE FRAUD OPPORTUNITIES (CONT.)

Implementing a Proper Control Structure

With respect to financial statement fraud, the control environment is probably the most important element of fraud prevention. The control environment consists of the actions, policies, and procedures that reflect the overall attitudes of top management, the directors, and the stakeholders about control and its importance to the company.

BECOMING FAMILIAR WITH WAYS TO ELIMINATE FRAUD OPPORTUNITIES (CONT.)

Management Philosophy and Operating Style

Does management set a good example by following controls?

Do they stress the importance of controls to other employees?

Are they risk averse, dominated by one or two individuals, realistic about goals, and so on?

BECOMING FAMILIAR WITH WAYS TO ELIMINATE FRAUD OPPORTUNITIES (CONT.)

Organizational Structure

A good control environment is created when an organization identifies clear lines of authority and responsibilities and is not overly complex so that dishonest transactions can be concealed.

BECOMING FAMILIAR WITH WAYS TO ELIMINATE FRAUD OPPORTUNITIES (CONT.)

Organizational Structure

Usually, a good organizational structure requires a clear organizational chart that not only specifies the formal lines of authority, but also indicates departmental responsibilities and does not allow an informal system, based on personalities of individuals and group dynamics, to override the formal system.

BECOMING FAMILIAR WITH WAYS TO ELIMINATE FRAUD OPPORTUNITIES (CONT.)

Accounting System

It is impossible for a company to have a good control structure without a good accounting system. To be effective, the accounting system should contain adequate controls to ensure that:

- Only valid transactions are recorded.
- All transactions are properly authorized.
- All legitimate transactions are recorded and the records are complete.

BECOMING FAMILIAR WITH WAYS TO ELIMINATE FRAUD OPPORTUNITIES (CONT.)

Accounting System

- All transactions are properly classified.
- All transactions are recorded in the proper time period.
- All transactions are properly valued.
- All transactions are properly summarized in the records and the financial statements.

BECOMING FAMILIAR WITH WAYS TO ELIMINATE FRAUD OPPORTUNITIES (CONT.)

Control Activities

Control activities (or control procedures) are those policies and procedures, in addition to the control environment and accounting system that management has adopted to provide reasonable assurance that the company's established objectives will be met and that financial reports are accurate.

BECOMING FAMILIAR WITH WAYS TO ELIMINATE FRAUD OPPORTUNITIES (CONT.)

Control Activities

Generally control activities fall into five categories:

1. Adequate segregation of duties.
2. Proper procedures for authorization.
3. Adequate documents and records.
4. Physical control over assets and records.
5. Independent checks on performance.

BECOMING FAMILIAR WITH WAYS TO ELIMINATE FRAUD OPPORTUNITIES (CONT.)

Control Activities

A company that either does not have these control activities in place, does not follow these procedures on a consistent basis, or allows for management override of these procedures represents a significant risk to auditors and accountants who associate themselves with such an organization, as well as to stakeholders and creditors who provide financing to the company.

DISCUSSION OF TECHNIQUES TO DETECT COMMON FRAUD TECHNIQUES

Just rely on your external auditors.....right?

DISCUSSION OF TECHNIQUES TO DETECT COMMON FRAUD TECHNIQUES (CONT.)

NO!

According to a study by the Association of Certified Fraud Examiners (ACFE), external auditors detected only 3% of the reported financial statement fraud.

DISCUSSION OF TECHNIQUES TO DETECT COMMON FRAUD TECHNIQUES (CONT.)

So if the professionals aren't finding it, how do you
expect us to find it?!?!?

DISCUSSION OF TECHNIQUES TO DETECT COMMON FRAUD TECHNIQUES (CONT.)

Creating Widespread Monitoring by Employees

Fraud research shows that it is employees and managers, not auditors, who detect most misappropriation of assets and financial statement frauds. To prevent fraud effectively, widespread monitoring by employees and others must be encouraged.

DISCUSSION OF TECHNIQUES TO DETECT COMMON FRAUD TECHNIQUES (CONT.)

Creating Widespread Monitoring by Employees

The most effective way to involve employees in the monitoring process is to provide a protocol for communication that informs employees to whom they should report suspected violations, what form that communication should take, that guarantees confidentiality, that stresses that retribution will not be tolerated, and that specifies the consequences for violation and for nonreporting.

DISCUSSION OF TECHNIQUES TO DETECT COMMON FRAUD TECHNIQUES (CONT.)

Creating Widespread Monitoring by Employees

Companies that are serious about fraud prevention must make it easy for employees and others to come forward with suspicions of fraud. Having every employee in the organization realize that all fellow employees know what to do if they see violations is an effective fraud deterrent.

“Whistleblower Policy”

DISCUSSION OF TECHNIQUES TO DETECT COMMON FRAUD TECHNIQUES (CONT.)

What else can we do to help detect fraud?

Keep your eyes open!

Most fraudsters exhibit behavioral traits that can serve as warning signs of their actions. These red flags — such as living beyond one's means or exhibiting excessive control issues — generally will not be identified by traditional internal controls.

DISCUSSION OF TECHNIQUES TO DETECT COMMON FRAUD TECHNIQUES (CONT.)

What else can we do to help detect fraud?

Keep your eyes open!

Beyond the regular processing of vendor payments and payroll perform periodic reviews. Look at the list of approved vendors for abnormalities. Compare address of vendors to those of employees. Review the payroll file to determine if fake employees have been added, that all employees have proper documentation (IRS W-4, I-9, state tax forms, etc.)

WHAT TO DO IF YOU SUSPECT FRAUD

So you suspect fraud or have detected fraud, now what?

- Don't panic – develop a plan to handle the issue.
- Do something – sweeping the fraud “under the rug” will just tell the fraudster and other employees that they are free to do as they wish with no consequences.
- Be discreet – if the fraudster knows you are on to them they may attempt to destroy the evidence of the fraud or to otherwise cover their tracks.
- Lock down relevant data – you are most likely already backing up your company financial information and communications, but now is the time to preserve all the evidence you have uncovered.

WHAT TO DO IF YOU SUSPECT FRAUD (CONT.)

So you suspect fraud or have detected fraud, now what?

- Get help – don't try to handle the fraud on your own. Contact your agency's attorney and an accountant with experience with fraud investigating.
- Set an example – there are three basic levels of consequences for fraud:
 - Termination
 - Civil lawsuit
 - Criminal prosecutionImpose the severest consequence as possible, all three if possible!
- Make positive changes – do what you can to prevent fraud in the future.

COMMENTS

QUESTIONS

IDEAS