CARES Act Update and Discussion

WEALTH ADVISORY | OUTSOURCING | AUDIT, TAX, AND CONSULTING

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- *This presentation is for educational purposes only. It should not be construed or relied on as legal advice or to create any client, advisory, fiduciary, or professional relationship between you and CLA.*

- *This presentation considers guidance provided by the US Department of the Treasury and OMB through October 19, 2020. Additional guidance is being provided on a regular basis, please refer to the US Department of the Treasury website (https://home.treasury.gov/policy-issues/cares/state-and-local-governments) for recent updates.*

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Learning Objectives

By the end of this session, you will be able to -

- Discuss the latest guidance on CARES funding.
- Compare best-known strategies used to ensure compliance with CARES funding regulations.

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CARES Act Related Governmental Funding

RELIEF FUND

$150 billion in direct aid specifically for COVID-19 related expenses to states, tribal governments, and others with population greater than 500,000 people.

FEDERAL RESERVE MUNICIPAL LIQUIDITY FACILITY

The Federal Reserve will purchase up to $500 billion of short term notes directly from U.S. states, counties and cities.

EDUCATION

$30 billion to be distributed to entities providing education services.

CENTERS FOR DISEASE CONTROL

$1.5 billion for the (CDC) State and Local Preparedness Grants.

$100 billion to reimburse eligible health care providers for health care related expenses.

FEMA

Public Assistance Grants

TRANSPORTATION

$25 billion for COVID-19 related operating and capital costs are eligible.

JUSTICE

$850 million for the Coronavirus Emergency Supplemental Funding (CESF) grant program to assist state and local law enforcement and jails prevent, prepare for, and respond to COVID-19.

FEDERAL AVIATION ADMINISTRATION

$9.9 billion in total available to commercial airports through the Airport Improvement Program (AIP).$9.4 billion for airports to prevent, prepare for, and respond to COVID-19.

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Overview, Coronavirus Aid, Relief, and Economic Security Act (CARES) Act

- Issued into law March 27, 2020
- Over $339 billion in funding sent to various federal agencies with some impact to state and local governments

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Coronavirus Relief Funds (CRF)

- $150 billion for the Coronavirus Relief Fund
  - Administered by U.S. Department of Treasury
  - $3 billion reserved for territories and DC
  - $8 billion reserved for tribes
- Amounts were paid based on 2019 population data.
- Each state and local government over a population of 500,000
- Each state received a minimum of $1.25 billion.

Direct Payment for Specific Use - Financial assistance provided directly to individuals, private firms, and other private institutions to encourage or subsidize a particular activity by conditioning the receipt of the on a particular performance by the recipient. This does not include solicited contracts for the procurement of goods and services for the Federal government.

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Interpreting the Guidance for CRF

Title VI – Coronavirus Relief Fund, CARES Act

The Coronavirus Aid, Relief, and Economic Security (CARES) Act was passed by Congress with overwhelming, bipartisan support and signed into law by President Trump on March 27th, 2020.

Title VI – Coronavirus Relief Fund

a. Appropriation

b. Authority to make payments

c. Payment amounts

d. **Use of funds**

e. Certification

f. Inspector General oversight, recoupment

g. Definitions

Guidance for State, Territorial, Local, and Tribal Governments

Document created by U.S. Treasury.

The purpose of this document is to provide guidance to recipients of the Coronavirus Relief Fund (the "Fund")

September 2, 2020 version

Frequently Asked Questions (FAQ)

The answers to frequently asked questions supplement Treasury's Coronavirus Relief Fund Guidance for State, Territorial, Local, and Tribal Governments.

Amounts paid from the Fund are subject to the restrictions outlined in the Guidance and the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act").

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Use of Funds Under Title VI, CRF – The CARES Act

Governments shall use the funds to cover only those costs of the state, tribal government, or unit of local government that meets all three (3) requirements.

- Costs are necessary expenditures incurred due to the public health emergency with respect to the Coronavirus Disease 2019 (COVID–19)
- Cost were not accounted for in the budget most recently approved as of March 27, 2020 for the State or government
- Cost were incurred during the period that begins on March 1, 2020, and ends on December 30, 2020

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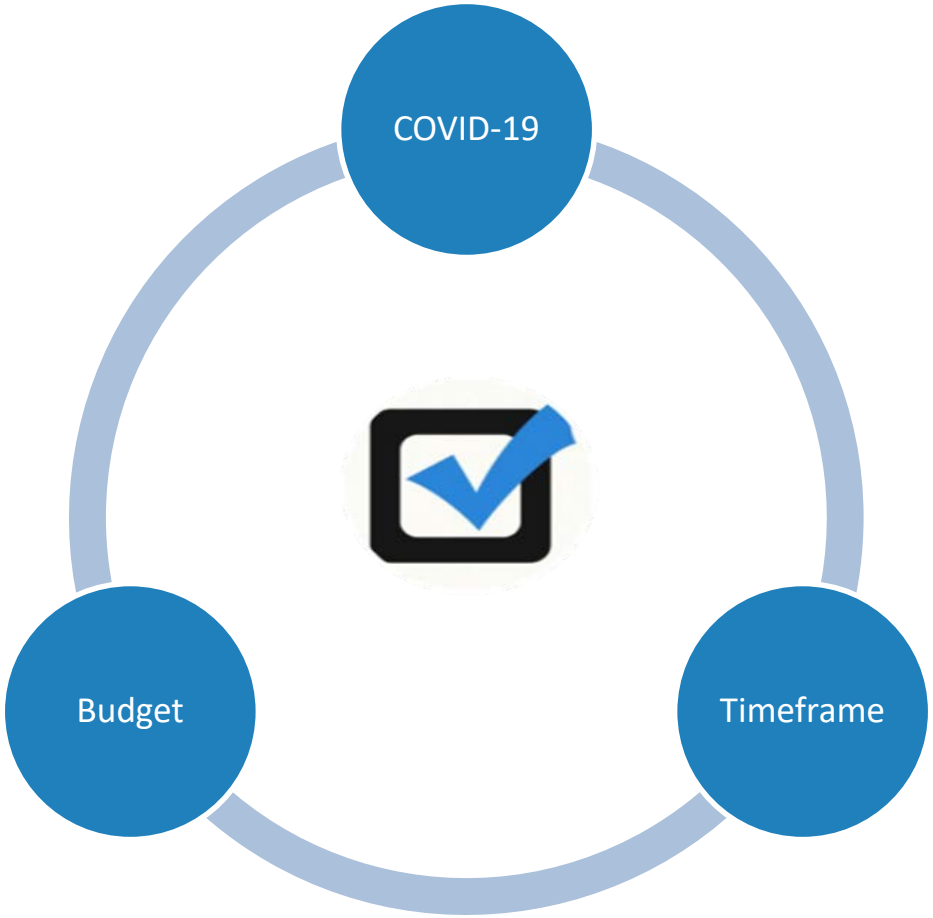
Compliance Visual



- Every program, transaction, and use should be analyzed and documented for compliance with these requirements.
- Imprudent application of these concepts could result in a debt to the Federal government.

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Necessary Expenditures Incurred Due to Public Health Emergency

- Due to Public Health
  - For actions taken to respond to emergency
    - ◊ Direct, or
    - ◊ Second-order effects such as economic support for employment and business interruptions
- Necessary
  - Reasonably necessary as determined by the reasonable judgement of government official(s) responsible for spending
- Revenue replacement (supplant) is <u>not permissible</u>.

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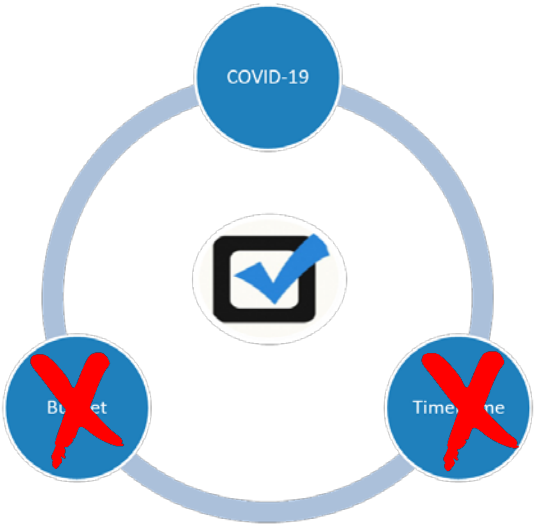
Necessary COVID-19 Expenditures

- The Guidance provides a generalized listing of both eligible and ineligible expenditures.
- This listing is suggestive of <u>use of funds</u>. This list <u>does not</u> consider the budget and timeframe of the expenditures.



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Coronavirus Relief Funds (CRF) – Eligible Expenditures

Medical

- Medical facilities
- Testing
- Telemedicine

Public Health

- PPE
- Safety measures
- Technical assistance
- Disinfection
- Communication

Payroll

- Public safety
- Public health
- Health care
- Human service
- Others similar substantially dedicated to COVID-19 emergency

Facilitate Compliance with Public Health Measures

- Food delivery
- Distance learning
- Telework capabilities
- Sick pay and family pay
- Prisons and jails
- Homeless populations

Economic Support

- Grants to small businesses
- Payroll support
- Unemployment insurances

Other

- Other Reasonably necessary expenses related to COVID-19

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Coronavirus Relief Funds (CRF) – Ineligible Expenditures

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- Expenses for the State share of Medicaid.
- Replacement of lost revenues, including property tax relief.
- Payroll or benefits expenses for employees whose work duties are not substantially dedicated to mitigating or responding to the COVID-19 public health emergency.
- Expenses that have been or will be reimbursed under any federal program, such as the reimbursement by the federal government pursuant to the CARES Act of contributions by States to State unemployment funds.
- Reimbursement to donors for donated items or services.
- Workforce bonuses other than hazard pay or overtime.
- Severance pay or legal settlements
- Damages covered by insurance.

Cost Not Accounted for in the Budget

- CRF payments use is only to cover cost not accounted for in the most recently approved budget as of March 27, 2020
  - i.e. cost you did not consider when preparing your budget
  - i.e. if were going to spend the dollars anyway, not those costs. (referred to *Supplement Not Supplant*)

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If the Costs are Budgeted and …

- The cost cannot lawfully be funded using a line item, allotment, or allocation within that budget OR

- The cost is a **substantially different use** from any expected use of funds in such a line item, allotment, or allocation.

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Supplemental Guidance on Use of Funds to Cover Payroll and Benefit of Public Employees (September 2, 2020 Add)

- Expenditures are not limited to only incremental costs above budget amounts.
- Rather, the budgeted provision was to avoid using the funds for a government provide general assistance (i.e.; original / substantially similar use)
- Documentation should be maintained supporting "substantially dedicated" for its employees.

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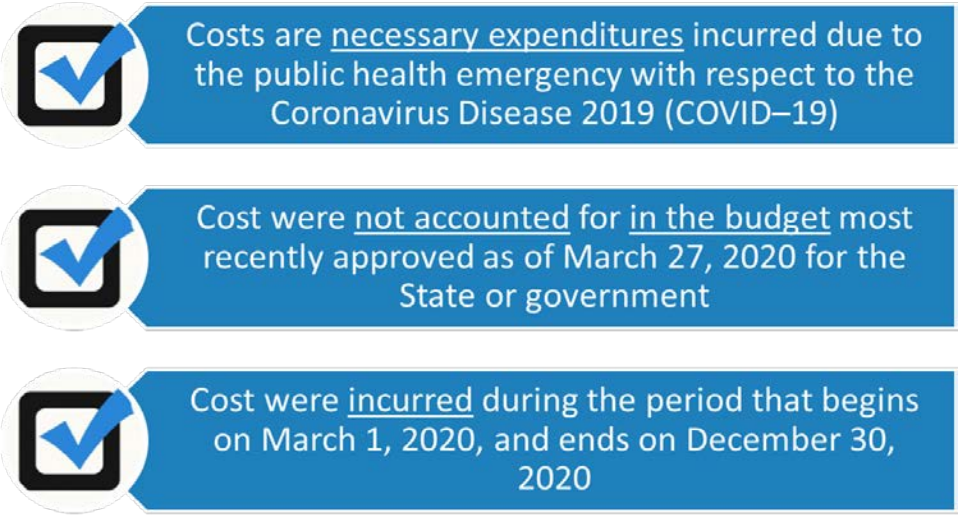
Public Health and Public Safety

- A government may presume that public health and public safety employees are substantially dedicated and; therefore, substantially different use.



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Other Employee Types

- Support is needed to claim substantially dedicated and substantially different use. Time and effort records would be appropriate.

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Supplemental Guidance on Use of Funds to Cover Administrative Costs (September 2, 2020 Add)

- No indirect rates
- Administrative cost must be incurred prior to December 30, 2020 –

  Except for –

  - Single audit costs
  - Reporting and recordkeeping costs imposed by OIG
- If costs are going beyond September 2021, government needs to provide an estimate to OIG

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Frequently Asked Questions

- Supplement Treasury's Guidance
- Reminder that amount paid for CRF subject to the three criteria discussed earlier
- October 19, 2020
  - 59 related to eligibility considerations
  - 13 administration questions

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Interpreting the Guidance for CRF

(Restated for Emphasis)

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Inspector General Oversight; Recoupment

Oversight authority

- Conduct monitoring and oversight of receipt, disbursement, and uses of funds.

Recoupment

- If Inspector General determines noncompliance, a liability to the Federal government should be recorded.

Appropriation

- $35,000,000 allocated to Inspector General to oversee these funds. (e.g. funded mandate)

Authority of Inspector General

- Nothing in this subsection shall be construed to diminish the Inspector General's authority.

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Desk Review Procedures Released

- OIG-CA-21-004
  - October 26, 2020
- Generally, the methodology includes –
  - GrantSolution submissions
  - Other audit reports (i.e., single audit, etc.)
  - Professional association issues
  - Sample of contracts
  - Review quarterly submissions
  - Interview prime recipients
  - Interview State auditors
  - Conduct site visits, as necessary

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Uniform Guidance – Single Audit

- Timing concerns
  - Compliance Supplement to be issued soon, this month?
  - CRF audit guidance will not be available until November/December?
- Program coverage and risk assessment
  - Type A threshold increasing on many audits
  - Program selection is difficult and in flux
- Changing internal control environments
- Remote work is a challenge for many clients particularly at the program administration level

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Compliance Supplement for CRF (Draft)

- Activities allowed or unallowed
  - COVID-19 related and not already covered by other Federal funding
- Cash management
  - Reconciliation of receipts of funding to expenditures
  - Short-term cash borrowing is okay
- Eligibility
  - Sub-recipients - Beneficiaries
- Period of performance
  - March 1 to December 30, 2020
- Reporting
  - Quarterly submission
- Sub-receipient monitoring

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Findings, Comments, Etc.

- Currently, we are concerned about more findings and comments related to the new and additional funding.
- Coronavirus Relief Fund specific concerns –
  - Undocumented and poorly supported cost eligibility determinations
  - Decision pressure, money, and remote work
  - Significant changes (personal, work-challenges, emotional, etc.)
  - Poor communication (Federal, state departments, local government)
  - Creativity and odd rationale
  - $35,000,000 US Treasury IG budget

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Discussion of Our Experiences

States

- Vermont
- Mississippi
- New Jersey
- Delaware
- Pennsylvania
- South Carolina
- Maryland

Locality

- Frederick County, MD
- Montgomery County, MD
- Pinellas County, FL
- Prince George’s County, MD
- Anne Arundel County, MD

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Challenges

- Changing guidance from US Treasury and others
- Time is running out (12/31/2020)
- Pressure!
- Normal procurement process, not quick enough
- Delay in starting spending, long deliberation
- Lack of resources for distribution and oversight
- Slow on issuing pass-through awards, pass-through entities cannot spend within period of performance

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Challenges (cont.)

- Program development
  - Economic support
  - Beneficiary or sub-receipent
  - Eligibility determines compliance

- Beneficiary concerns
  - Ability to provide information
  - Poor support and records
  - Eligibility and legitimacy concerns

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Federal Program Audits: Auditee and Auditor Perspectives

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Learning Objectives

At the end of this session you will:

- Discuss key strategies to improve communication and understand the Federal audit process
- Implement new actions to increase the benefit of the audit process and reduce uncertainty

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Single Audit Project Management Activity Timeline

- Setting the scope & identifying federal programs subject to audit
  - Type A:

Total Federal awards expended	Type A/B threshold
Equal to or exceed $750,000 but less than or equal to $25 million	$750,000.00
Exceed $25 million but less than or equal to $100 million	Total Federal awards expended times .03.
Exceed $100 million but less than or equal to $1 billion	$3 million.
Exceed $1 billion but less than or equal to $10 billion	Total Federal awards expended times .003.
Exceed $10 billion but less than or equal to $20 billion	$30 million.
Exceed $20 billion	Total Federal awards expended times .0015.

(last year VT's Type A threshold was $6,102,611)

  - Type B: 25% of Type A threshold

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Program Determination: High Risk Type A Program Criteria

- Not audited in the last two years
- Modified Opinion
- Material Weakness in internal controls
- Known or likely questioned costs exceeding 5% of total program expenditures
- Other – Auditor's judgement
- Federal government classified as high risk program

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Program Determination: Type B Risk Assessments

- Assess if there are low risk Type A's (Type A's not audited for the current year)
  - The maximum number of Type B programs is 25% of the low risk Type A programs
- Use the same mindset as Type A assessment:
  - Was there a modified opinion in the prior year?
  - Was there a material weakness or significant deficiency in internal controls?
  - Known or likely questioned costs exceeding 5% of total program expenditures
  - Auditor Judgement

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Program Determination: Schedule of Federal Awards (SEFA)

- SEFA is prepared by the State of Vermont identifying all federal program expenditures
- CLA determines the major programs, as previously discussed
- CLA communicates the major programs to the Statewide Grants Administrator

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Organize Single Audit Project Team

- The Statewide Grant Administrator notifies the respective State agencies and departments of the major programs within their Agency
- Each State agency and department should identify an overall Single Audit **Project Leader (aka "Liaison")** who, in turn, should identify a Single Audit **Program Team** for each Federal program under audit
- IAG assists in coordination with program staff

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Organize Single Audit Project Team

- Single Audit **Program Team**
  - should be directly experienced and knowledgeable in who/how the program is managed

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Determination of Program Specific Audit Procedures

- Federal Compliance Supplement
  - Part 4 / Part 7
    - ◊ Compliance requirements for each major requirement
  - Publically available
  - Typically Published April/May Timeframe, have been August or later the past years
  - Used to help build PBC List

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Federal Compliance Supplement: Part 4

A	B	C	E	F	G	H	I	J	L	M	N
Activities Allowed or Unallowed	Allowable Costs/Cost Principles	Cash Management	Eligibility	Equipment/ Real Property Management	Matching, Level of Effort, Earmarking	Period Of Performance	Procurement Suspension & Debarment	Program Income	Reporting	Subrecipient Monitoring	Special Tests and Provisions
Y	Y	Y	Y	N	Y	N	N	N	Y	N	N

Note: If the program under audit does not contain a Part 4 Compliance Supplement, CLA will utilize a general Part 7 and inquire to determine which compliance areas are in scope for the federal program.

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Development of PBC Lists for Each Program

- Using aforementioned information the PBC list is developed and provided to the Internal Audit Group
  - Each line corresponds to compliance supplement testing requirement
  - Use same letter conventions as compliance supplement for tracking
- Entrance Meetings to Discuss PBC list, audit areas and meet the program
- CLA will use this PBC List for tracking deliverables, sample selections and testing progress

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PBC List as the basis of Project Team organization

- Using the PBC list as a guide, the Project Leader should assemble a team of program management personnel so that each PBC test/information request is adequately covered

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Kick-off/Entrance Meetings

- CLA/Program Team introductions
- CLA leads meeting, walking the Program Team through the planned audit process as defined by the PBC List
- Project Leader uses the kick-off meeting to ensure that the correct people are involved to cover the PBC-defined audit requirements
- Project Leader schedules weekly status meetings going forward including Program Team and CLA in order to ensure efficient and effective completion of the PBC list
- **Confirm that the correct/complete Program Team is assembled so that all PBC items are adequately covered**

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Compliance Areas Tested

- A – Activities Allowed or Unallowed
  - Activities Allowed Under the Grant's Purpose
  - Specific activities may not be funded under a specific program
- B - Allowable Costs/Cost Principles
  - Costs reasonable and necessary for the program based on requirements of the grant
  - Direct and Indirect Costs
- IAG Expenditure Breakouts

Note: CLA will often select a single sample and test the Allowable Costs and Allowable Activities together

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Compliance Areas Tested (continued)

- C – Cash Management
  - Advances versus Reimbursements
  - Cash Draw Samples
  - IAG assists in coordinating with Central Office
- E – Eligibility
  - Unique to each federal program
  - Specifies criteria for individuals who can participate in the program
  - IAG assists in coordinating with program staff
- F – Equipment and Real Property Management
  - Need to maintain records to track purchases and take a physical inventory every 2 years
  - If equipment or real property sold, federal government/state entitled to a portion of sales proceeds depending on funding level

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Compliance Areas Tested (continued)

- Matching, Level of Effort, and Earmarking
  - *Matching* - provide contributions of a specific amount or percentage to match federal awards.
    - Must be non-federal source
  - *Level of effort* (program specific)
    - a specified level of *service* to be provided or *expenditures* to be maintained from period to period
    - Federal funds to supplement and not supplant non-federal funding of services
  - *Earmarking* - (program specific)
    - a minimum or maximum amount or percentage of the program's funding to be used for certain activities

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Compliance Areas Tested (continued)

- H – Period of Performance
  - Federal awards may specify a time period during which the federal funds may be used
  - Generally specified in the grant award
- I – Procurement, Suspension and Debarment
  - Records to detail the history of procurement
- J – Program Income
  - Income received directly generated by a federally funded project during the grant period

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Compliance Areas Tested (continued)

- Reporting
  - Program specific and outlined in grant agreements
  - Programmatic & Financial
- Subrecipient Monitoring
  - Big deal for pass through entities
  - Entity needs to monitor and ensure their subrecipient is carrying out the grant purpose and abiding by grant agreement
  - Entity needs to ensure sub awards contain all required information
- Special Tests
  - Specific to each federal program

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Weekly Status Meeting

- Project Leader aka Liaison leads the meeting
- Review PBC List each week updating the status of each PBC item accordingly
- Affixes ownership and accountability to committed due dates for each PBC item
- Address questions and concerns in a collaborative setting
- Identification and discussion of findings in “real time”

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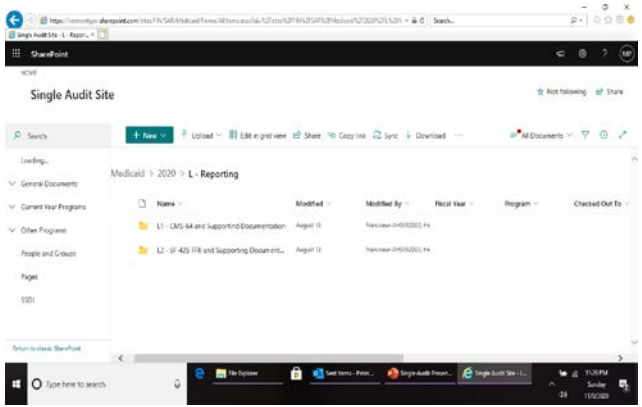
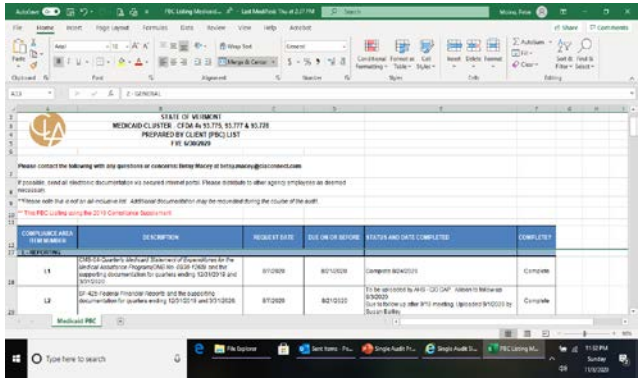
SharePoint Shared Folder System

- Navigate to SharePoint SFY 2020 Single Audit Site Medicaid example….
  - Medicaid PBC List match-up with Medicaid Folder hierarchy and nomenclature





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Findings and Corrective Action Plan (CAP)

- Potential findings are brought to the attention of the Program Team by CLA during fieldwork/weekly status meetings – NO SURPRISES
- Potential findings are either resolved or confirmed
- Confirmed findings are noted as either SD or MW
- Each finding must have a corrective action plan (CAP)
- CAPs must be written in compliance with Policy #9

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Risks of Occupational Fraud Facing State and Local Governments

State of Vermont – 11/12/2020

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Learning Objectives

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

- **List and describe the common fraud schemes**
- **List the eight important facts of fraud**
- **Identify actual instances of fraud that have recently occurred within state and local governments**
- **Identify common red flags and indicators of fraud**
- **Recognize what internal control activities could have been in place to prevent the fraud from occurring or detect the malfeasance earlier**
- **Describe the importance of the tone at the top**

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Introduction

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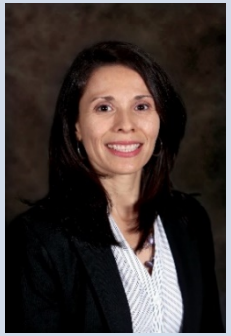
Speaker Introduction

Manager
CLA's Forensic Practice

Seven years of experience performing forensic accounting engagements, fraud investigations, and internal control assessments for governmental, educational, and private entities.



Ana Rodriguez

CPA, CFE

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Speaker Introduction

Senior
CLA's Forensic Practice

Over six years of experience, including leading fraud investigations, litigation support, audits, and other specialized consulting work.

Kyle Shafer

CPA, CFE

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Introduction to the ACFE

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Association of Certified Fraud Examiners (ACFE)

- **World's largest anti-fraud organization**
- **Provides Certified Fraud Examiner (CFE) credential**
  - Requires meeting professional, educational, and ethical standards and passing a rigorous exam on the four major disciplines that comprise the fraud examination body of knowledge: Fraud Prevention and Deterrence, Financial Transactions and Fraud Schemes, Investigation, and Law
- **Headquartered in Austin, TX**
- **85,000+ members**
- **196 Chapters worldwide**

From ACFE website: www.acfe.com

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ACFE *Report to the Nations* 2020

- **Report to the Nations 2020 Global Study on Occupational Fraud and Abuse**
- **Bi-Annual Report**
- **Analysis of 2,504 cases of occupational fraud across 125 countries**
- **Results based on 2019 *Global Fraud Survey* opened to CFEs about their single largest fraud case investigation completed between January 2018 and September 2019**
- **First ACFE Report to the Nations was issued in 1996**

https://www.acfe.com/report-to-the-nations/2020/

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The Fraud Tree

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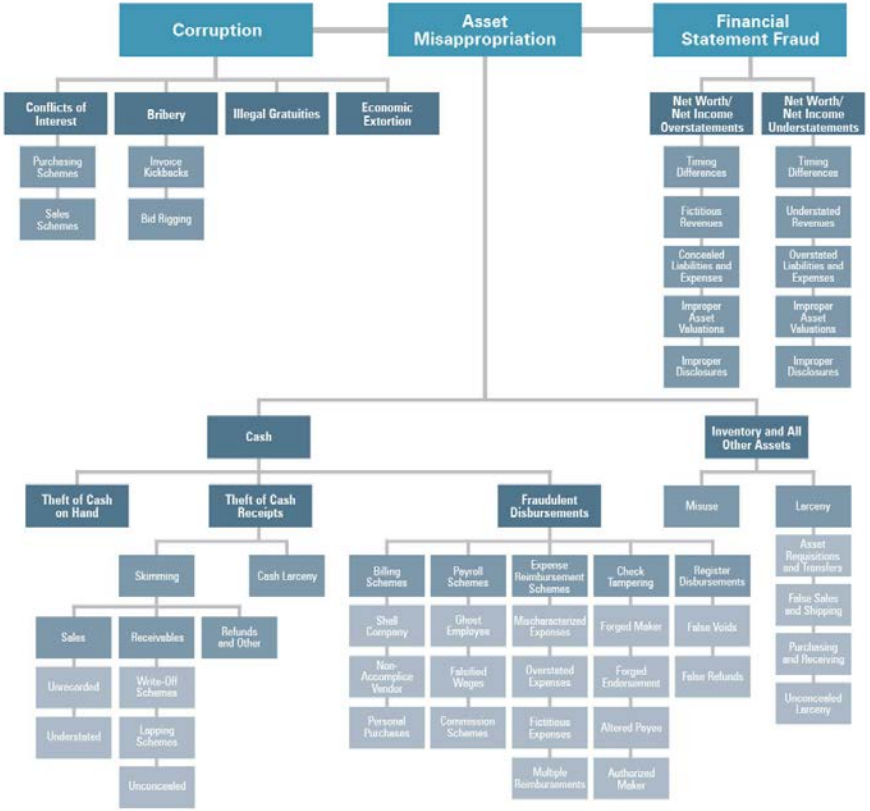
THE FRAUD TREE

OCCUPATIONAL FRAUD AND ABUSE CLASSIFICATION SYSTEM



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Types of Fraud Schemes

Corruption

- Involve employees' use of their influence in a business transaction in a way that violates their duty to their employer for the purpose of obtaining a benefit for themselves or someone else
- Often involve collusion between an internal employee and an outside party
- Can be difficult to detect

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Types of Fraud Schemes

Financial Statement Fraud

- Manipulation, falsification, or alteration of accounting records or supporting documentation from which the financial statements are prepared
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions, or other significant information
- Intentional misapplication of accounting principles

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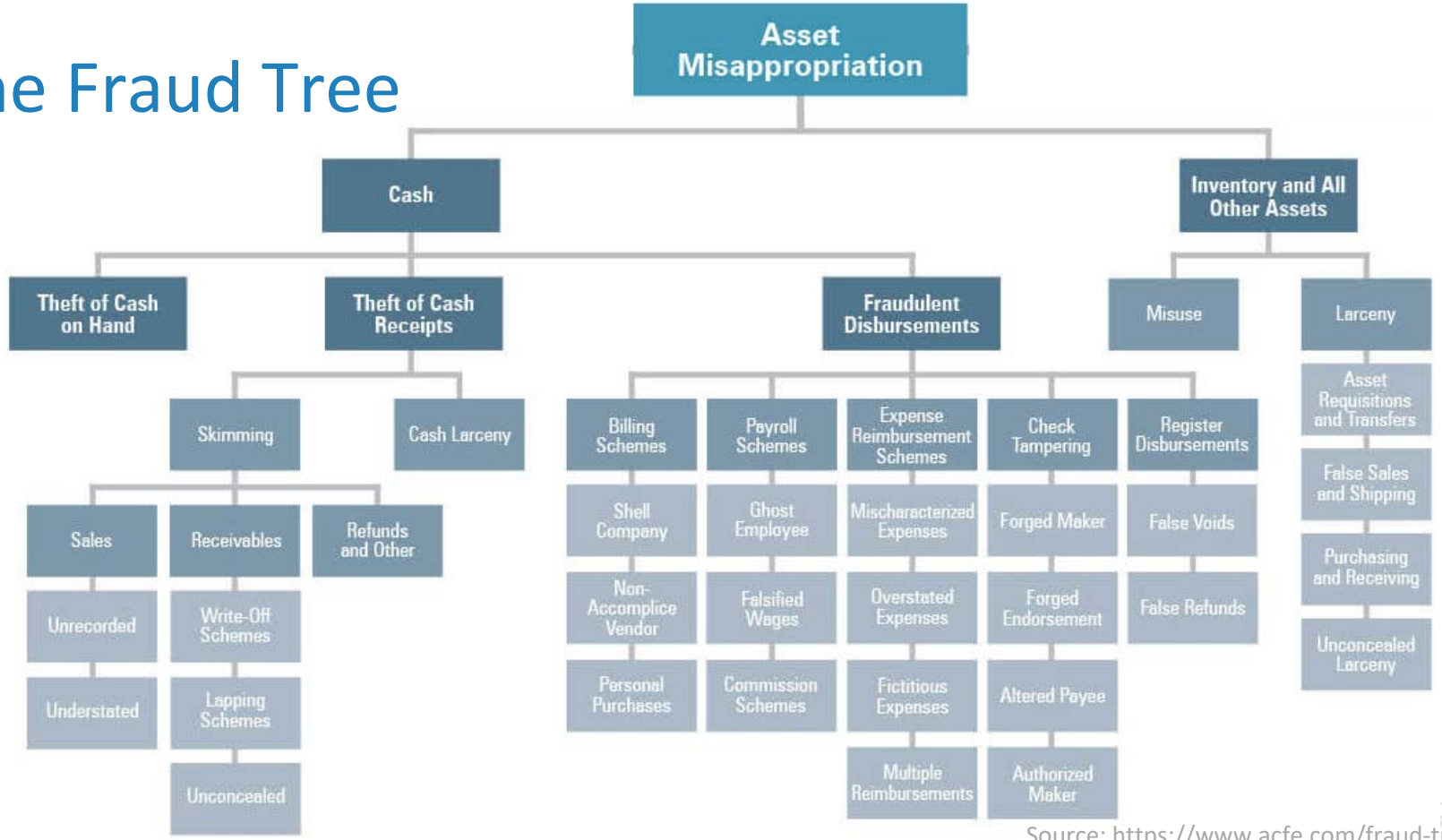
The Fraud Tree



Source: https://www.acfe.com/fraud-tree.aspx

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Question #1

Polling Question

- **The ACFE defines occupational fraud as:**
  a. A knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment
  b. The theft or misuse of a company's resources and includes schemes such as skimming, check tampering, payroll fraud, expense reimbursements, and cash register disbursements, among others
  c. The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets

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Occupational Fraud by Organization Type

FIG. 20 **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
2020	Government and public administration	189	18%	5%	9%	4%	48%	17%	4%	17%	17%	0%	7%
2018	Government and public administration	184	15%	11%	11%	9%	50%	11%	5%	22%	7%	2%	11%

Source: ACFE 2020 & 2018 Report to the Nations

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The Fraud Triangle

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The Fraud Triangle

Understanding the Fraud Triangle is critical to:

- Minimize the risk of abuse
- Minimize the risk of fraud
- Develop strong internal controls

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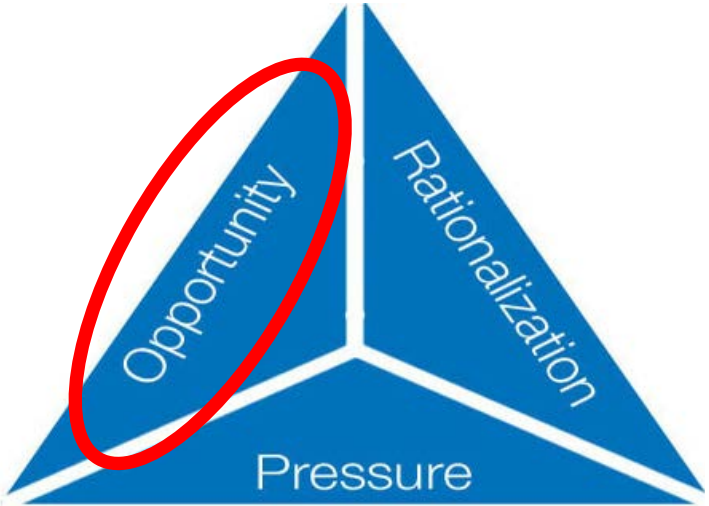
The Fraud Triangle

What aspect of the Fraud Triangle does your organization have some control over?



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The Fraud Triangle

What has been the impact of COVID-19 on internal controls?

1. Fewer staff (reduced segregation of duties)
2. Revised approval processes
   a) Approvals by email only (no electronic or wet signature)
   b) Fewer approvals required
   c) Original documents not available for review
3. Less oversight and monitoring
4. Heightened risk of cyber-crimes
5. Greater reliance on technology

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Eight Important Facts About Fraud

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Eight Key Facts from the *Report to the Nations* and Our Experience

1. **Typical organizations lose 5% of revenue in a given year as a result of fraud**
2. **Fraud exists in every organization and every industry type – <u>top 5</u> industries with the highest occurrence of fraud:**
   - Banking and financial services (median loss: $100,000)
   - Government and public administration (median loss: $100,000)
   - Manufacturing (median loss: $198,000)
   - Health care (median loss: $200,000)
   - Energy (median loss: $275,000)
3. **Prominent weakness – lack of internal controls**

ACFE
Association of Certified Fraud Examiners

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Eight Key Facts from the *Report to the Nations* and Our Experience

4. **Most common form of occupational fraud – asset misappropriation**
5. **Check tampering and billing schemes represent the greatest risk**
6. **Most perpetrators are first time offenders (only 4% had prior convictions)**
7. **Frauds with highest frequency occur in operations, the accounting department, and in executive/upper management**
8. **The majority of occupational frauds are not material to the financial statements (frequent, small transactions taking place over an extended period of time)**

DEPARTMENT	Cases
Operations	288
Accounting	277
Executive/upper management	234
Sales	225
Customer service	175
Administrative support	116
Finance	101
Purchasing	96

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Occupational Fraud by Category - Frequency

FIG. 2 How is occupational fraud committed?

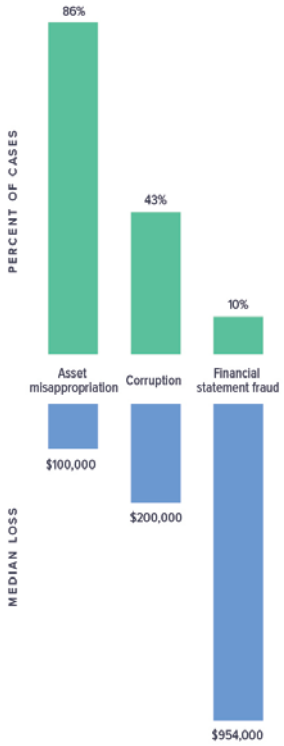
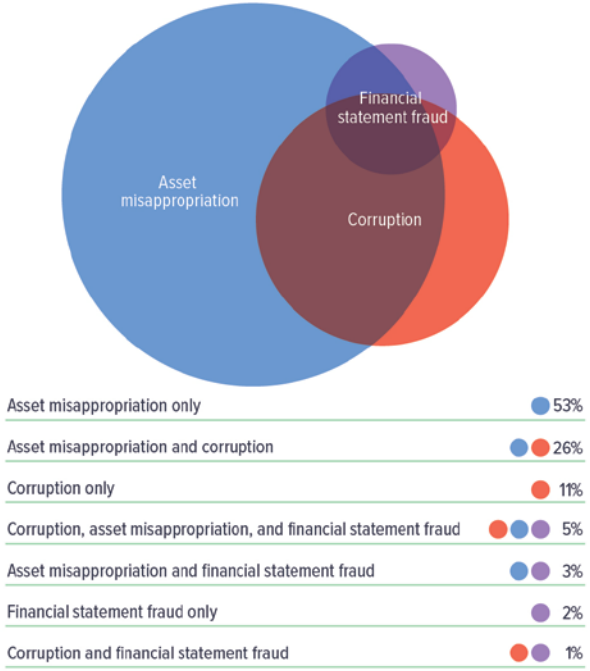


FIG. 4 How often do fraudsters commit more than one type of occupational fraud?



Source: ACFE 2020 Report to the Nations

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Occupational Fraud by Organization Type

FIG. 14 **What types of organizations are victimized by occupational fraud?**

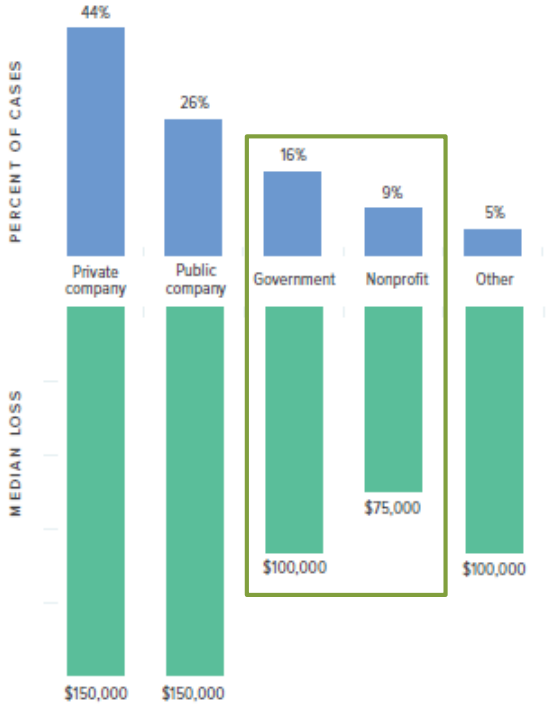
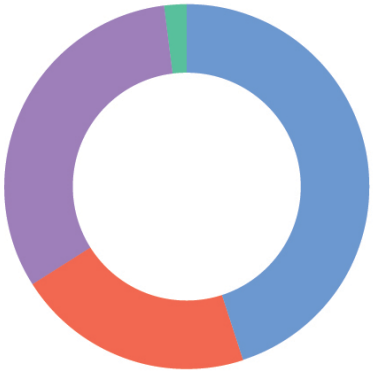


FIG. 15 **What levels of government are victimized by occupational fraud?**



National: 45% ($200,000*)

Local: 32% ($75,000*)

State/provincial: 21% ($91,000*)

Other: 2% ($N/A*)

**Dollar amounts are median loss. Median losses calculations for categories with fewer than 10 cases were omitted.*

Source: ACFE 2020 Report to the Nations

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Frauds that Have Occurred Recently within State and Local Governments

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Question #2

Polling Question

- **What was the median loss for governments and public administrations?**
  a. $50,000
  b. $100,000
  c. $250,000

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Fraud in State and Local Governments

1. Public Contracts
2. Purchasing Process
3. Payroll & Stipends
4. Utilities & Public Works
5. Public Safety
6. Transportation
7. General IT vulnerabilities including phishing emails (increased risk with remote work)
8. Public integrity & conflicts of interest

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Impact of Fraud – More than Just Money

Monetary

- Actual loss
- Costs and time spent by investigators/attorneys

Reputation

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

Increased Costs

- High risk audit / increased audit costs

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State and Local Government Fraud in the News

- **Police Sergeant Charged with Embezzlement**
- **City considers internal financial controls after embezzlement**
- **State ACO faces allegations of fraud and faulty data**
- **State's role in scandal paused as auditor issues an interim EB-5 report**
- **City bribery investigation puts CEO in federal prison**

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Case Study #1

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Overview

- **Organization**
  - Water district in a California region serving about 830K people
  - Contracted with a regional wastewater agency
  - Wastewater agency collected water waste from the water district territory
  - Water district collected sewer connection fees from new construction and tenant improvement related construction
- **Detection**
  - Environmental Services Dept. of Wastewater agency had concerns that a transaction had an unsupported credit

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Scope of Engagement

- **Primary Objective**
  - Determine the circumstances behind a credit issued to a new construction site
  - Assess whether a loss was incurred by the water district/wastewater agency
- **Secondary Objective**
  - Determine individuals involved in the questioned transaction
  - Gather evidence of wrong doing for law enforcement referral

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Fraud Scheme

- **Perpetrator**
  - Male mid-40s; married with 2 children, no known addictions or health issues
  - Hired as an industrial waste inspector
  - Over 14-year tenure promoted to development service supervisor and then to engineering analyst
  - Responsible for issuing and renewing industrial sewer use permits with minimal to no supervision
  - Was the point of contact for the wastewater agency environmental service department and for the internal audit department

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Fraud Scheme

- **Type of Fraud – Hybrid between "Sales Scheme" and "Unrecorded Sales"**
  - Sales Scheme = Involves the underselling of company goods by an employee to a company in which the employee maintains a hidden interest (giving company more goods than it paid for)
  - Unrecorded Sale = Collecting cash, keeping a portion of the cash, and underreporting the sale amount
- **Total theft – $505,000**

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Background

- **Connection fees are measured in Equivalent Dwelling Units (EDU) by the water agency**
  - 1 EDU represents the sewage from a single family residential household
  - One-time fee assessed to connect to sewer system is based on EDUs
  - Fee is assessed and collected by the water district and passed onto the regional wastewater agency
  - EDU purchases remain with the existing building and are not transferrable
  - Transfer of EDUs from one physical location to another is allowed only if a building with existing EDUs is demolished and proof of demolition is documented

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Background

- **An applicant purchased EDUs from another business for $505,000; however:**
  - There was no record (at the water agency) that this other business had ever paid for EDUs
  - There was no record (at the water agency) that these EDUs existed at the location specified
  - If the business had paid for EDUs but never used them, it could have received a credit from the water district

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Background

- **Supervisor included a "credit" in the fee calculation**
- **The explanation for the credit on the paperwork indicated that it was due to <u>existing</u> EDUs at the location**

CAPITAL CAPACITY REIMBURSMENT FEES:

- COMMERCIAL USE

  130.5 FIXTURE UNITS × 0.0741 SEWER FACTOR = 9.67005 Equivalent Dwelling Units [EDUs]

- INDUSTRIAL USE

  SEWER FLOW: 50,000 *gallons per day (largest average discharge based on calendar month average)*

  BOD: 500 *mg/liter (largest average concentration based on calendar month average)*

  TSS: 115 *mg/liter (largest average concentration based on calendar month average)*

  50000 gpd / 270 gpd × [0.37 + 0.31 × (500 mg/L / 230 mg/L) + 0.32 × (115 mg/L / 220 mg/L)] = 224.29 EDUs

- CAPITAL CAPACITY CREDIT

  The following paid and available Capital Capacity EDUs are to be applied to this Tenant Improvement project per the Building Owner's written permission submitted to the District, or by demolition of existing sewer drainage fixtures within Tenant space:

  EDU Credit: 119.54926 EDUs

- TOTAL EDUs *(Ord. 32-C, Exhibit A)*

  114.41079 EDUs × $4,909.00 PER EDU = $561,642.57

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Investigative Techniques

- **Public database searches and background checks**
- **Interviews:**
  - Employees of the water district
  - Internal auditors at the wastewater agency
  - Environmental Services department at external agency (first raised concern about transaction)
  - Suspect (Supervisor)
- **Analyzed available documents**
- **Computer hard-drive image & search; email search**

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Investigative Techniques

Pulled Fictitious Business Name filing and found that the copy provided by the "owner" to the applicant had been altered

Altered Document

2011-002433

JAN-25-2011

FILED
Ernest J. Dronenburg, Jr.
SAN DIEGO COUNTY CLERK
FEES: 42.00
EXPIRES: JAN-25-2015
DEPUTY: MPONIENT

Actual Document

2013-002433

JAN-25-2013

FILED
Ernest J. Dronenburg, Jr.
SAN DIEGO COUNTY CLERK
FEES: 42.00
EXPIRES: JAN-25-2018
DEPUTY: MPONIENT

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Investigative Techniques

A public record search on the "owner" of the business that received payment for the EDU transfer and revealed that he lived in a house owned by the Supervisor at the water district (information partially redacted)

1576 V[redacted] ESCONDIDO CA 92026-222

Summary]

Owner:

SHAWN [redacted] [View Person Record]

Purchase Date: **03/25/2015**

Assessed Value: **$256,000**

Living Square Feet: **1,188**

Land Square Feet: **13,600**

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Investigative Techniques

Email Review:

- **In June 2012, Supervisor sent an email to his accomplice confirming that the address had only 11.93 EDUs**
- **Supervisor sent himself a template of a transfer agreement that was ultimately used and signed by the two companies in making the "transfer"**
- **In January 2013, Supervisor sent an email stating that the address had EDUs of 119.54926 from past tenants and occupancies**

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Investigative Techniques

“I have achieved some professional ‘stretch goals’ of which you are unaware, and I think you would be surprised. I also would like to request some additional ‘stretch goals’ that I can demonstrate are very achievable. Please let me buy lunch. I’ve been anxious to share with you guys for *many* months.”

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Red Flags - Supervisor

- **Shared with co-workers how he made "good money" on a side job – one time thing**
- **Personal relationship with the "owner" of the fictitious business**
- **Often complained that there was not an "open market" for the sale of EDUs**

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Internal Control Weaknesses

- **Supervisor had autonomy – lack of oversight/review**
- **Supervisor was the only person that calculated EDUs for this particular type of tenant improvement**
- **All records of existing EDUs were in paper – no database**
- **EDUs are not a physical asset – only exist on paper**

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Outcome

- **On the same day of the interview of the Supervisor, his <u>defense counsel</u> contacted the water district and asked if the matter had been referred to law enforcement**
- **He ultimately resigned from his position**
- **Pleaded guilty to grand theft by false or fraudulent representation or pretense**
- **Water district received full restitution from the Supervisor (former employee) and the accomplice on the day the guilty plea was entered**
  - Supervisor: $463,257.56
  - Accomplice ("owner" of business that sold EDUs): $65,044.44

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DISCUSSION

What control deficiencies <u>may</u> have existed in this scenario?

1. Inadequate segregation of duties between the person issuing EDU credits and the person approve those credits
2. No separate review or monitoring of EDU credits
3. No system for verifying addresses or existing customer records
4. Insufficient oversight and monitoring of management activity
5. No rotation of work load/tenant types or responsibilities
6. No annual employee declaration of business interests/conflict of interest

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Sales Schemes

Red Flags & Risk Areas:

- Unusual amount of interest in contract or contractor
- Accepts items not favorable to the organization
- Acts outside their normal scope of duties
- Undisclosed relationship between employee and third-party
- Insufficient or no segregation of duties
- Poor internal controls over key functional areas
- Insufficient capacity to monitor high-risk employees or units
- Inadequate anti-corruption control plan

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Sales Schemes

- Periodic comparisons of vendor/customer information with employee information, such as addresses and telephone numbers
- Identify opportunities to separate duties
- Reporting procedure for personnel to report concerns about vendors/customers receiving favored treatment
- Require employees to sign an annual disclosure document
- Audits conducted by someone independent of the purchase, sales, billing, and receiving departments

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Case Study #2

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Overview

- **Organization**
  - County department with $1.5 million annual budget
  - Serves over 190,000 customers
- **Perpetrator**
  - Long-term, trusted employee
  - Female, late-40s, divorced, adult children
  - Alleged drug addiction; family medical issues
  - Handled all accounting for 3 agency funds
- **Detection**
  - A temporary receptionist questioned why the subject was picking up so many checks for hand-delivery that normally would have been mailed

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Scope of Engagement

Primary objective:

- **Prepare a written report for County's insurance claim**

Secondary objective:

- **Confirm theft identified by County internal audit department**
- **Assess whether additional losses or other schemes were perpetrated**

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Fraud Scheme

- **Misappropriation Scheme #1 – Refunds (Primary)**
  - Deposits from customers were held in an agency fund
    - As services were provided, deposits were transferred to the departments operating account
    - Unused deposits were refunded to customers
  - Created and approved claim requests for fictitious refunds to customers
  - Created fictitious supporting documentation
  - Used a “one-time” vendor number that allowed manual entry of payee name and address
    - Intended use was for one-time, non-recurring payments (no W-4)

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Fraud Scheme

- **Misappropriation Scheme #1 – Refunds (Primary)**
  - Earlier years:
    - ◊ Used co-conspirator names and addresses as payees (not employees)
    - ◊ Checks were mailed directly to co-conspirators
  - More recent years:
    - ◊ Used name of community organization of which she was the Treasurer and had access to the bank account
    - ◊ Marked payments for pick-up, which required the approval of her supervisor
    - ◊ Gained access to supervisor's log-in credentials and used log-in to approve checks
    - ◊ Indicated her own name for pick-up
    - ◊ Picked up checks from accounting
    - ◊ Deposited checks into bank account

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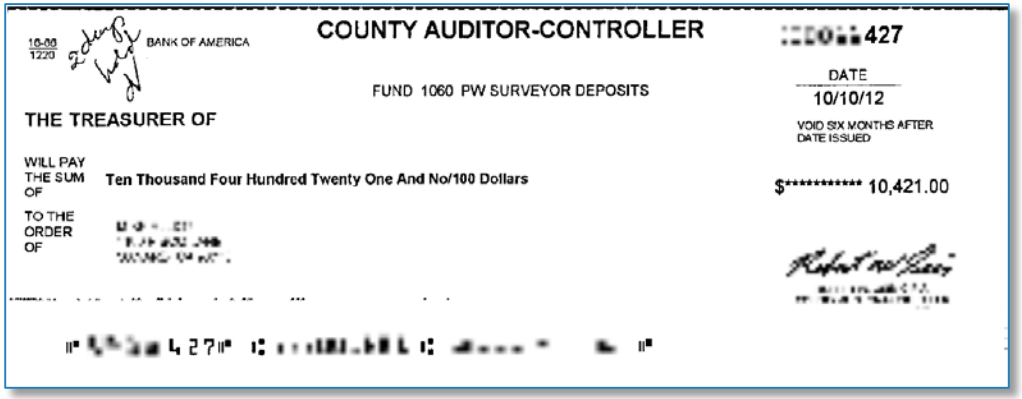
Fraud Scheme

- **Misappropriation Scheme #1 – Refunds (Primary)**
  - Misapplied deposits to ensure sufficient money available in the agency funds
  - Department leaders noticed that the department operations were struggling, but did not fully understand cause


10-00
1220

BANK OF AMERICA

COUNTY AUDITOR-CONTROLLER

427

FUND 1060 PW SURVEYOR DEPOSITS

DATE
10/10/12

VOID SIX MONTHS AFTER DATE ISSUED

THE TREASURER OF

WILL PAY THE SUM OF Ten Thousand Four Hundred Twenty One And No/100 Dollars

$********** 10,421.00

TO THE ORDER OF

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Fraud Scheme

- **Misappropriation Scheme #2 – Fictitious Vendor**
  - Used a co-conspirator name and prepared quotes for fictitious professional services
  - Got permission from risk management to override requirement for proof of insurance
  - Requested that purchasing approve a PO for the work
  - Created fictitious invoices from co-conspirator
  - Submitted invoices for payment
  - Issued departmental approval on invoices (no 2nd approval required from department)

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Investigative Techniques

- **Document Examination**
  - Cancelled checks
  - Check requests and supporting documentation
  - Perpetrator's and co-conspirators' bank statements (provided by DA)
  - Access databases used to track County projects
- **Interviews**
  - Understand internal investigation conducted by County
  - Understand processes to assist with data analytics
  - Determine whether other schemes were used

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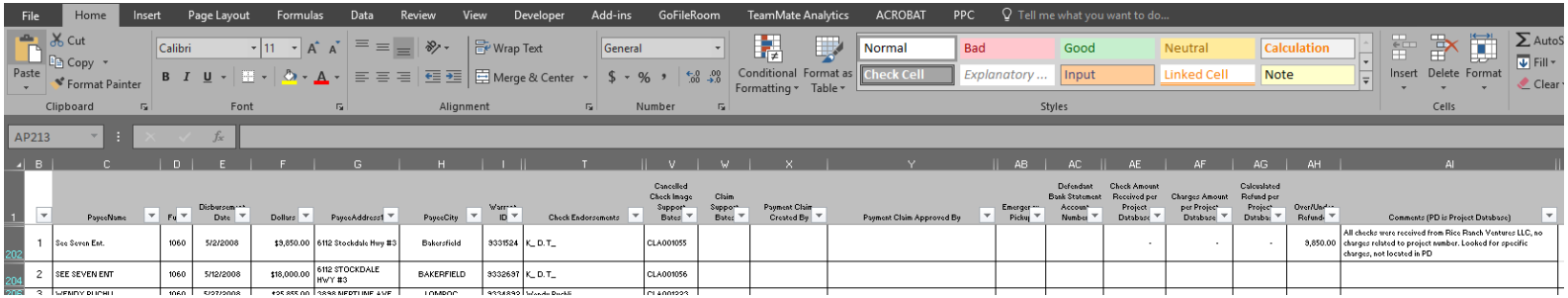
Investigative Techniques

- **Data Analytics**
  - Identify other possible misappropriation by perpetrator
  - All misappropriated checks identified?*

*Bank statements went back only 7 years



	PayeeName	Dollars	PayeeAddress	PayeeCity	Check Endorsements	Cancelled Check Image Support Dates	Payment Claim Created By	Payment Claim Approved By	Check Amount Received per Project Database	Charges Amount per Project Database	Calculated Refund per Project Database	Over/Under Refund	Comments (PD is Project Database)
1	See Seven Ent.	$9,850.00	6112 Stockdale Hwy #3	Bakersfield	K_ D.T_	CLA001055			-	-	-	9,850.00	All checks were received from Rice Ranch Ventures LLC, no charges related to project number. Looked for specific charges, not located in PD
2	SEE SEVEN ENT	$18,000.00	6112 STOCKDALE HWY #3	BAKERFIELD	K_ D.T_	CLA001056							

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How Suspect Got Away With It

- No second department level approval required for mailed checks
- Gained access to supervisor's log-in credentials (to pick-up checks)
- Decentralized organization
- Minimal oversight by department/accounting
- Employees that create/approve check requests could pick-up checks from accounting
- Lack of separation of duties
- Accounting approval meant only that support matched check request information

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Results of Investigation

- **Loss to organization: $2.05 million**
  - Refunds: $1.8 million (240 checks)
  - Fictitious vendor: $290,000 (42 checks/ACH)
- **Time Period: 5/2/2008 to 7/25/2017***
- **No other county employees involved**
- **16 different payee names/addresses were used**

***Believe misappropriation may have gone back further; however, no supporting documentation available for review**

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Results of Investigation

- **Administrative: Employee was terminated**
- **Civil: No civil action taken; insurance claim filed to recover loss**
- **Criminal: Indicted by DA; pleaded guilty; sentenced to 9 years, 8 months prison term; ordered to pay $2.5 million in restitution**
- **8 other co-conspirators were indicted; 5 of whom pleaded guilty and received prison sentences ranging from 6 months to 13 years**

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DISCUSSION

What control deficiencies <u>may</u> have existed in this scenario?

1. Not adequate segregation between the person(s) approving the invoice, preparing the check, and signing the check
2. Employee had access to checks after they were signed; checks should always be mailed immediately after being signed
3. Inadequate purchasing documents (approved contract, purchase order, etc.)
4. No review of disbursements by higher level management
5. Ability to request (or enter) address or other information change for vendor

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Question #3

Polling Question

- **What red flags existed in this scenario?**
  a. No one was responsible for reviewing employee purchasing card statements
  b. There was a large volume of check disbursements that required high level authority for approval
  c. The one-time vendor code was used frequently

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Billing Schemes

Red Flags & Risk Areas:

- Poor controls over vendor master list
- One-time (temporary vendor) number
- Employees can request that checks be routed back to themselves
- Employees can pick-up checks from accounting
- Payments to individuals, new vendors, or unknown vendors
- Round dollar payments, payments just below approval thresholds
- Excessive use of one account type by a single employee
- Vendor used by only one employee
- Lack of detail on the supporting invoice
- Consecutively numbered invoices / duplicate invoice numbers
- Lack of a physical address on the invoice

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Billing Schemes

- Segregate purchasing duties from payment duties
- Maintain an approved master vendor list limited to a few authorized employees
- Payments to Management and Elected Officials requires board or council approval
- Implement board review process
- Prohibit manual pick of vendor payments

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Case Study #3

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Overview

- **Organization**
  - Quasi governmental organization
  - Mission is to improve the lives of its constituents
  - Areas of focus: land, culture, economic self-sufficiency, education, governance, and health
- **Concern**
  - Constituents demanded a higher level of transparency for how funds that were intended to benefit them were being used for contracts, grants, and disbursements

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Scope of Engagement

Primary objective:

- Conduct an examination of the organization and its limited liability companies for a period going back five years
- Examine financial records, accounts, business transactions, accounting practices, internal controls and compliance
- Identify potential areas of fraud, waste, and abuse in the procurement processes

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Examination

- **Contracts and Disbursements Examined for the Organization**
  - Approval and execution in accordance with the state's procurement code, state's standards of conduct, and the organization's internal policies and procedures
  - Sufficiency of oversight by the contract/grant managers
  - Deliverables were met by contractor
  - Evidence of fraudulent or wasteful disbursements

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Examination

- **Contracts and Disbursements Examined for its LLCs**
  - Sufficiency of oversight by the contract/grant managers
  - Deliverables were met by contractor/grant recipient
  - Conflict of interests with the LLC managers and directors
  - Evidence of fraudulent or wasteful disbursements

- **Examine reporting from the LLCs to the Organization**
  - Review LLC's quarterly reports to the elected Board of Trustees
  - Assess whether sufficient internal controls were in place to ensure integrity of performance indicators reported by the LLCs to the organization

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Red Flags

- Fiscal Procedures Manual was over ten years old
- Standard contracts were missing or incomplete
- Contract start dates began before the contract execution dates
- Required signatures on procurement documents were missing
- Organization was unable to produce evidence that contractors provided deliverables as required by the contracts

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Results of Examination

- **39 out of 39 grants had findings**
  - Potential conflict of interests
  - Several grantees did not have a complete grant application
  - Several grant files did not contain sufficient evidence that the organization monitored or evaluated the grant activities
  - Several grant files did not contain evidence of the Board of Trustees approval
  - Several grant files did not contain evidence that the organization's procurement process was followed, e.g., proof of award letters

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Results of Examination

- **9 out of 9 competitive sealed contract proposals had findings**
  - State's public procurement code criteria for competitive proposals was either not met or documentation was missing
- **14 out of 14 professional service contracts had findings**
  - One contract had a potential conflict of interest
  - Several contracts did not have evidence of being solicited in the appropriate time period or proof of publication
  - Several contracts did not have evidence of a deliverable

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Results of Examination

- **17 out of 17 contracts processed as exempt from state requirements had findings**
  - Several contracts were questionable whether they qualified as exempt under the State's statutes
- **Disbursements had several findings**
  - Organization's CEO could approve sponsorships up to $25K without Board review
    - All sponsorships lacked evidence that the organization monitored or evaluated the sponsorship activities as required by State statute
    - One sponsorship was issued to an associate of the CEO
  - Former CEO approved payments while no longer an employee of the organization

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Results of Examination

- **LLCs Examination**
  - Two contract payments exceeded the approved contract amount
  - One check of over $10K was issued without a signature (cleared the bank)
  - Missing documents including vendor certificates of good standing, certificates of insurance, contractor's license

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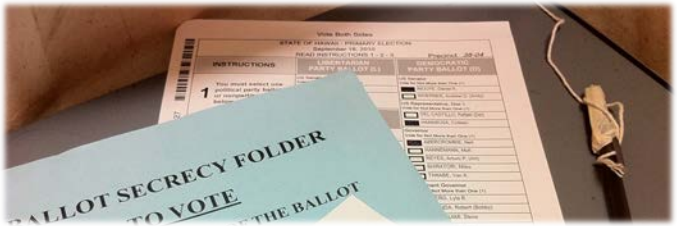
Findings: In Detail



- **Organization Examination**
  - One grant recipient, a foundation, received a nearly $2.6 million grant for the purpose of facilitating an election of delegates
  - Foundation's Executive Director was wife of organization's CEO at the time
  - Entire $2.6 million was requested before the election occurred and foundation did not submit proof of expenses before requesting payments
  - Over $475,000 went to attorney fees and other consultants
  - Election was eventually cancelled and did not achieve intended results
  - Organization did not document any communication between itself and the foundation, including notification the election was cancelled

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Findings: In Detail

- **LLCs Examination**
  - Three payments totaling $90K to a food manufacturer, previously owned by an LLC but transferred to a local non-profit and managed by friend of the CEO (CEO of the organization was considered a manager of the LLCs)
  - Organization previously spent over $1 million to acquire plant for the LLC
  - Payments labeled as grants and loans to help with cash flow issues
  - One payment was made before the LLC legally transferred the title to the non-profit, indicating this was start-up cash
  - Organization had no copies of the non-profit's business plan
  - Non-profit eventually had find a new manager, run by a for-profit

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Recommendations

- Update written policies to align with current procedures and ensure best practices are followed
- Increase documentation of the decision-making process, authorizations, and oversight of contracts and grants
- Additional employee training and development
- Increase public transparency
- Improve the overall financial internal control efficiencies and effectiveness of the financial processes of the organization
- Strengthen the Board's fiduciary, general oversight and governance of the organization, including over the LLCs

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Internal Control Considerations and Tone at the Top

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General Internal Control Considerations

- **Develop written policies and procedures**
  - Conduct appropriate training for new employees
  - Conduct ongoing training for existing employees
  - Ensure elected officials are aware of their oversight requirements
- **Provide anti-fraud and ethics training for employees and elected officials**
- **Ensure adequate technical training for employees**
- **Consider whether organization has resources for internal audit function**
  - Surprise audits
  - Financial analytics and transaction review

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General Internal Control Considerations

- **Implement the use of an anonymous fraud hotline**
- **Subordinate level employees should not be responsible for the review/approval of a supervisor's activity (expense reports, credit cards, etc.)**
- **Rotate job functions / cross-training**
- **Require employees take vacation**

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Tone at the Top

- Tone at the top refers to the ethical atmosphere that is created in the workplace by the organization's leadership.
- If the tone set by managers upholds ethics and integrity, employees will be more inclined to uphold those same values.
- It takes more than a code of ethics.
- A negative work environment will spawn low levels of employee morale. Employees will be more prone to committing fraud since there is no obligation to protect it.

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Why Employees Don’t Report Unethical Conduct

- **No corrective action**
- **No confidentiality of reports**
- **Retaliation by superiors**
- **Retaliation by coworkers**
- **Unsure whom to contact**

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Important Steps to Take

- Set an ethical tone at the top
- Establish a code of ethics
- Carefully screen job applicants
- Assign proper authority and responsibility
- Mandate fraud and ethics training for staff
- Implement effective disciplinary measures

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Important Steps to Take

- **Implement a confidential hotline**
- **Establish a whistleblower policy**
- **Follow through with reports of misconduct and promote effective internal controls**
- **Prevent reprisals**
- **Create a culture of doing the right thing**

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Thank you!

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