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# FRAUD RISKS AND EFFECTIVE CONTROLS


  
LEAGUE  
OF WISCONSIN  
MUNICIPALITIES

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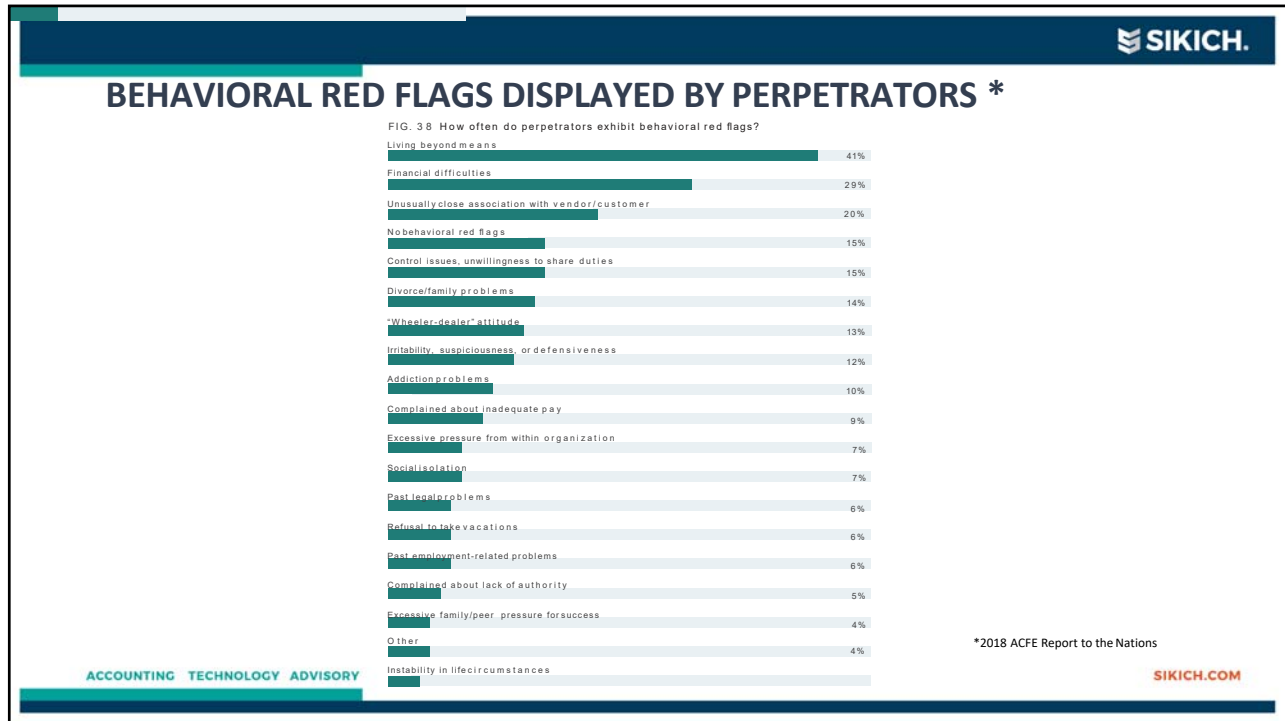
## AGENDA

- Fraud stats
- 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

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## LOCAL GOVERNMENTS – FRAUD RISK

- Small offices
  - Lack of segregation of duties
- Trust
- Small budgets
- Civil service / Career Service
- No oversight
  - Internal Audit
  - Inspector General
  - Monitor
- Concentrating on the core mission of the agency

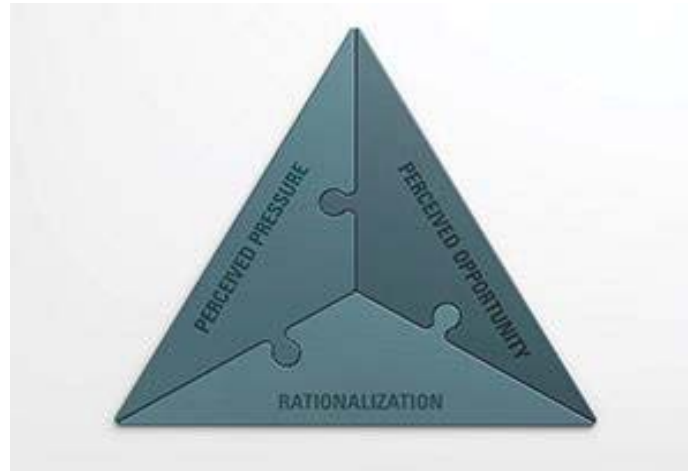
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## FRAUD RISK

- Itinerant employees / volunteers
- Not designed to make a profit
- Not your money
- Inexperience/Naivete´ makes agency ripe for vendor fraud
- Conflicts of Interest
  - Direct or indirect economic interest in business of the agency
- Political Activity

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## FRAUD TRIANGLE



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## 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

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## 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

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## COMMON FRAUD SCHEMES

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

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## COMMON FRAUD SCHEMES

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

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## COMMON FRAUD SCHEMES

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

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## COMMON FRAUD SCHEMES

- Contractors performing employee role (construction management, maintenance, security etc.)
  - Vendors managing vendors
  - Over billing
  - Incentive to be efficient?
  - How attenuated is agency oversight?

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## 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
  - Employee's don't know the rules
  - Pressure
  - Inappropriate tone-at-the top

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## PROCUREMENT / VENDOR FRAUD

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

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## 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

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## GRANT FRAUD

- Conflict of Interest – disclose
- Grantee disclosures that may affect award
  - Violations of law – fraud, bribery
  - Civil, criminal or administrative proceedings
- Grant property and equipment used only for authorized purposes
- Procurement Rules
  - Competition
  - Consistent with agencies non-grant policies and practices
  - Awards to responsible contractors possessing ability to perform
- Salary and Benefits
  - Compensation consistent for similar non-grant work
  - Fringe benefits consistent with agency policies
  - Severance – only if required by law

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## GRANT FRAUD

- Personal use of cars and equipment not allowed
- Charge only allowable costs – necessary, reasonable and conform to grant conditions
  - Reasonable and prudent person
  - Sound business practice
  - Arms-length bargaining
  - Market price
- Not allowed
  - Alcohol
  - Lobbying costs
  - Costs of goods for personal use
  - Entertainment – including amusement, diversion and social activities and associated costs (unless authorized by grantor)
  - Contributions to other entities
  - Court / Litigation costs relating to violations of law or non-compliance with terms of award

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## GRANT FRAUD

- Supplement vs. Supplant
  - Supplement – to build upon or add to
  - Supplant – replace or take the place of
  
- Federal law prohibits recipients of federal funds from replacing state, local or agency funds with federal funds. Supplementing is encouraged

## GRANT ADMINISTRATION ISSUES

- Compliance with Grant / Grantor requirements
- Segregation of funds
- Respond to issues of non-compliance – prompt action when issues arise
- Report deviations from scope
- Record retention
- Effective and efficient administration of award
- Property funded by award
  - Records / title
  - Physical inventory
  - Adequate safeguards to prevent loss
  - Records of disposition

## 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)

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## COSO INTERNAL CONTROL FRAMEWORK

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

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## 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)

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## 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)

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## 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)

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## 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)

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## 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)

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## EFFECTIVE CONTROLS

- Audit Committee
  - Regularly audit
- Communication / Training
- Consistent Discipline
- Handbook / Codes of Conduct
  - Exclude right to privacy
  - Mandatory time off / vacations
  - Employee duty to cooperate
- Code of Ethics
  - Defining “relationship”
  - Direct and indirect economic interest
  - Contract management authority
  - Gift ban (especially procurement)

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## EFFECTIVE CONTROLS

- Due Diligence in Hiring
- Segregation of duties
- Cross train
- Rotate staff
- Whistleblower System
- Fraud Hotline
- Updated IT systems
  - Regularly assess vulnerabilities and access rights

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## 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

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# 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

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## HOTLINES AND REPORTING MECHANISMS

### HOTLINES AND REPORTING MECHANISMS

Respondents provided information about hotlines and reporting mechanisms that can help us understand who is reporting fraud, how they are doing so, and how effective such mechanisms are in government agencies.

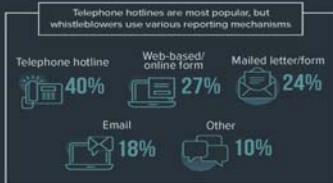


**TIPS** are by far the most common initial detection method.

Employees provide over half of tips, while a substantial amount also come from anonymous parties and customers.



Government agencies without hotlines were three times as likely to detect fraud by accident and four times as likely to detect it by external audit.



#### NOT ALL TIPS COME THROUGH HOTLINES


When a reporting mechanism is not used, the top three parties whistleblowers report to are:

- DIRECT SUPERVISOR 39%
- LAW ENFORCEMENT OR REGULATOR 21%
- INTERNAL AUDIT 13%

Data Source: Report to the Nation, Government 3.0000

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## ANTI-FRAUD CONTROLS IN LOCAL GOVERNMENT ORGANIZATIONS

### Anti-Fraud Controls in Government Organizations


Internal controls play an important part in protecting organizations against fraud. As part of our research examined which anti-fraud controls the victim organizations had in place at the time the fraud occur as what internal control weaknesses primarily contributed to the fraud.

FIG. 7 What anti-fraud controls are the most common in government agencies?

Control	Percent of cases
Code of conduct	86%
External audit of financial statements	84%
Internal audit department	79%
External audit of internal controls over financial reporting	71%
Employee support programs	68%
Management certification of financial statements	68%
Hotline	66%
Management review	58%
Anti-fraud policy	50%
Independent audit committee	49%
Fraud training for employees	48%
Fraud training for managers/executives	47%
Formal fraud risk assessments	35%
Dedicated fraud department, function, or team	34%
Surprise audits	28%
Proactive data monitoring/analysis	27%
Job rotation/mandatory vacation	16%
Rewards for whistleblowers	12%

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## 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

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