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Current Fraud Risks Facing Local Governments

May 11, 2023



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Learning Objectives

At the end of this session, you will be able to:

- List the 8 important facts of fraud
- Describe current fraud trends and risks
- Identify recent cases of fraud in state and local governments
- Identify key concepts in fraud awareness and prevention

Speaker Introduction

Principal

CLA's VFLI Practice

Valuation, Forensics, Litigation, Investigations

More than 35 years of experience conducting domestic and international investigations for fraud, security and forensic accounting matters. Former Director of Security for a super regional bank, and 14-year career with the Hartford CT Police Department and FBI. Co-author of Forensic Accounting and Fraud Investigation for Non-Experts, 3rd Edition.



**Frank
Rudewicz**

Esq., CAMS



Speaker Introduction

Manager

CLA's VFLI Practice

Valuation, Forensics, Litigation, Investigations

Over 10 years of audit, tax, and consulting experience serving state and local governments, nonprofits, and for-profit entities, including forensic accounting, fraud investigations, internal control assessments, and litigation support.



Ayla Grady

CPA, CFE





Eight Important Facts of Fraud

Eight Important Facts of Fraud

1. Estimated that organizations lose 5% of revenue each year as a result of fraud
2. Fraud exists in every organization and every industry type – **Top 5**
Median Losses by Industry:
 - Real estate (median loss: \$435,000)
 - Wholesale trade (median loss: \$400,000)
 - Transportation and warehousing (median loss: \$250,000)
 - Construction (median loss: \$203,000)
 - Utilities (median loss: \$200,000)
3. Prominent weakness – lack of controls



Eight Important Facts of Fraud (continued)

4. Most common form of occupational fraud = asset misappropriation
5. Billing and check tampering represent the greatest risk
6. Most perpetrators are first time offenders, though not all cases are reported to law enforcement
7. Frauds with highest frequency occur in operations, accounting, and in executive/upper management
8. Most occupational frauds are not material to the financial statements (frequent, small transactions taking place over an extended period of time)

DEPARTMENT	Cases
Operations	273
Accounting	230
Executive/upper management	206
Sales	203
Customer service	140
Administrative support	131
Purchasing	131
Finance	95



Occupational Fraud by Organization Type

FIG. 21 WHAT ARE THE MOST COMMON OCCUPATIONAL FRAUD SCHEMES IN VARIOUS INDUSTRIES?

INDUSTRY	Cases	Billing	Cash larceny	Cash on hand	Check and payment tampering	Corruption	Expense reimbursements	Financial statement fraud	Noncash	Payroll	Register disbursements	Skimming
Government and public administration	198	21%	8%	7%	9%	57%	12%	8%	16%	16%	3%	8%



Traits of a Fraudster

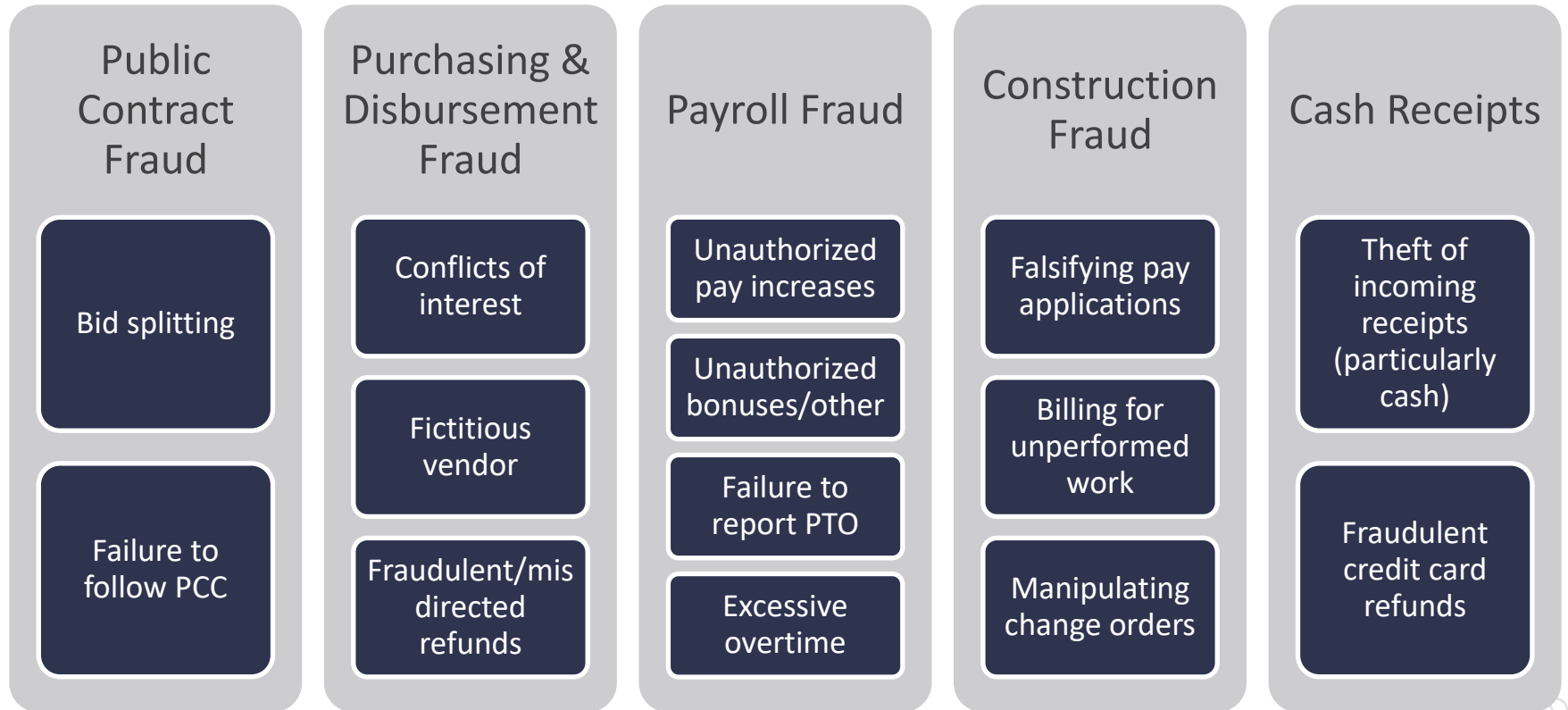
- Six traits of a fraudster's personality:
 - Positioning
 - Intelligence and Creativity
 - Ego
 - Coercion
 - Deceit
 - Stress





Current Fraud Trends & Risks


Fraud in State and Local Governments




Vendor Disbursement Fraud

Possible Schemes:


1. Diversion of vendor disbursements by changing mailing address or banking information (internal or external) or intercepting check




2. Fake vendor (shell company)



3. Falsified or inflated invoices from a legitimate vendor (with or without involvement of vendor)



4. Fictitious refunds (falsified supporting documentation; forged approval)



Vendor Disbursement Fraud

How do you protect your organization?

1. Require verification of vendor information change requests via a mechanism other than how the request was received
2. Require a minimum period of time (i.e., 10 business days) before processing payments after a change is made
3. Ensure only appropriate staff can add and modify vendors
4. Ensure the vendor master list is reviewed and maintained; change unused vendors to inactive status
5. On a monthly basis, run a vendor change report to monitor and review for inappropriate or questionable changes

External Fraud Threats - Cybercrime

Social engineering

- Phone or email
- Fake “vendor”
- Gain trust
- Change payment information

Phishing

- Type of SE
- Malicious email
- Obtain sensitive information (i.e., login)
- Ransomware (cyberextortion)

Hacking

- Obtain PII
- Data is used to perpetrate fraud or sold on dark web
- Data used for:
 - Unemployment fraud
 - Student F.A. Fraud
 - Tax return fraud

Impact of Fraud – More than Just Money

Monetary

- Actual loss
- Costs and time spent by investigators/attorneys
- Less funds available for services

Reputation

- Media attention (newspapers, social media)
- Loss of confidence by community, donors, etc. (public mistrust)

Increased Costs

- Higher risk audit/increased audit costs





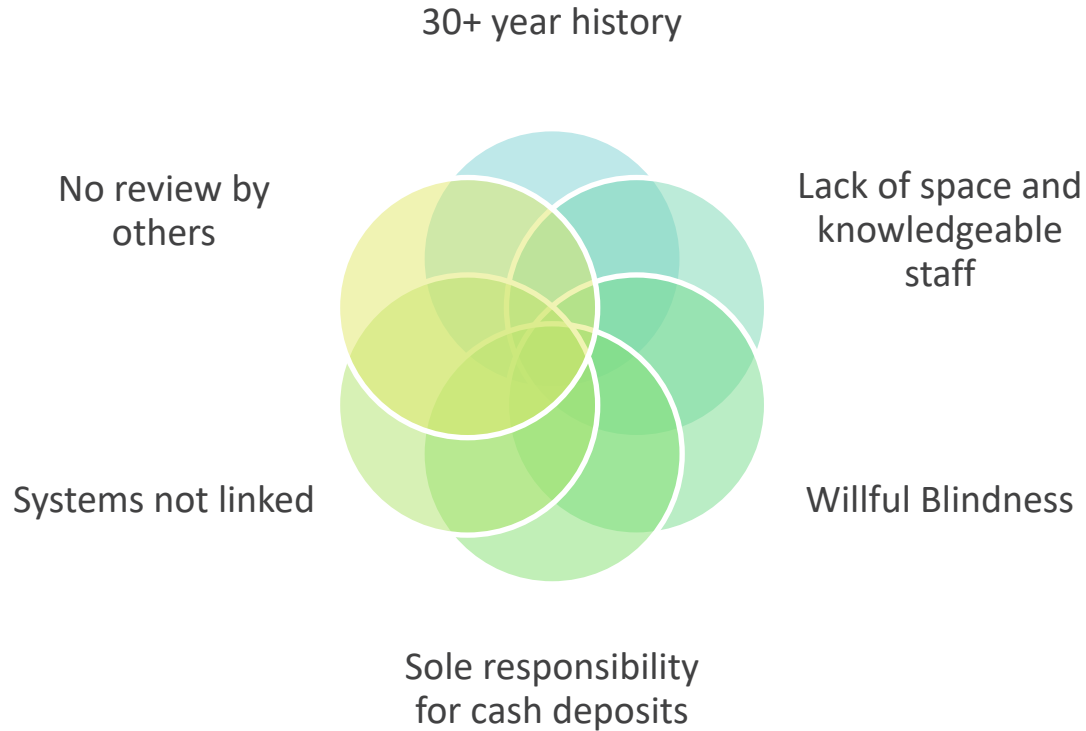
Recent Cases of Fraud in State & Local Governments

Case Study #1

Large Metropolitan Police Department

- Seized evidence and property
- Monies seized during multiple drug arrests
- Money inventoried, submitted by arresting officers
- Inventory amount later changed by Property Room Officer
- Over \$300,000 taken

Factors Leading to Fraud





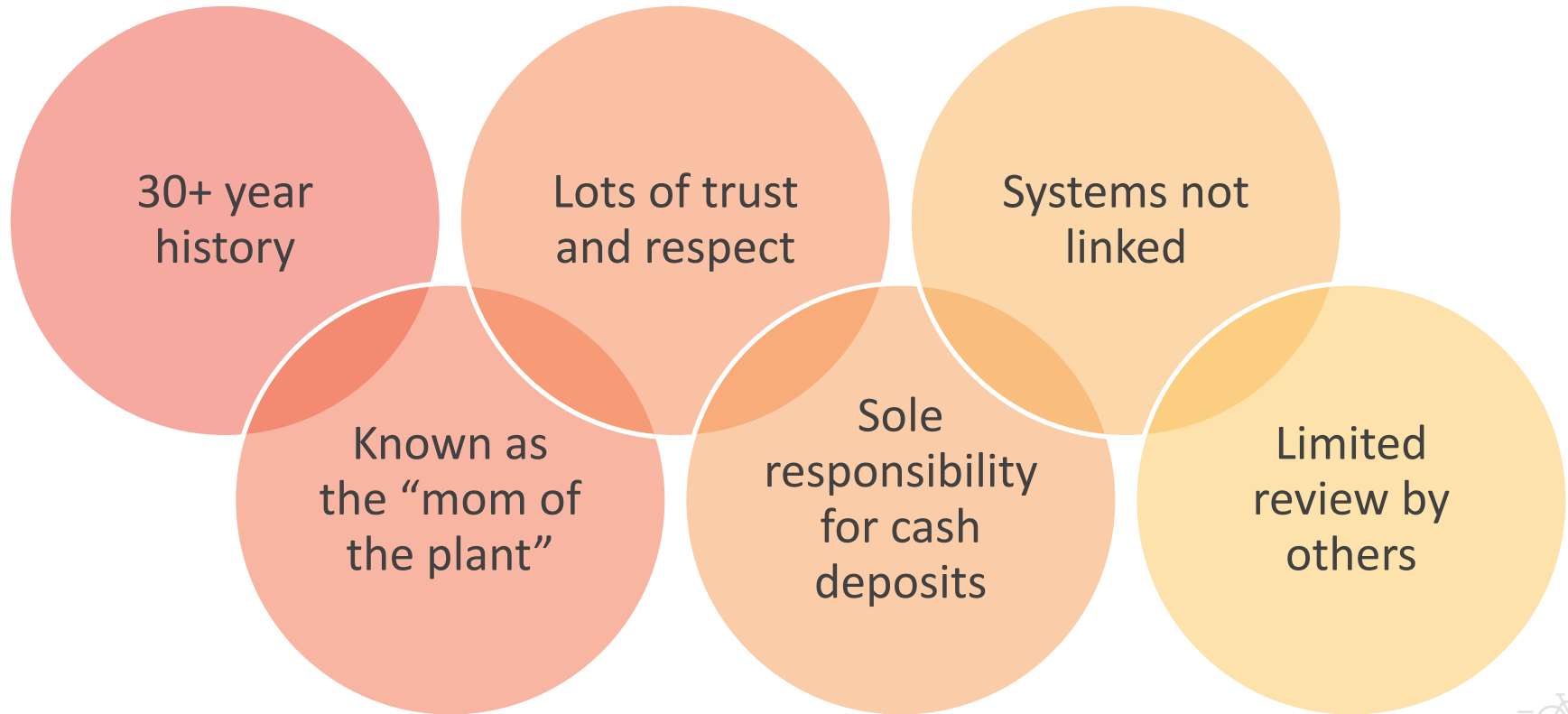
Recent Cases of Fraud in State & Local Governments

Case Study #2

Overview – County Recycling Center

- Joint venture between two neighboring Counties
- Oversight by both Counties, but Recycling Center also has its own employees
- One County operates as the fiscal agent for the Recycling Center
- Long-time employee, Supply Chain Coordinator, misappropriated over \$100,000 in 5 years (January 2018-November 2022).

Factors Leading to Fraud



Discovery of Discrepancies

Discovered when
“something just didn’t
seem right” with one
deposit made

Upon closer inspection,
found two days’ worth
of collections missing
from the deposit

Prompted investigation
of historical deposits



Forensic Investigation

Interview of staff at the Recycling Center

Analysis on cash collection reports and cash deposit records

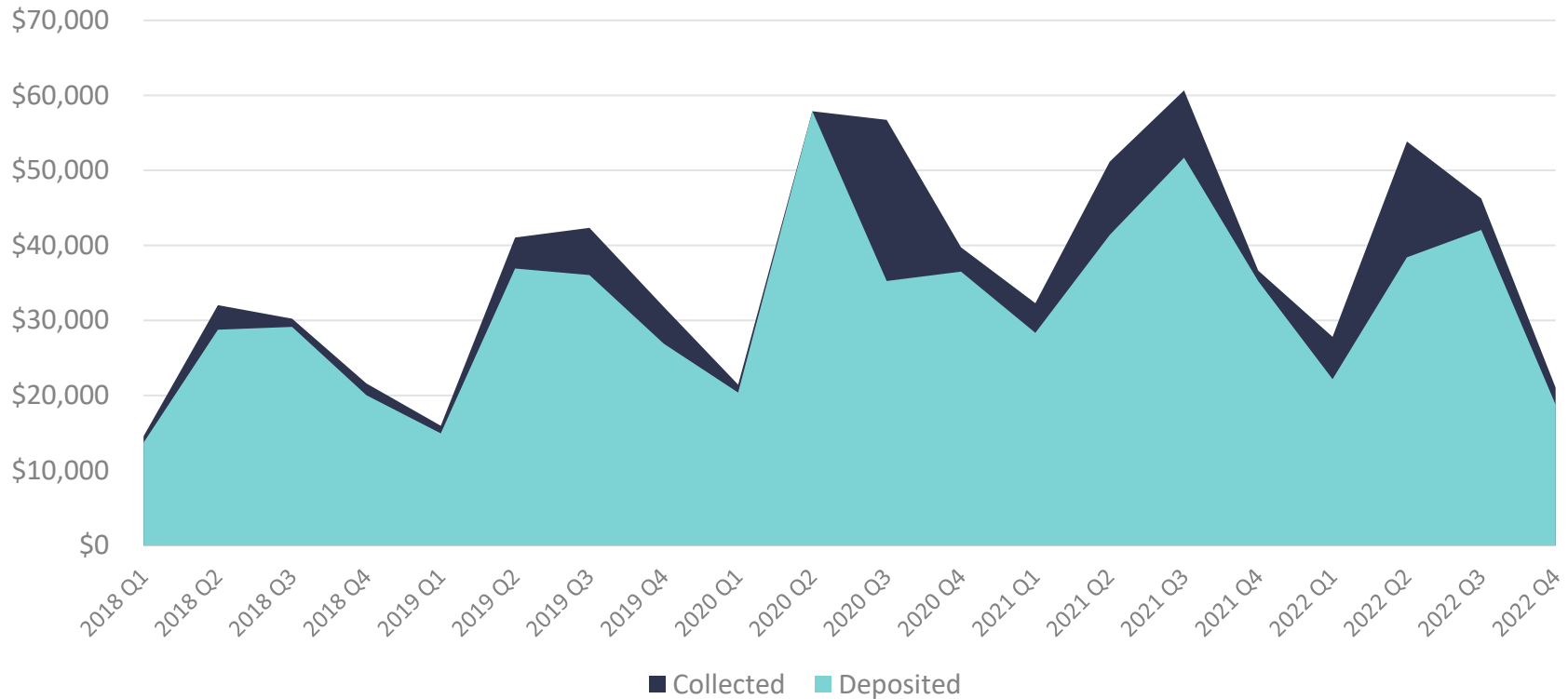
Identification of days of collections never deposited

Interview of subject

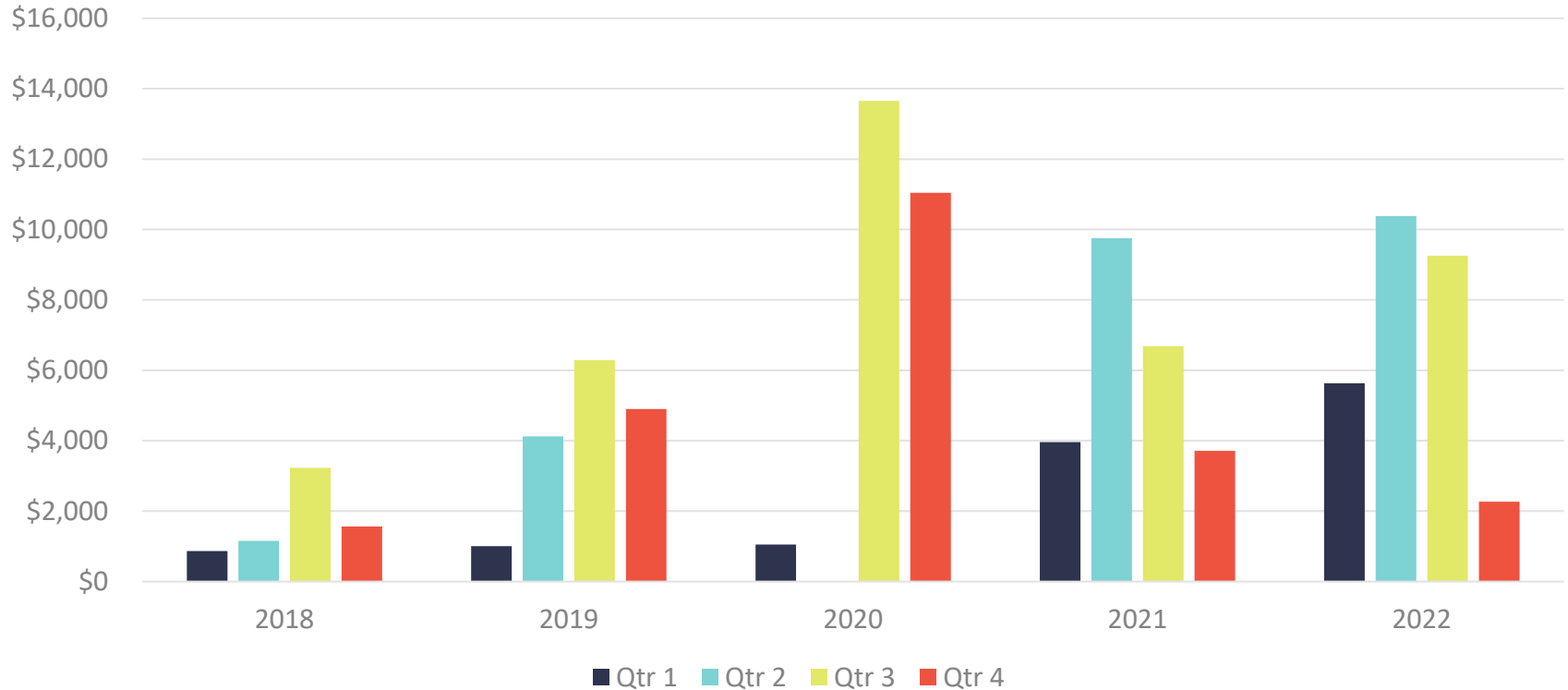
Report of findings, including recommendations



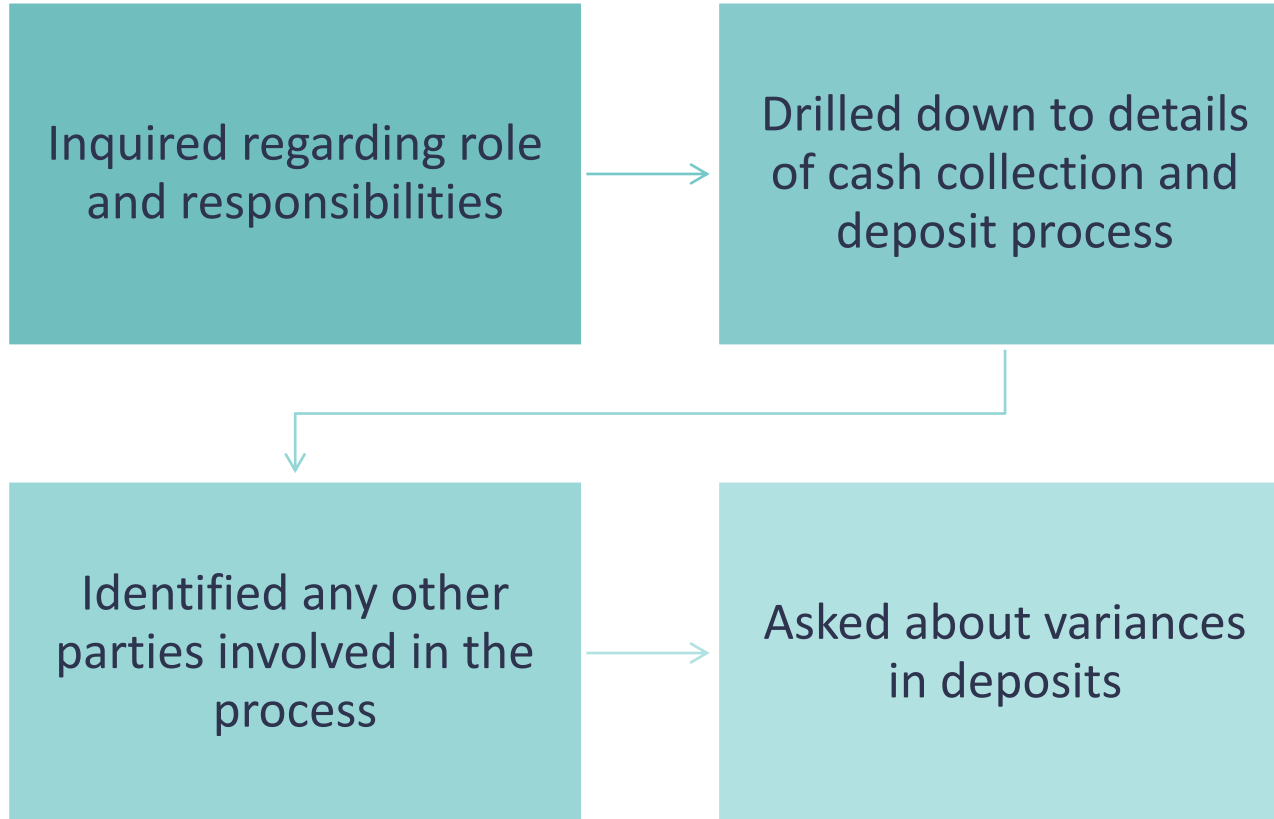
Analysis on Cash Collections and Deposits



Variance Between Cash Collections and Deposits



Interview of Subject



Conclusions

Identified over
\$100,000 in
misappropriated
cash deposits

- Cash collected but not deposited
- No other subjects – access and knowledge
- Scope limited to 2018-2022

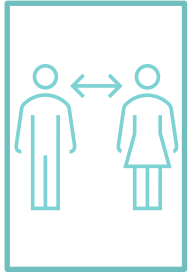
New procedures
were
implemented

- Third-party courier for cash transport
- Additional reconciliation of cash collections and deposits are performed



Key Concepts in Fraud Awareness & Prevention

Recommendations to Mitigate Fraud Risk



At least two people are looking at every transaction (adequate segregation of duties)



Ensure secondary approval by someone with knowledge of the business area



Trust is NOT an internal control – ensure proper and sufficient supporting documentation for all transactions



Ensure regular and timely reconciliation of asset accounts; ensure the reconciliations are reviewed



Recommendations to Mitigate Fraud Risk



Conduct regular monitoring and management review



Mandatory job rotation and/or vacations



Implement the use of positive pay with your bank (if available, include payee/account name positive pay)



EFT/ACH/Wires – Third-party services that verify bank account information



Require confirmation when vendor change requests are received

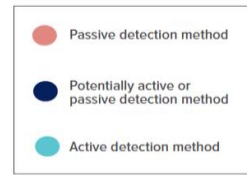
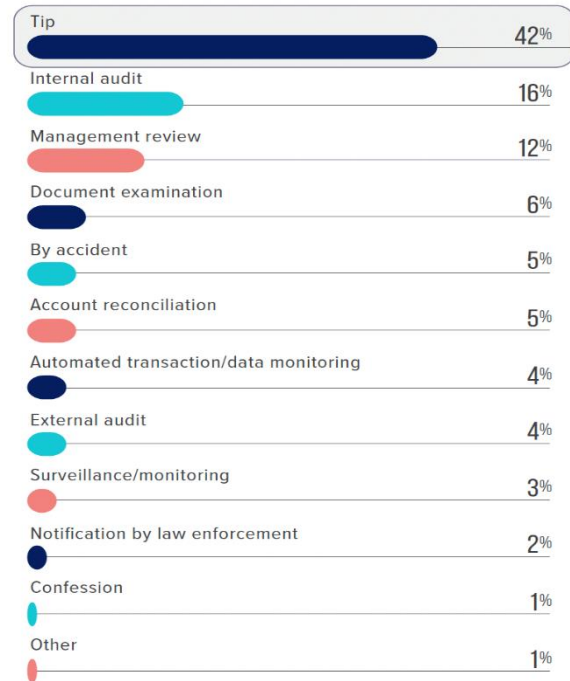


Ensure adequate IT and system controls (multi-factor authentication, firewalls, etc.)



Median Loss & Duration by Detection Method

FIG. 10 HOW IS OCCUPATIONAL FRAUD INITIALLY DETECTED?



Limitations for Mitigating Fraud Risk

- No set of internal controls guarantee prevention of fraud
- What is your fraud risk tolerance?
 - Lower tolerance = more controls
- Critical component to detecting fraud – monitoring and management review
 - Vendor master change report
 - One-time/temporary vendor number
 - Manual check request or refunds
 - Payroll change report
 - Monthly reconciliations



Attributes of an Anti-Fraud Program

- ❑ Person or office responsible for anti-fraud, ethics, and compliance
 - ✓ Empowered by management and governance
- ❑ Lead by example (“tone at the top”)
 - ✓ Management and governance promote an environment of integrity
- ❑ Encourage transparency and accountability
 - ✓ Review, oversight, monitoring
- ❑ Well-developed anti-fraud and ethics policy and/or code of conduct
 - ✓ In writing, communicated to and acknowledged by employees
- ❑ Well-developed and updated written policies and procedures
 - ✓ Kept current and acknowledged by employees

Attributes of an Anti-Fraud Program (continued)

- ❑ Regular technical training of employees on policies, procedures, applicable laws, ethics, fraud awareness, etc.
 - ✓ Internal or external instructors
- ❑ Strong compliance/internal audit programs
 - ✓ Internal, outsourced, or combination – prioritized by management and governance
- ❑ Established fraud and ethics hotline
 - ✓ Anonymous, confidential, protect whistleblowers – prioritized by governance
- ❑ Reinforce good behavior and don't reinforce bad behavior
 - ✓ Follow through on reports of misconduct – encourages people to come forward



Questions?

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