FRAUD RISKS AND EFFECTIVE CONTROLS

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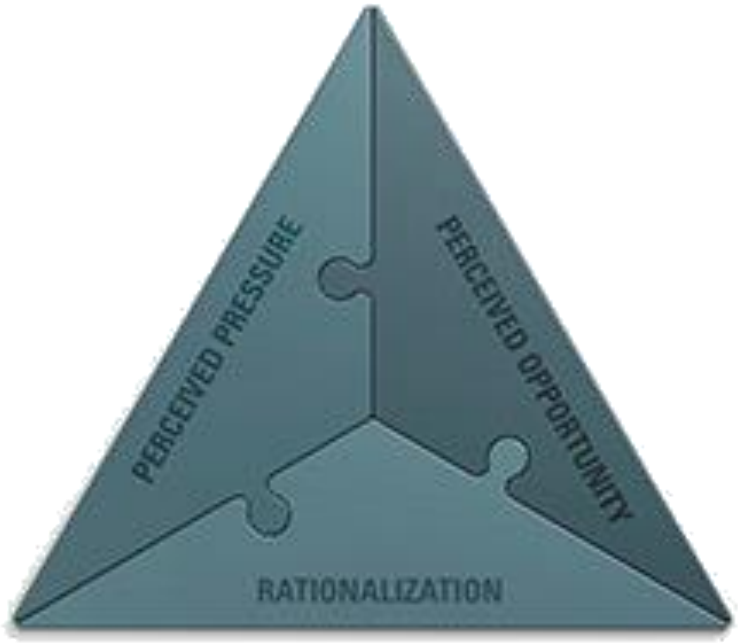
AGENDA

- Fraud stats
- Occupational fraud
- Government sector vulnerability to fraud
- Fraud triangle
- Common fraud schemes
  - Employees
  - Contractors in the role of employees
  - Procurement related
  - Vendors
- Internal control framework (COSO / ACFE)
- Effective controls
- Incident response

FRAUD

- A knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment.
- Fraud includes any intentional or deliberate act to deprive another of property or money by guile, deception, or other unfair means.

FRAUD TRIANGLE



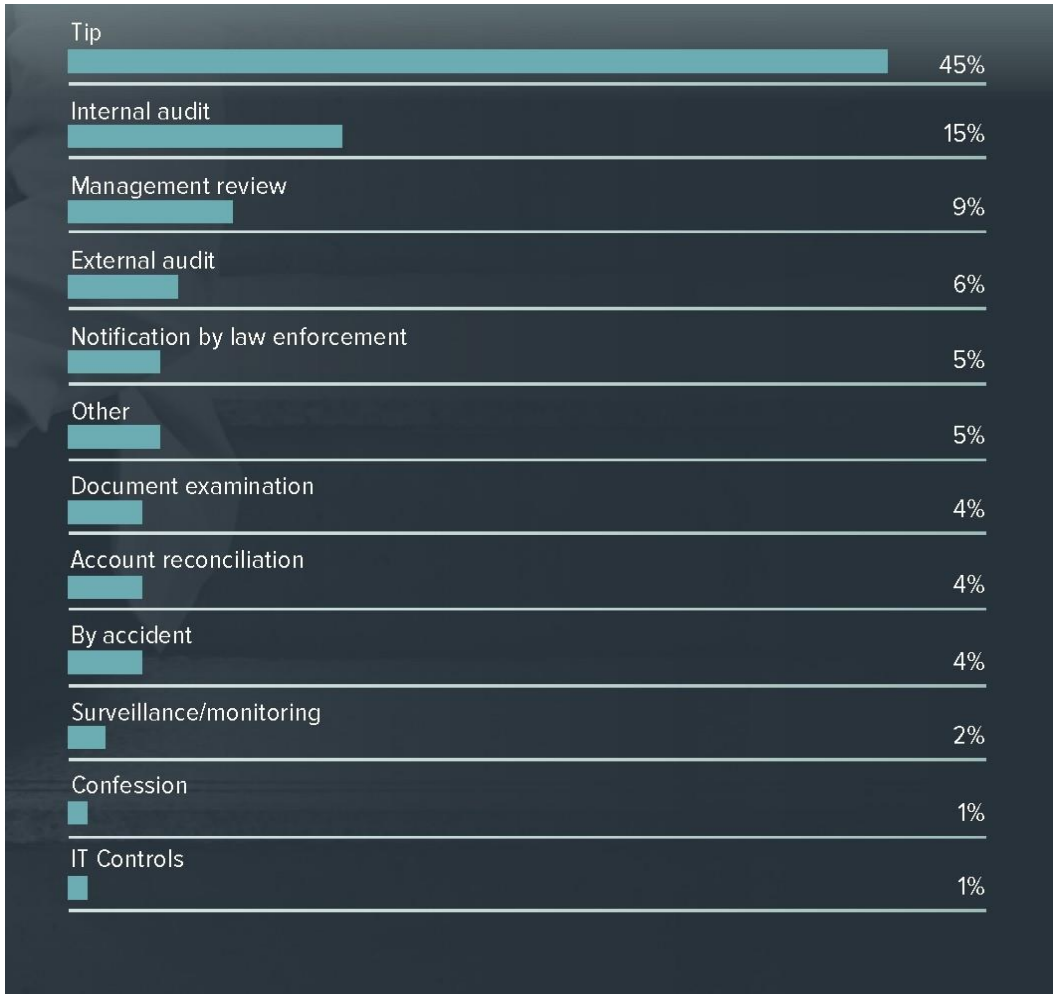
WHEN PEOPLE COMMIT FRAUD

- Pressure
  - Personal financial problems
  - Power
  - Overlook controls to get the job done or impress the boss
- Opportunity – the person must see some way he can use his position of trust to solve his financial problem with a low risk of getting caught
- Rationalization – fraud is acceptable or justifiable act
  - Borrowing
  - Underpaid
  - Provide for family
  - Employer is dishonest, deserved to be fleeced
  - Nobody will miss the money

OCCUPATIONAL FRAUD

- Internal fraud, also called *occupational fraud*, can be defined as “the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the organization’s resources or assets.”
- Simply stated, this type of fraud occurs when an employee, manager, or executive commits fraud against his or her employer.

HOW IS OCCUPATIONAL FRAUD INITIALLY DETECTED IN GOVERNMENT AGENCIES? *



* 2018 ACFE Report to the Nations – Government Edition

LOCAL GOVERNMENTS – FRAUD RISK

- Small offices
  - Lack of segregation of duties
- Small budgets
- Trust
- Civil service
- No oversight
  - Internal Audit
  - Inspector General
- Concentrating on the core mission of the agency
- Not your money or the money of a business

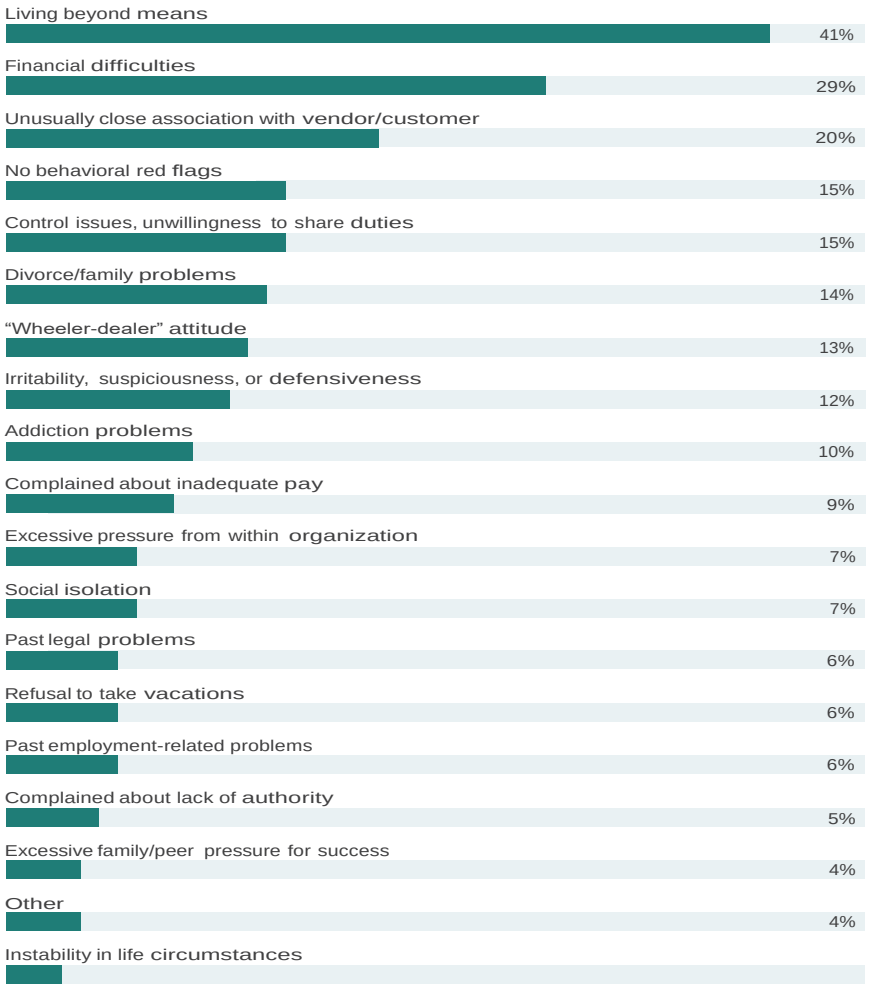
  - profit

WHEN PEOPLE COMMIT FRAUD

- Trusted employees
- Lack of oversight creating a “perceived” opportunity
- Management and others focusing on the core mission of the agency
- Rationalization

BEHAVIORAL RED FLAGS DISPLAYED BY PERPETRATORS *

FIG. 38 How often do perpetrators exhibit behavioral red flags?



*2018 ACFE Report to the Nations

COMMON FRAUD SCHEMES

- Payroll fraud – cheating time, fraudulent time edits
- Ghost payrollers
- Fraudulent reimbursements
- Excessive overtime
- Misuse of assets
- P-Card
  - Unauthorized expenditures
  - Circumventing procurement / spending rules
- Stringing
- Tax-exempt purchases

COMMON FRAUD SCHEMES

- Criminal background
- False representations on credentials
- Falsification of employment records
- Fraudulent leaves of absence
- Worker's comp fraud
- Unauthorized use of Agency assets

COMMON FRAUD SCHEMES

- Ethics violations
  - Direct and indirect economic interest
  - Gifts / Wining and dining
  - Post employment restrictions
- Bribery and kickbacks
- Collusion with vendors
  - Stringing
  - Overbilling
- Lack of knowledge of procurement and spending rules

PROCUREMENT / VENDOR FRAUD

- Many times agency employees knowingly or unwittingly facilitate procurement and vendor fraud.
- Organizational fraud – fraud committed for the benefit of the organization and as a result, the indirect benefit of the individual.
  - Get the job done
  - Bonuses, recognition, promotions, job retention
  - Employees don’t know the rules
  - Pressure
  - Inappropriate tone-at-the top

PROCUREMENT / VENDOR FRAUD

- Bidding / specs - Collusion schemes
  - Bid rigging
  - Bid rotating
  - Bid suppression
  - Market division
- Sole source
- Emergency
- Change orders
- M/WBE fraud

PROCUREMENT / VENDOR FRAUD

- Fraudulent misrepresentations
  - False representations on vendor applications
  - False insurance/bonding documents
- Ghost vendors
- Ghost invoices
- Billing
  - Overbilling
  - Mischarging
  - Excessive billing
- Product substitution
- Time and materials contracts

INTERNAL CONTROL FRAMEWORK

- It is management's job to ensure that proper controls are in place to prevent fraud, as well as detect it. (ACFE)
- 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 relating to operations, reporting, and compliance. (COSO)

COSO INTERNAL CONTROL FRAMEWORK

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring

CONTROL ENVIRONMENT

- Control Environment provides the foundation for the internal control system throughout the entire organization. The control environment is established by the directors and senior management and sets the moral and ethical tone of an organization.

- Principles
  - Personnel at all levels demonstrate a commitment to integrity and ethical values.
  - Board oversees the development and performance of internal control.
  - With Board oversight, management establishes the structures, reporting lines, and appropriate authorities and responsibilities.
  - Organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives.

(ACFE)

RISK ASSESSMENT

- Risk Assessment involves the identification and assessment of the risks the entity faces in achieving its organizational objectives. This process is dynamic and iterative, and it forms the basis for determining how risks will be managed.
- Principles
  - Clear objectives to enable the identification and assessment of risk.
  - Identify risk to the achievement of objectives.
  - Consider the potential for fraud.
  - Identify and assess changes that could significantly impact the system of control.

(ACFE)

CONTROL ACTIVITIES

- Control Activities are the policies and procedures that enforce management's directives intended to mitigate risk.
- Principles
  - Control activities selected to mitigate risks.
  - General control activities over technology to support the achievement of objectives.
  - Control activities deployed through policies that establish what is expected and procedures that put policies into action.

(ACFE)

INFORMATION AND COMMUNICATION

- Information and Communication relates to the exchange of information in a way that allows employees to carry out their internal control responsibilities.
- Principles
  - Obtain or generate and use relevant, quality information to support the functioning of internal control.
  - Internally communicate information, including objectives and responsibilities for internal control.
  - Communicate with external parties regarding matters affecting the functioning of internal control.

(ACFE)

MONITORING

- Monitoring is the process that assesses the effectiveness of a control system over time. Includes both ongoing, automated evaluations and periodic, separate evaluations.
- Principles
  - Select, develop and perform ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.
  - Evaluate and communicate internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the Board.

(ACFE)

EFFECTIVE CONTROLS

- Audit Committee
  - Regularly audit
- Due Diligence in Hiring
- Segregation of duties
- Communication / Training
- Consistent Discipline
- Handbook / Codes of Conduct
  - Exclude right to privacy
  - Mandatory time off / vacations
  - Employee duty to cooperate

EFFECTIVE CONTROLS

- Code of Ethics
  - Defining “relationship”
  - Direct and indirect economic interest
  - Contract management authority
  - Gift ban (especially procurement)
- Cross train
- Rotate staff
- Whistleblower System
- Fraud Hotline
- Updated IT systems
  - Regularly assess vulnerabilities and access rights

EFFECTIVE CONTROLS

- Due diligence in hiring vendors
  - Know the market
  - References
  - “Google”
- Right to Audit Vendors
- Mandatory record retention
- Vendor Duty to cooperate
- Positive Pay
- Data mining (employee / vendor relationships)
- Independent Monitor

CODE OF CONDUCT

- Code of Conduct as a control
  - Duty to report misconduct
  - Discipline for non-cooperation with investigation
  - Inattention to duty
  - Preferential treatment
  - Sexual harassment
  - Discrimination
- Acceptable Use policy

FRAUD INCIDENT MANAGEMENT PROTOCOL

- Establish a Response Team
  - Receive and evaluate tip
  - Puts process into place
  - Avoids conflicts
  - Confidentiality and Privileged
- Decide who will investigate and how investigation will be conducted (Law enforcement is not always the answer)
- Preserve evidence
- Is immediate action warranted? (Administrative Leave)
- Who will interview witnesses and subjects?
- Evaluate evidence
- Present to Board
- Media response

QUESTIONS?

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