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FRAUD IN GOVERNMENT - AN OPEN DISCUSSION

**Presented By
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AGENDA

- Fraud and Ethics Discussion
- Fraud Triangle and Beyond
- Data from 2016 ACFE Report to the Nations
- Recent Fraud Investigation
- Government Audit Expectation GAP
- Red Flags
- Internal Controls

FRAUD AND ETHICS DISCUSSION



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How is Ethics Related to Fraud?

Because Ethics is a discipline dealing with what is good and bad with moral duty and obligation.



What is Ethics?

Ethics is:

- A set of moral principles or values
- A theory or system of moral values
- The principles of conduct governing an individual or a group
- A guiding philosophy

Ethics must
begin at the top
of an
organization. It
is a leadership
issue and the
chief executive
must set the
example.

Edward Hennessey

QuotePixel.com

Ethical Conflicts

Personal Values vs. Social Values

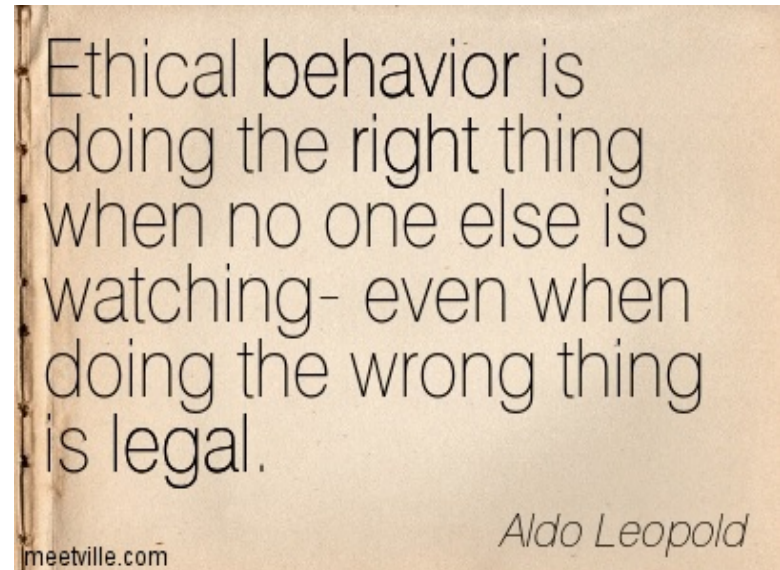
Self Interests vs. Benefits to Others

Personal Values vs. Organizational Rules

Ethical Codes vs. Benefits to Others

Honesty vs. Benefits to Others

Personal Values vs. Social Norms



FRAUD DISCUSSION



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Fraud Triangle...



The Fraud Environment

OPPORTUNITY

I'll take the cash from the deposit, write-off the A/R as bad debt....I can work around the controls

INCENTIVE

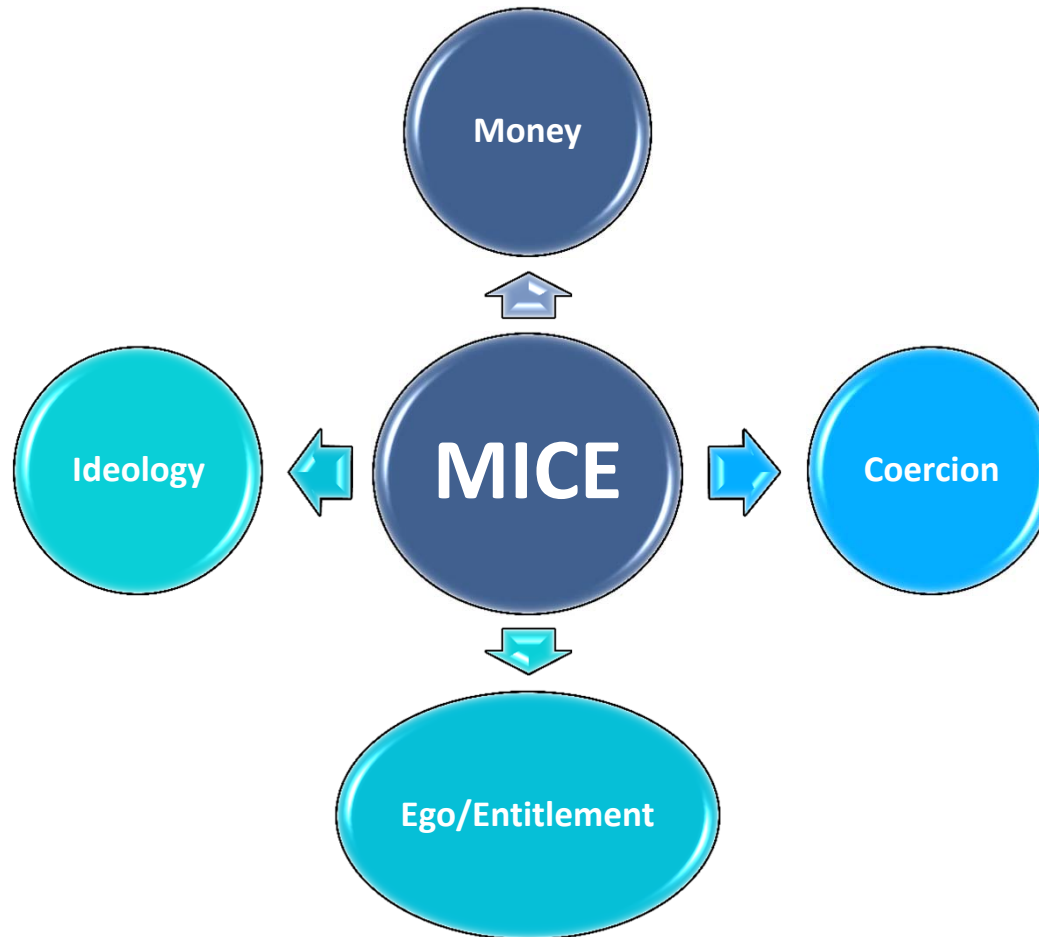
How will I pay my bills?
Kids need....
I want
Casino night
Drugs ...



RATIONALIZATION

I deserve a raise...
I work long hours..
I should have been promoted..
I'll pay it back...

Fraud Motivation



The Fraud Diamond – Considers Two Types of Fraudsters

FIGURE 5: A New Fraud Diamond Emerges With a Common Element



Fraudsters – More Details

Accidental Fraudster

Focus of Fraud Triangle

First-Time Offender

Well-Educated, Male, Middle Class, Good Person

Pressure Occurs

Rationalization

Predator Fraudster

Deliberate, Arrogant

Seeks Opportunities

No Pressure or Rationalization

May Begin as Accidental

Criminal Mindset

Fraud, Waste and Abuse

Fraud – as defined by Generally Accepted Government Auditing Standards:

A type of illegal act involving the obtaining of something of value through **willful** misrepresentation. Whether an act is, in fact, fraud is a determination to be made through the judicial or other adjudicative system and is beyond the auditor's professional responsibility.



Fraud, Waste and Abuse (Cont.)

Waste – involves the taxpayers/public **not receiving reasonable value** for money in connection with any government funded activities due to an inappropriate act or omission by individuals with control over or access to government resources (e.g., executive, judicial or legislative branch employees, grantees or other recipients). Waste goes beyond fraud and abuse and most waste does not involve a violation of law. Rather, waste relates primarily to mismanagement, inappropriate actions and inadequate oversight.



Fraud, Waste and Abuse (Cont.)

Abuse – involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances. Abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate. Abuse does not necessarily involve fraud, violation of laws, regulations, or provisions of a contract or grant agreement.

The essence of Government is power; and power, lodged as it must be in human hands, will ever be liable to abuse.

James Madison

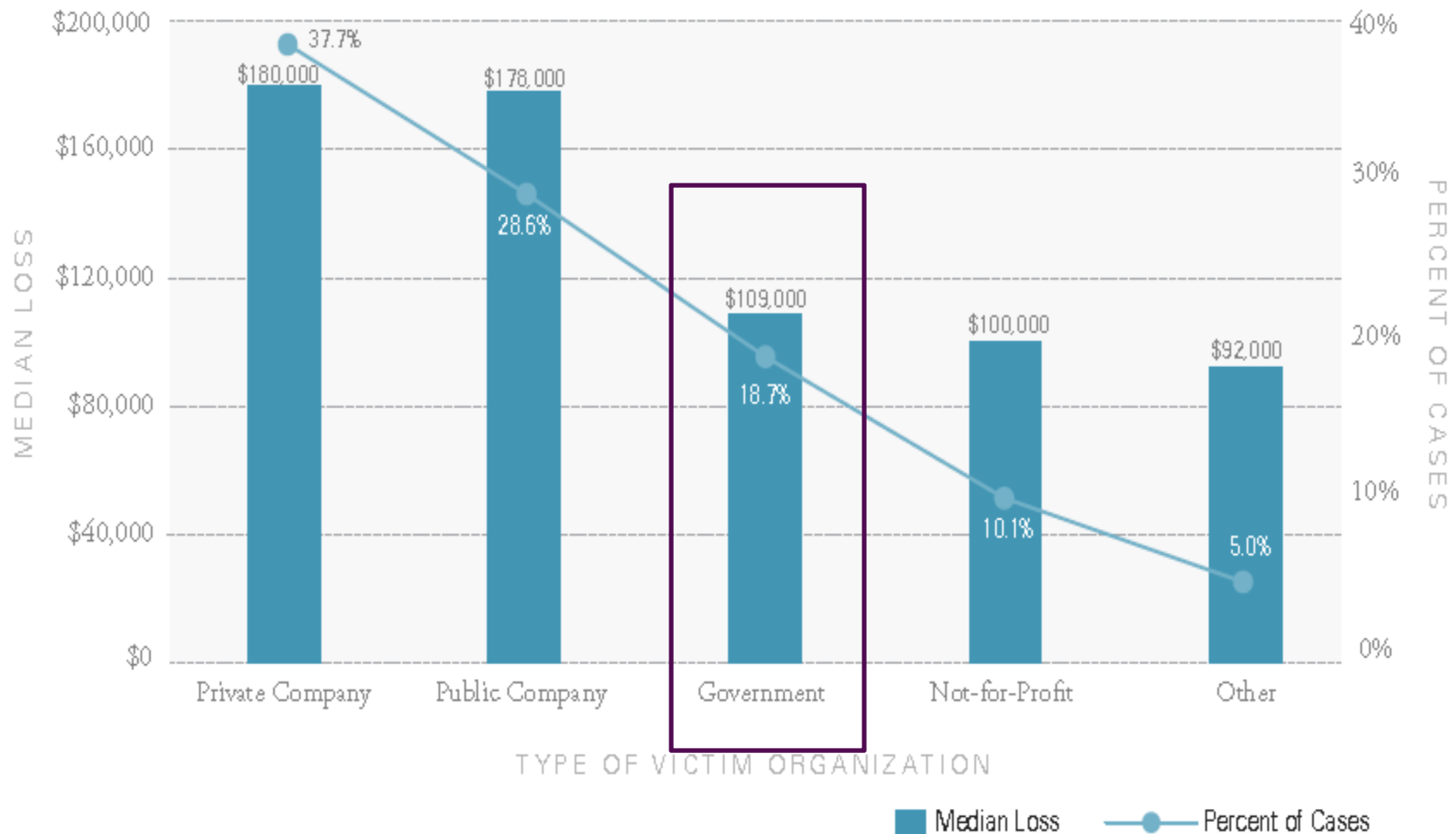
meetville.com

DATA – FROM 2016 ACFE REPORT TO THE NATIONS



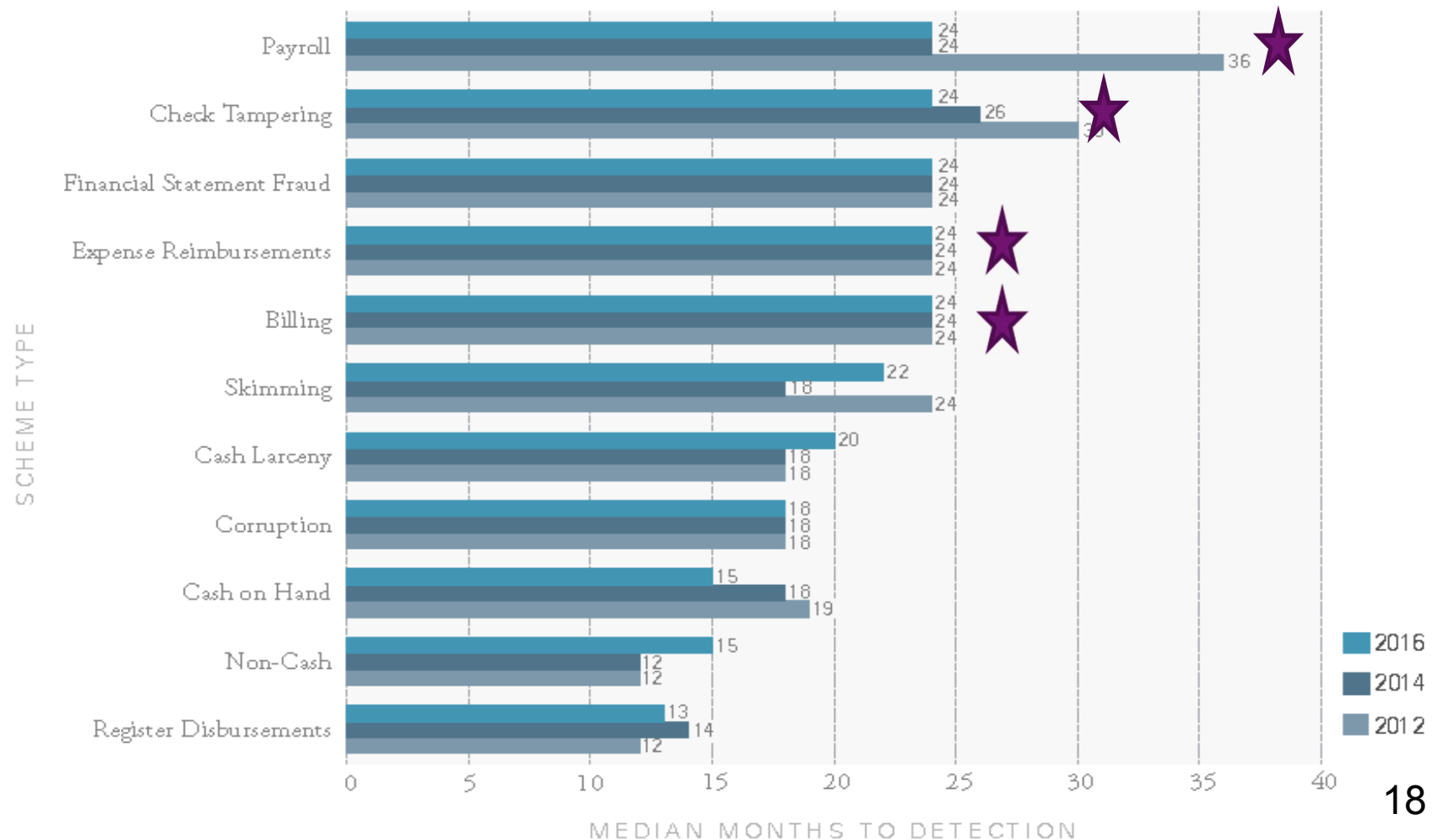
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Victim Organizations - Government



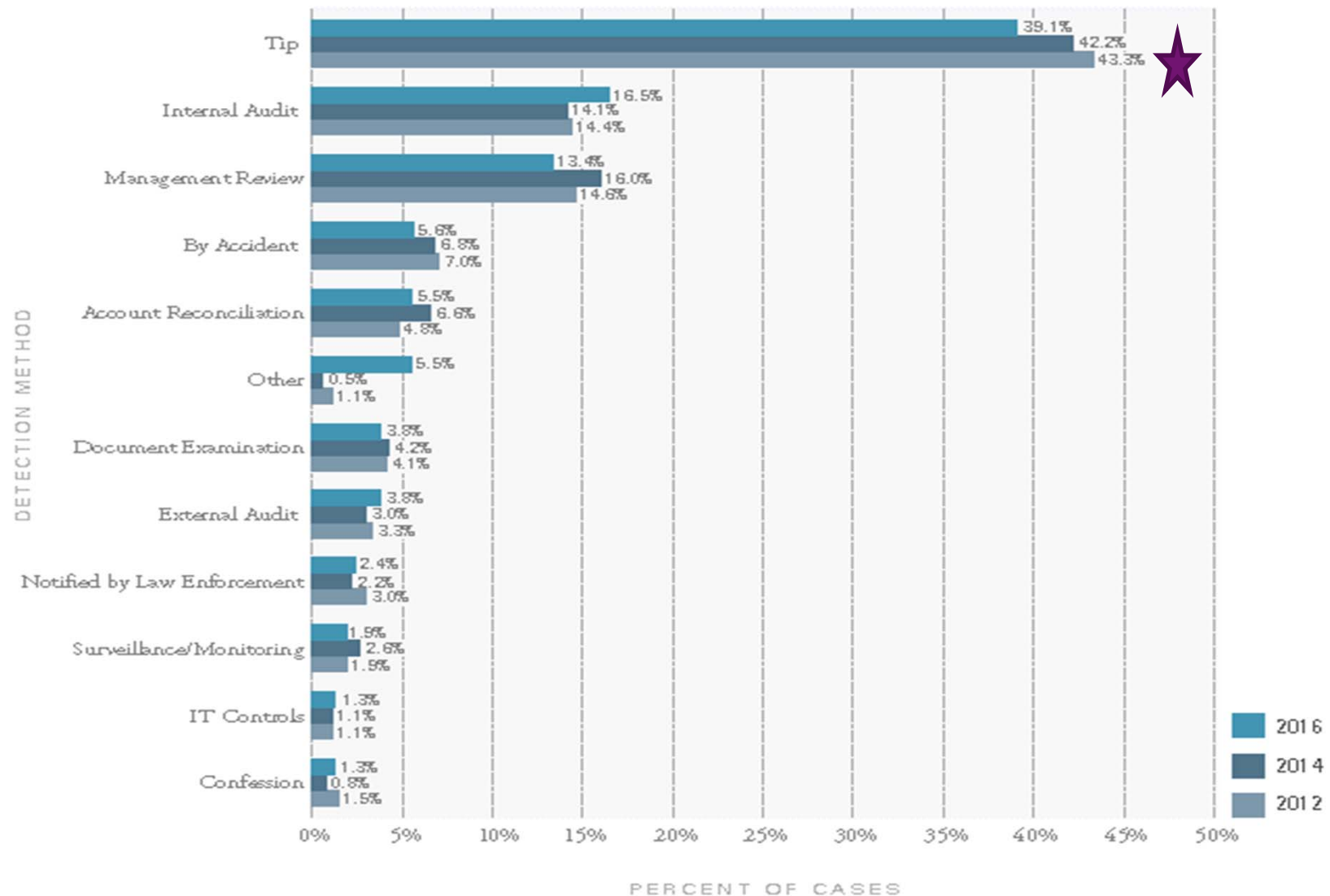
How Occupational Fraud is Committed

Duration of Fraud Based on Scheme Type



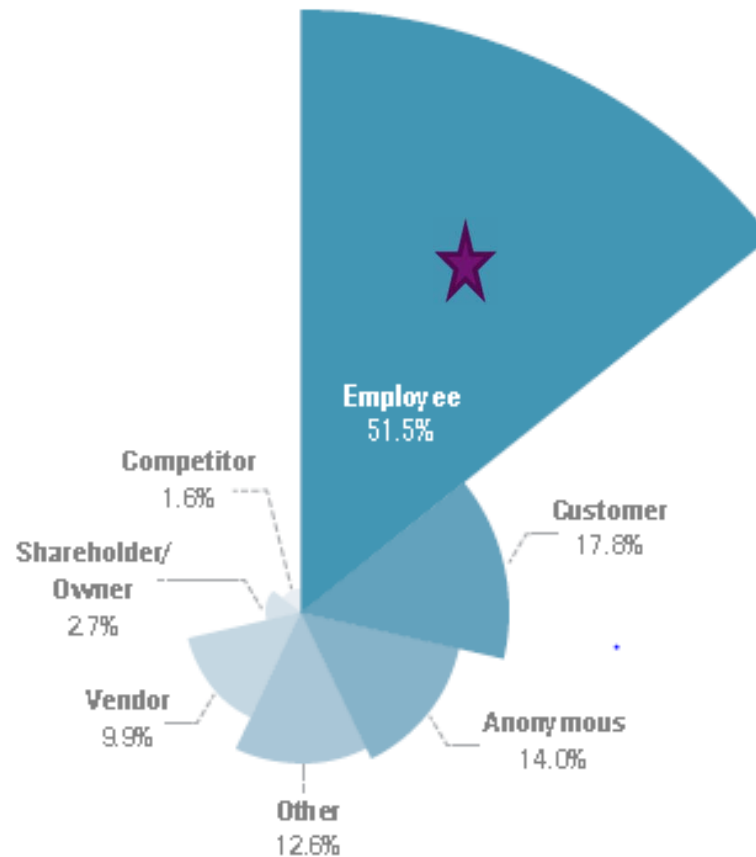
Detection of Fraud Schemes

Initial Detection of Occupational Frauds



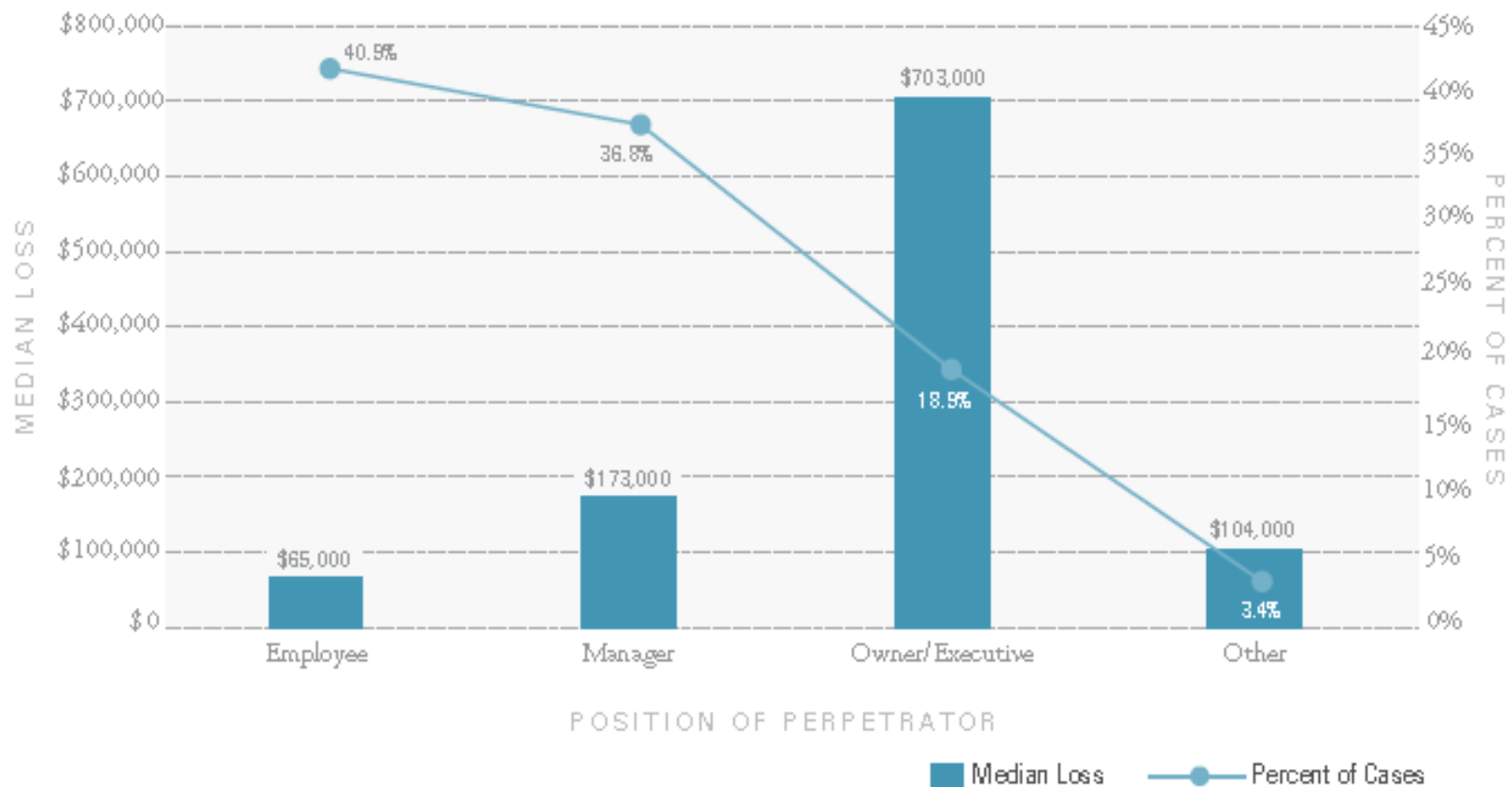
Detection of Fraud Schemes (Con't.)

Source of Tips



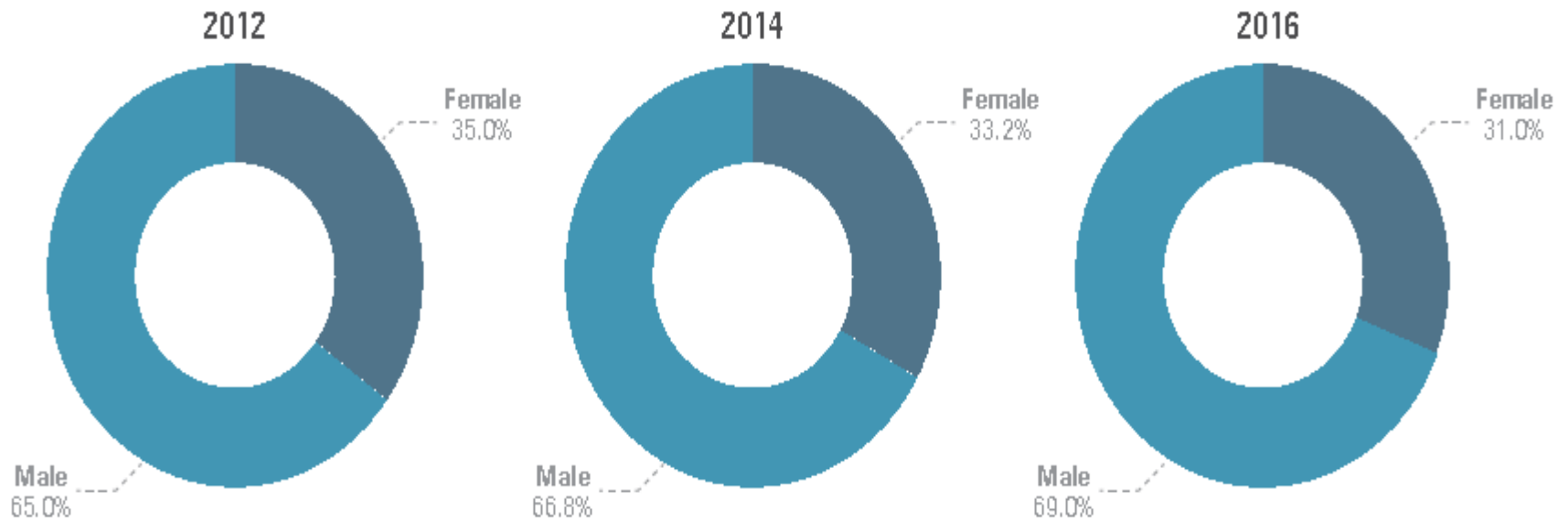
Perpetrators

Position of Perpetrator — Frequency and Median Loss



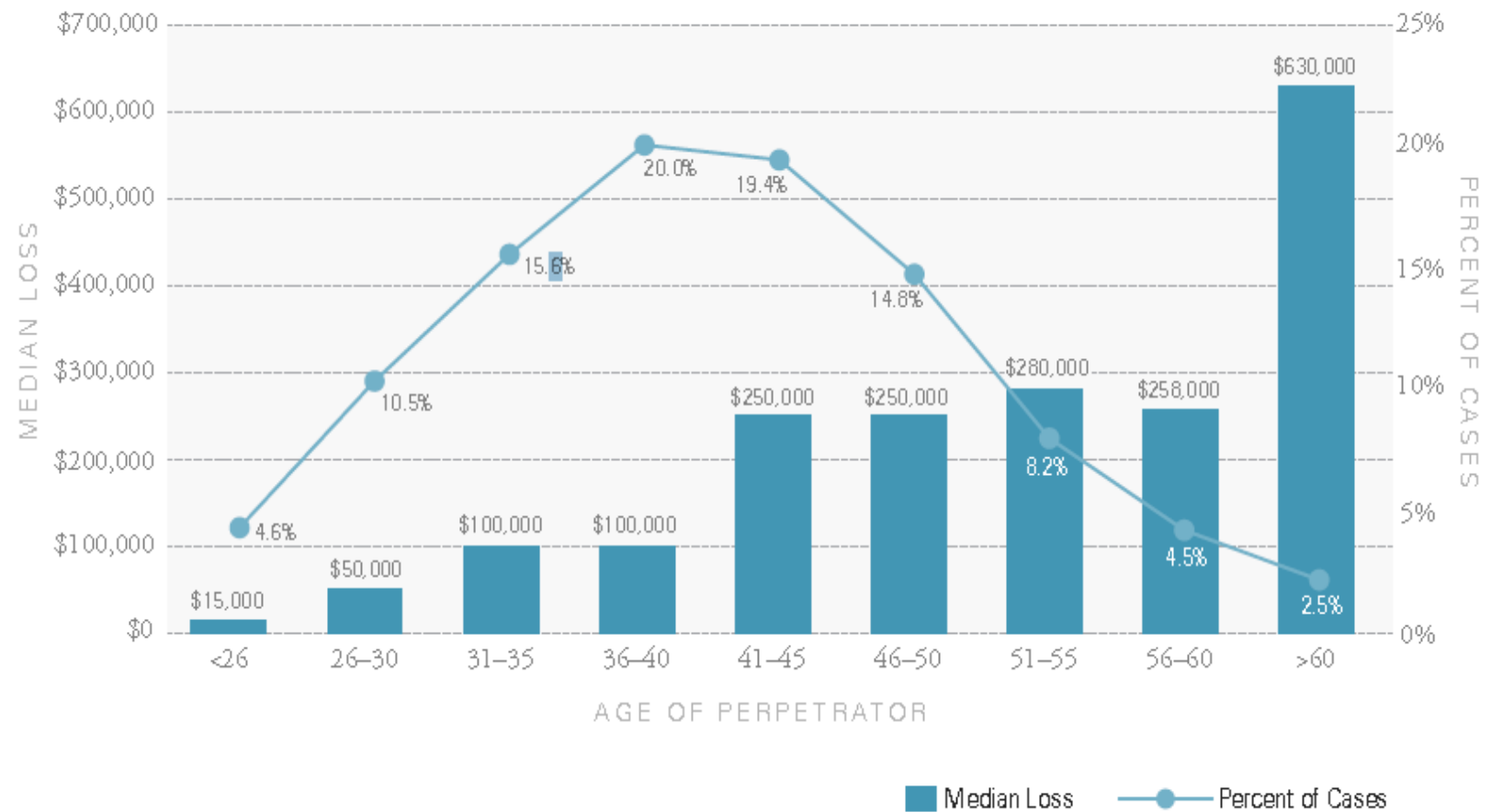
Perpetrator (Cont.)

Gender of Perpetrator — Frequency



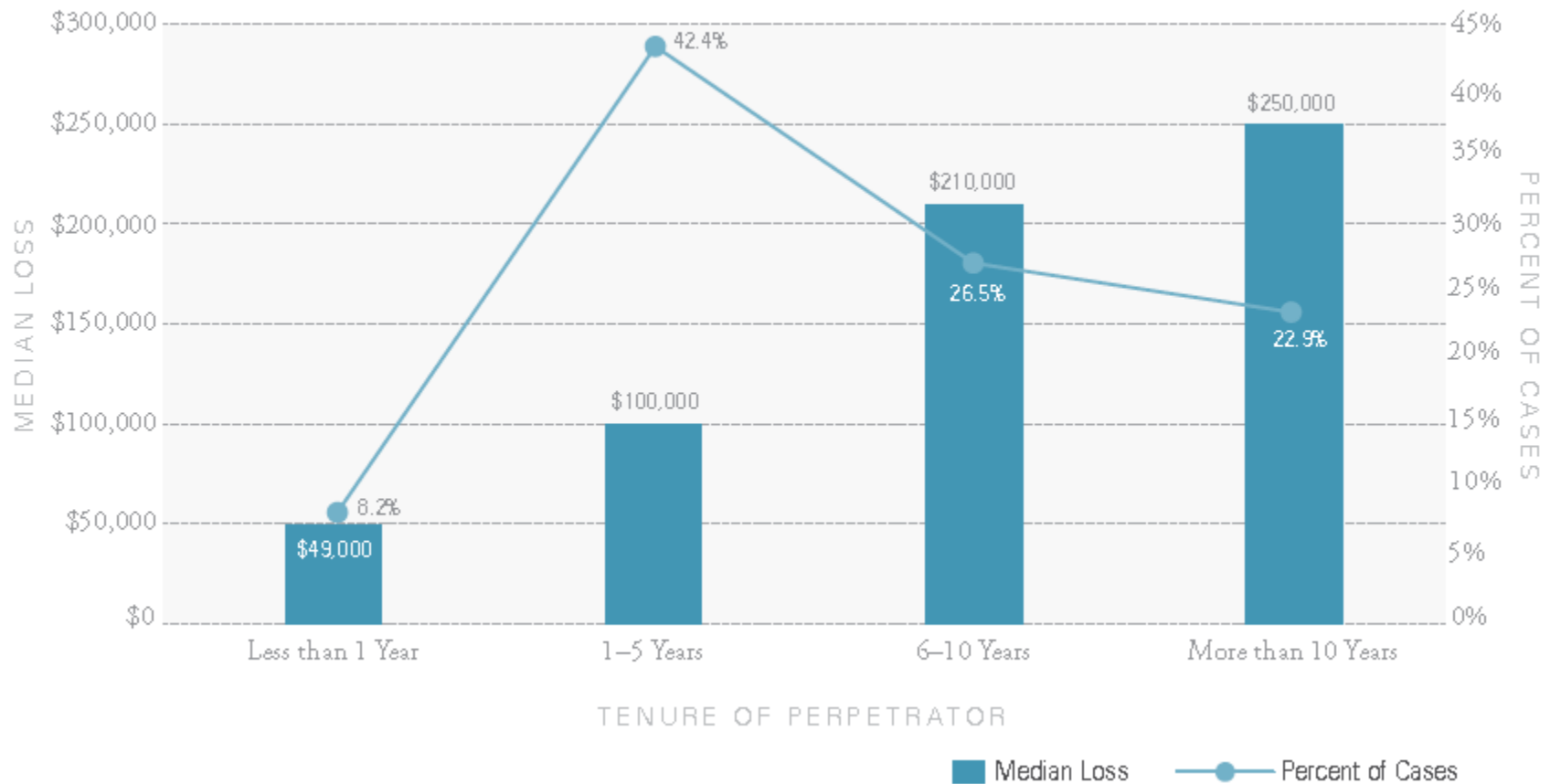
Perpetrators (Cont)

Age of Perpetrator — Frequency & Median Loss

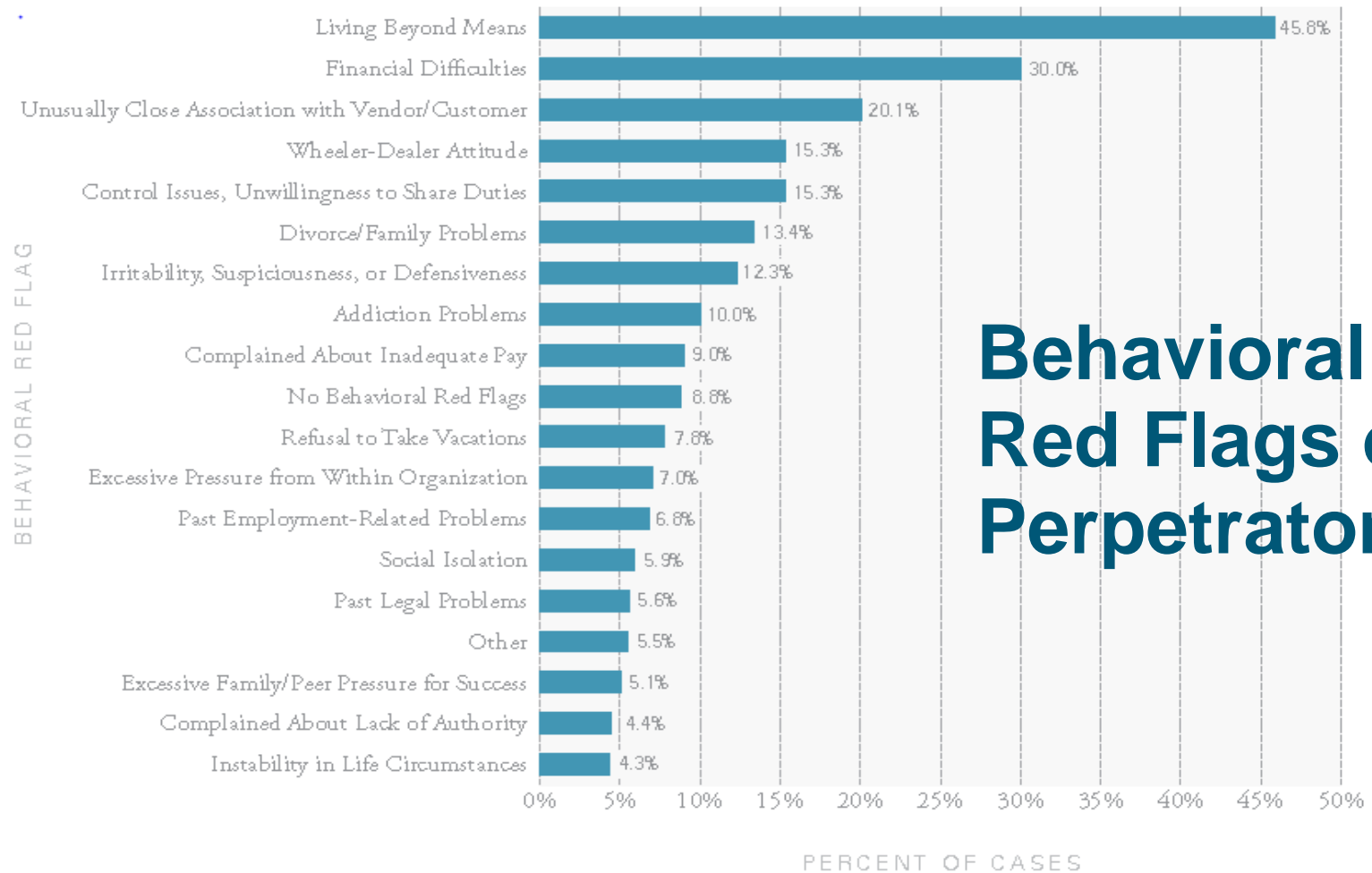


Perpetrators (Cont.)

Tenure of Perpetrator — Frequency and Median Loss



Perpetrators (Cont.)



REAL LIFE CASE



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The Team CEO + CFO

- Falsified healthcare reimbursement plan payments
- Personal transactions on corporate credit card
- Auto lease

GOVERNMENT AUDIT EXPECTATION GAP



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Types of Audits

Financial statement audits – Focuses on looking for misstatements in the financial statements

Compliance Audits (or Single Audits) – Focuses on compliance with federal programs requirements and internal control over federal expenditures

Forensic (Fraud) Audits – Focuses on identification of fraud. Usually, narrowly focuses on specific allegation or suspected fraudulent activity

Role of Financial Statement Audit

Primarily for an opinion about the fair presentation of the financial statements

Provide only reasonable assurance that the financial statements are free from material misstatement, regard-less of cause, but “reasonable” is defined as a “high” level of assurance

However, the role shouldn’t be taken for granted, as many analytical relationships among the financial statements, when performed by the auditor, can expose the potential issue

Financial Statement Audits

Only a small percentage of fraud detected by financial statement audit

Financial statement audits are not fraud or forensic audits

Objective is issuing an opinion of financial statements

The auditor's report only gives "reasonable assurance" that there are no material misstatements in the financial statements

Auditors are not required to detect fraud



Financial Statement Audits *(Con't.)*

Auditor's consideration of fraud risk is limited to material misstatements in the financial statements

Auditors obtain an understanding of internal control over financial reporting when planning the audit

A financial statement audit can provide valuable insight into adequacy of internal controls

Control weaknesses could be key indicator of a fraud opportunity

Auditors must exercise professional skepticism during the audit



AU-C Section 240 – Consideration of Fraud in a Financial Statement Audit

The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, whether caused by error or fraud.

- Professional skepticism
- Discussion among engagement personnel
- Identify risks of **material misstatement**
- Assess the risk
- Respond to the results
- Evaluate audit evidence
- Communicate with management – those charged with governance
- Document consideration of fraud

Government Auditing Standards – Reporting Fraud in a Financial Statement Audit

In an audit performed in accordance with **Government Auditing Standards** the **auditor has additional responsibilities** related to **reporting fraud** above what is required in AU-C 240.

If the auditor concludes that fraud has occurred or is likely to have occurred:

- Include in the report on internal control over financial reporting and on compliance and other matters.
- Information about fraud with material effect on the financial statements that warrant the attention of those charged with governance.
- Information that does not warrant the attention of those charged with governance, the auditor's determination of whether and how to communicate such instances to auditee officials is a matter of professional judgment.

RED FLAGS



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Behavioral Red Flags

- Providing unreasonable responses to questions
- Bragging about significant new purchases
- Refusing promotions
- Easily annoyed at inquiries
- Refusing to take vacations



Behavioral Red Flags *(Cont.)*

- Borrowing money from co-workers
- Gambling, drug use
- Excessive drinking
- Creditors or collectors appearing at workplace
- Change in “normal” behavior



Procurement Fraud and Red Flags

- **Unjustified Sole Source:** Unjustified sole source is defined as a fraudulent act involving procurement personnel who, in collusion with a supplier, improperly award a contract without competition or prior review.



Procurement Fraud and Red Flags *(Cont.)*

- **Unjustified Sole Source red flags:**
 - Sole source award above or just below competitive bidding limit.
 - Previously competitive procurements become non-competitive.
 - Vague justification or documentation requesting a non-competitive award.
 - Split purchases to avoid competitive bidding limits.

Procurement Fraud and Red Flags *(Cont.)*

- **Unjustified Sole Source red flags *(Cont.)*:**
 - Contract requirements were not reviewed and validated by management.
 - Contract requirements appear to be tailored to a specific contractor.
 - Awards made below the competitive bid limits that are followed by change orders that exceed such limits.

Procurement Fraud and Red Flags *(Cont.)*

- **Change Order Abuse:** Contractor acting alone or in collusion with contract personnel, can submit unjustified or inflated change order requests to increase profits, or, as a result of corruption, use the change order process to extend a contract that should be re-bid.



Procurement Fraud and Red Flags *(Cont.)*

- **Change Order Abuse red flags:**
 - Weak internal controls and procedures regarding review or need for change orders.
 - Numerous, unusual or unexplained change orders for a specific contractor approved by the same employee.
 - Pattern of low-bid award followed by change orders that increase the price or scope of the contract, or extend the contract period.
 - Vague contract specifications followed by change orders.

Procurement Fraud and Red Flags *(Cont.)*

- **Change Order Abuse red flags *(Cont.)*:**
 - Poorly documented change orders, or change order requests in round number amounts, if that is unusual for the job.
 - Pattern of change orders just below upper-level approval limit.
 - High-level personnel involved in change order decisions, especially for specific contractors.
 - Purchase orders of contracts extended by change order, rather than re-bidding of contract.

Procurement Fraud and Red Flags *(Cont.)*

- **Split Purchases:** A single procurement can be split into two or more purchase orders or contracts, each below upper-level review or competitive bidding thresholds, to avoid review or competitive selection. Repetition of this scheme, favoring the same parties, can be a strong indicator of corruption.

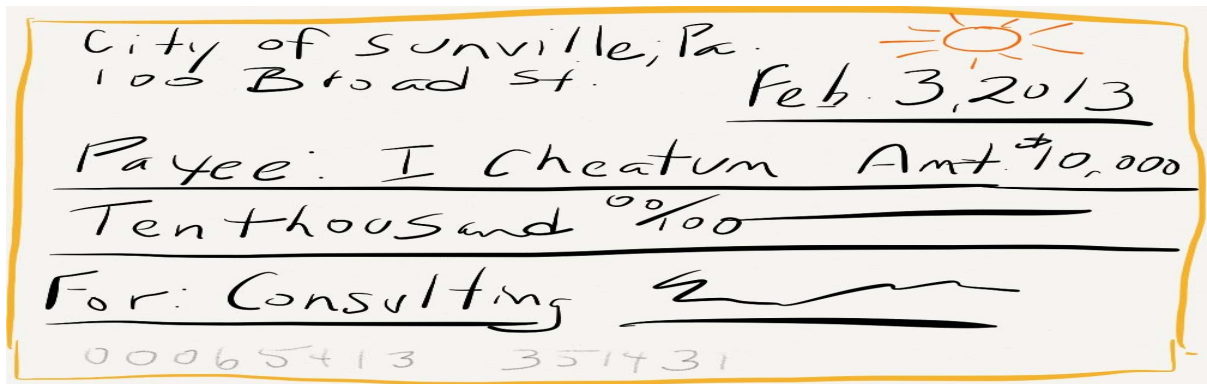


Procurement Fraud and Red Flags *(Cont.)*

- **Split Purchase red flags:**
 - Two or more similar procurements from the same supplier in amounts just under competitive bidding or upper-level review limits.
 - Unjustified separation of purchases, e.g., separate contracts for labor and materials, each of which is below competitive bidding limits, but when combined is over such limits.
 - Sequential purchase orders or invoices under upper-level review or competitive bidding limits.
 - Contracts under the competitive bid limit followed by change orders that increase amount of the contract.

Procurement Fraud and Red Flags *(Cont.)*

- **Fictitious Vendor:** an employee with procurement responsibilities, or in accounts payable, or an outsider, submit bills from a non-existent vendor. Normally, fictitious vendors claim to provide services or consumables, rather than goods or works that can be verified. Dishonest bidders also can submit “bids” from fictitious bidders as part of bid-rigging schemes.



Procurement Fraud and Red Flags *(Cont.)*

- **Fictitious Vendor red flags:**
 - Paid vendors are not on the approved vendor list or listed in business or telephone directories.
 - Invoiced goods or services cannot be located or verified.
 - Inadequate vendor identification information.
 - Incorrect or non-existent address or phone number.
 - Vendor address or telephone number is the same as an employee's.

Procurement Fraud and Red Flags *(Cont.)*

- **Fictitious Vendor red flags *(Cont.)*:**
 - Small initial purchase from vendor, followed by much larger purchases.
 - Payment provided without an invoice.
 - Copied or unusual supporting documents, such as purchase order or receiving document submitted with invoice.
 - Multiple companies that have the same address/telephone numbers.

Cash Collection Fraud and Red Flags

- **Cash Collection Environment Fraud:** when employees manipulate cash register transactions or operations to steal cash, inventory items, or non-cash assets. In governments, this often happens at locations such as recreation departments, offsite inventory locations, special events, golf course pro-shop, etc.



Cash Collection Fraud and Red Flags

(Cont.)

- **Cash Collection Fraud red flags:**
 - Insufficient supervisory review of cashiers' daily activities.
 - Cashiers working out of open cash drawers/boxes.
 - Cashiers have access to register Read and Reset keys. Cashier can then clear registers, determine sales figures for the day, and accumulate/remove overages at the end of day.
 - Cash register "Read Window" blocked from patron's view allowing cashier to not ring or under-ring sales.

Cash Collection Fraud and Red Flags

(Cont.)

- **Cash Collection Fraud red flags *(Cont.)*:**
 - Advance approval for voided transactions, refunds, and over-rings are not required.
 - Excessive use of the “no sale” key.
 - Cash deposits not received by the bank.
 - Excessive use of coupons and discounts.
 - Weak cash handling procedures and cash accounting records.
 - Significant inventory adjustments; generally write offs.
 - Significant/unexpected changes in sales without reasonable explanation.

Credit Card Fraud and Red Flags

- **Credit Card Fraud:** Employees use an organization's credit card to make unauthorized purchases. Credit cards are sometimes used to circumvent procurement policies.



Credit Card Fraud and Red Flags *(Cont.)*

- **Credit Card Fraud red flags:**
 - Unreasonable or unexplained high volume of purchases from a particular vendor.
 - Split purchases without purchase order to avoid upper-level review or to circumvent the purchasing policy.
 - Receipts or invoices supporting purchases are missing or photocopied, which may indicate they were altered.
 - Receipts or invoices are not sufficiently detailed to document actual purchases.

Credit Card Fraud and Red Flags *(Cont.)*

- **Credit Card Fraud red flags *(Cont.)*:**
 - Lack of proper approvals and/or separation of functions, such as requiring manager approval prior to purchase, cardholder makes the purchase, and an independent person receives the purchase.
 - Vendor used excessively by only one cardholder.
 - Purchases made during weekends or holidays which are outside of cardholder's or organization's work schedule period.

CONTROLS ARE THE KEY



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Types of Controls

Preventive

Detective

Corrective

Manual and Automated



Questions or Comments



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