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Ethical Challenges and Fraud Risks Facing Governments

NEGFOA – Spring Conference 2024



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Learning Objectives

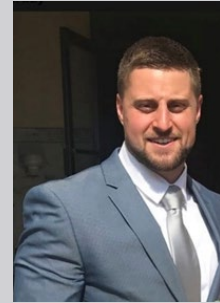
At the end of this session, you will be able to:

- Describe key concepts in ethics
- Identify common ethical challenges facing government officials
- Identify recent cases of fraud in state and local governments
- Identify key concepts in fraud awareness and prevention



Speaker Introduction

- **Manager**
 - Dave is a seasoned professional with over 8 years of experience in assurance and consulting for governmental entities. Throughout his career, he has help guide many of his clients in obtaining and maintaining awards, such as the GFOA Certificate of Achievement for Excellence in Financial Reporting.



**David
Hansen,**
CPA (RI)



Speaker Introduction (cont.)

- **Manager**
 - Steve is a seasoned professional with over 10 years of experience in assurance and consulting for governmental entities. Throughout his career, he has worked with a diverse range of organizations, including local governments and state agencies. His expertise includes audit, internal controls evaluations, and new standard implementations.



**Stephen
Gross,**
CPA, MSA





Ethics In Business



Ethical Leaders Start At Home

Personal Ethics

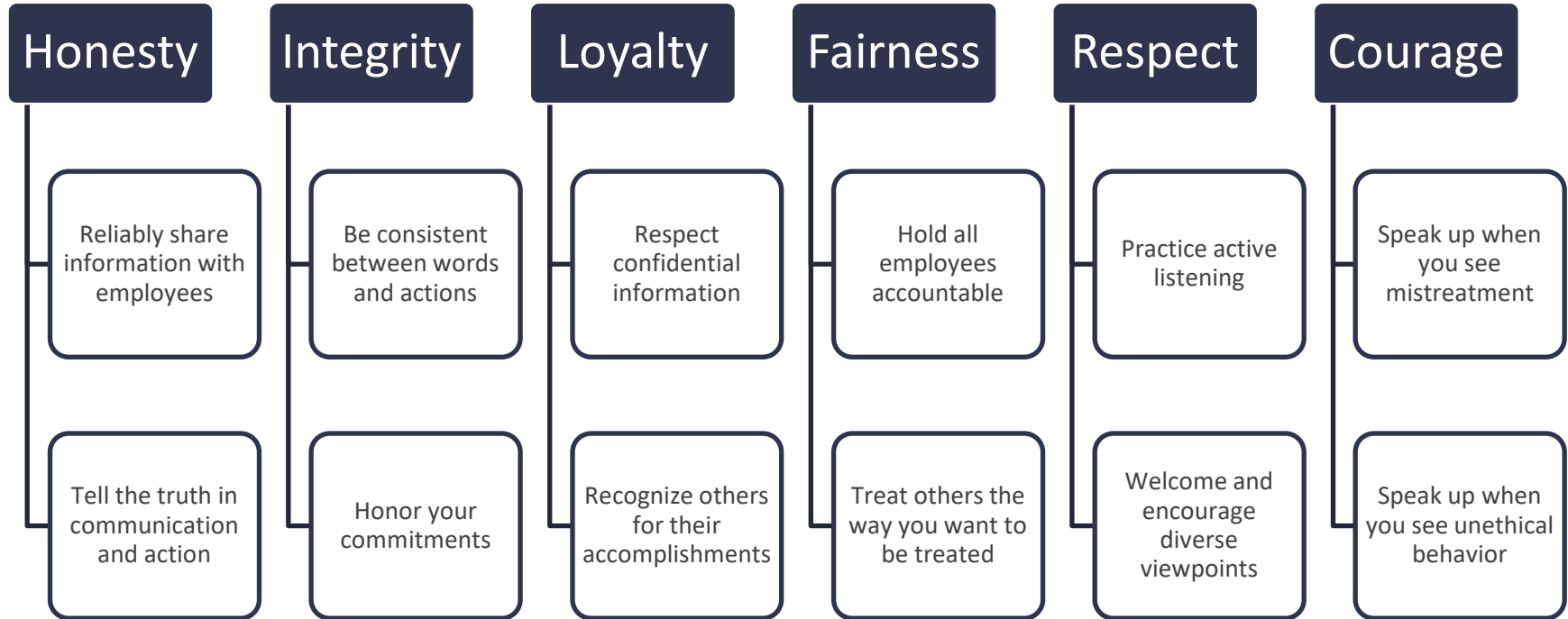
- Values
- Moral choices
- What we do when no one is looking
- Can change over time, by situation, or role
- Defined by:
 - Faith, spirituality
 - Upbringing, family
 - Laws, civil rights, academia

Business Ethics

- Personal Ethics
 - Values of the employees
- Organizational Culture
 - Tone at the top
 - History of the company
 - Perception of what is acceptable
- Organizational Systems
 - Policies and rules in place
 - Regulatory oversight
 - Code of ethics and how it's monitored and enforced



Principles Of Ethics In Business



Why Is Ethics Important In Business?

- Helps employees make good decisions; leads to happier, more satisfied employees
- Reduces liability
- Ensures high quality customer service
- Most importantly, keeps everyone off the front pages!



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Breakdowns In Business Ethics

Moral Muteness

- Not speaking up when witnessing unethical behavior
- Unwillingness to discuss ethics
- Discussing practices/decisions in a way that obscures your moral position and ethical beliefs (Bird & Walters, 1989)

Ethical Fading

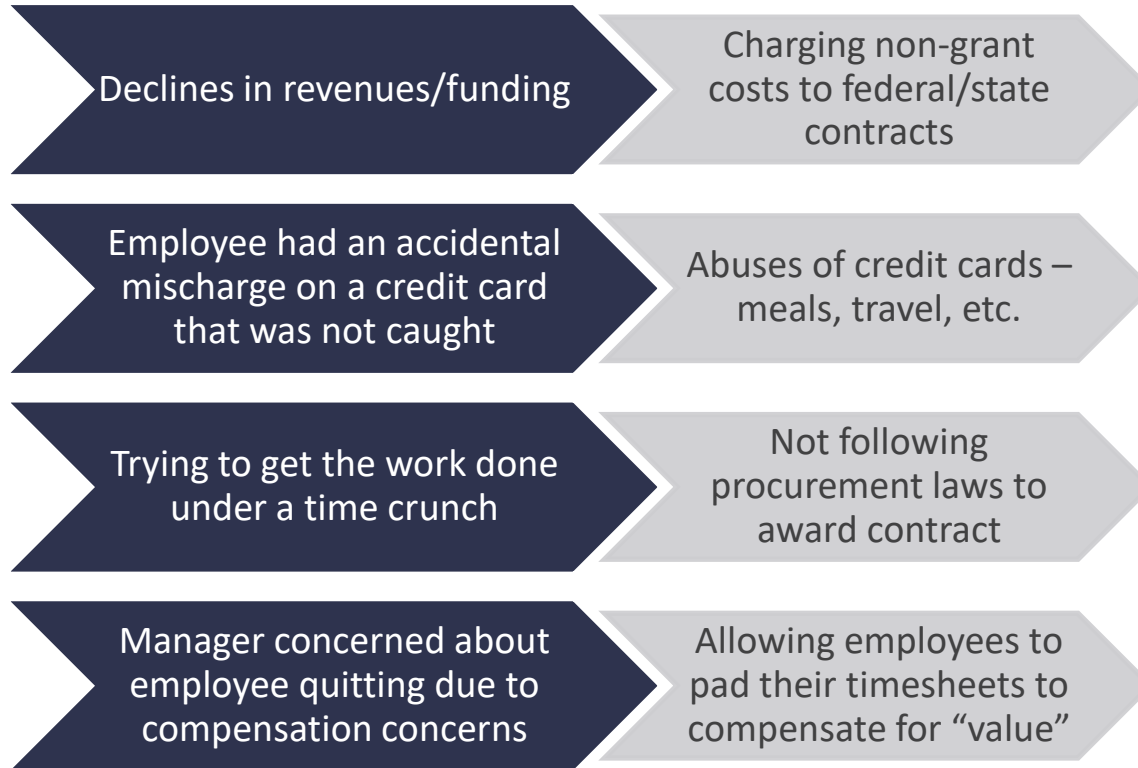
- Erosion of the ethical standard of a business in which employees become used to engaging in or condoning bad behavior

Situational Influence

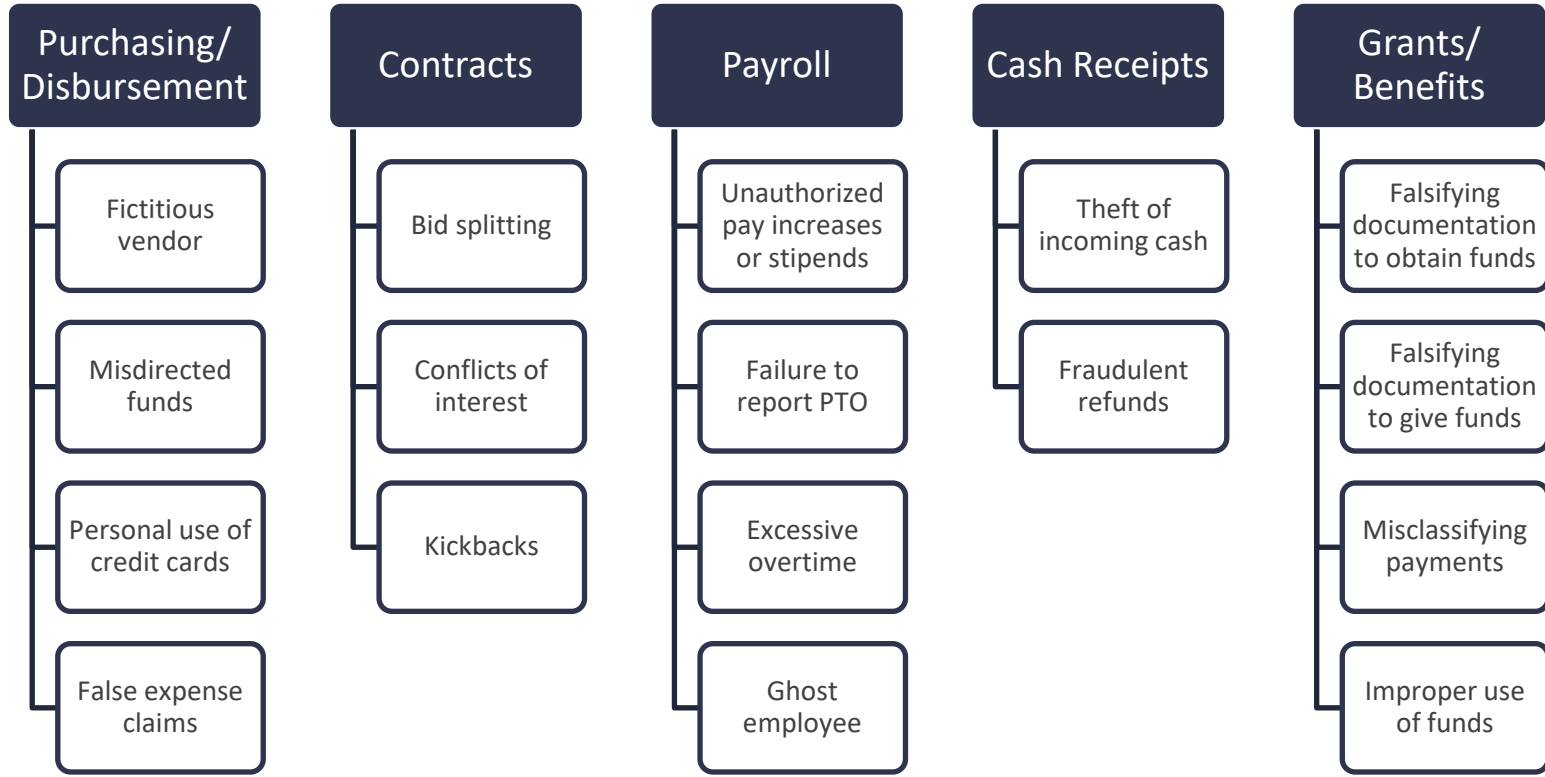
- Intent to please authority figure
- Focused on achieving a goal



Examples Of Ethical Challenges Leading To Fraud



Fraud In State And Local Governments - Internal



Fraud In State And Local Governments - External

Identify Fraud

Outsider posing as known customer/vendor

Could be a "new person" at the vendor

Phishing

Obtain account access

Pose as internal employee

Holding systems for ransom

Suppliers/Vendors

Overcharging

Under delivering

Contractors

False overtime

Fraudulent change orders

Conflict of interest (project manager)



The Trajectory Of Fraud

Starts out small

Increases in
complexity and
aggressiveness

Grows in magnitude
and number of
participants





Fraud Risks In Local Governments



Vulnerabilities And How To Address Them

Inadequate Segregation of Duties

- Assess roles and identify anyone with too much control
- Adjust level of access to those that need it
- Consider compensating controls like review/oversight

Lack of Oversight and Monitoring

- Implement regular monitoring procedures
- Example reports to review: monthly reconciliations, bank and credit card transactions, vendor change report, payroll change report, etc.

Poor Record-Keeping Practices

- Maintain documents that support financial transactions in a secure location (physical or electronic)
- Ensure documents are organized and easily accessible

Inadequate Security Controls

- Safeguard physical assets such as cash and checks (locked drawer, safe, etc.)
- Safeguard electronic assets (require strong passwords, changing passwords, restricting access, etc.)



Vulnerabilities And How To Address Them

Insufficient Training and Communication

- Document processes and procedures in writing
- Provide training to employees on their roles
- Stress importance of internal controls
- Promote open communication with management

Lack of Policies and Procedures

- Document proper authorization and approval processes
- Ensure consistent and transparent policies
- Implement fraud or ethics policy or include in code of conduct (consider hotline or other anonymous reporting method)

Not Reconciling Systems To Each Other

- Reconcile subsidiary ledgers to the general ledger regularly
- Ensure review of manual entries to record activity from an external system
- Consider automation options between systems

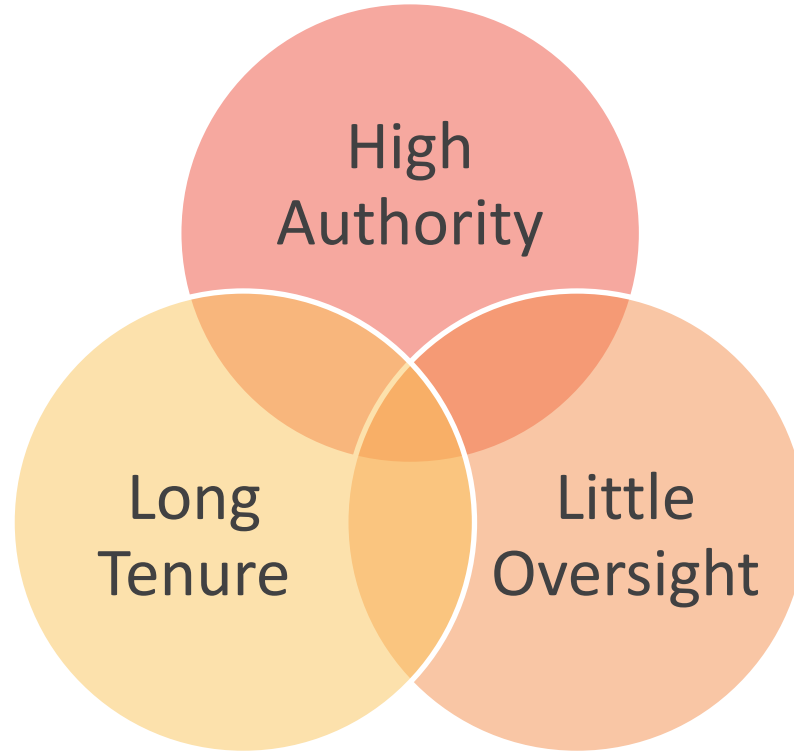


Who Presents Risk To The Government?

EVERYONE



Who Presents The GREATEST Risk?





Behavioral Red Flags



Behavioral Red Flags In Occupational Fraud

FIG. 44 HOW OFTEN DO PERPETRATORS EXHIBIT BEHAVIORAL RED FLAGS?



Source: ACFE 2022 Report to the Nations



Lifestyle Changes

- Most people who commit fraud do so under financial pressure
- Once perpetrators meet their financial needs that initially motivated them, they usually continue to steal and use the money to enhance their lifestyle
 - New cars
 - Expensive homes
 - Lavish vacations



Unusual Behaviors

- When people commit crimes (especially first-time offenders, as many perpetrators are), they are engulfed by feelings of fear and guilt. These emotions express themselves in unusual behavior.
- No particular behavior signals fraud; rather, changes in behavior are signals.
- Examples include refusal to take vacation and not willing to delegate work or relinquish control.



Accounting Anomalies

- Accounting records are often manipulated to conceal fraud, so anomalies and problems with accounting documents are common red flags of fraud
 - Missing documents
 - Excessive voids or credits
 - Common names or addresses of payees or customers
 - Alterations on documents
 - Revisions to vendor files (address, payee name, bank info)
- Certain records may also be unusual or unrealistic
 - Excessive purchases
 - Multiple payments to the same vendor in a month
 - Unreasonable expenses or reimbursements
 - Significant increases or decreases in account balances



Examples Of Red Flags From Recent Cases

Cash Skimming

Financial difficulties

Control issues

Defensiveness

Refusal to take vacations

Personal Use of Credit Card

Living beyond means

Financial difficulties

Control issues

Bullying

Wheeler-dealer attitude

Complained about pay

Conflicts of Interest

Unusually close with vendors

Control issues

Excessive pressure from organization and stakeholders





Recent Cases Of Fraud In State & Local Governments

Case Study #1



Tribal Housing Department

- Allegations that Covid Relief funds were being mismanaged
- Allegation that funds were used to renovate homes for relatives and friends of housing employees rather than qualified tribal members
- Allegations of exorbitant renovations
- Allegations of collusion with and kick-backs from contractors



Factors Leading To Fraud





Recent Cases Of Fraud In State & Local Governments

Case Study #2

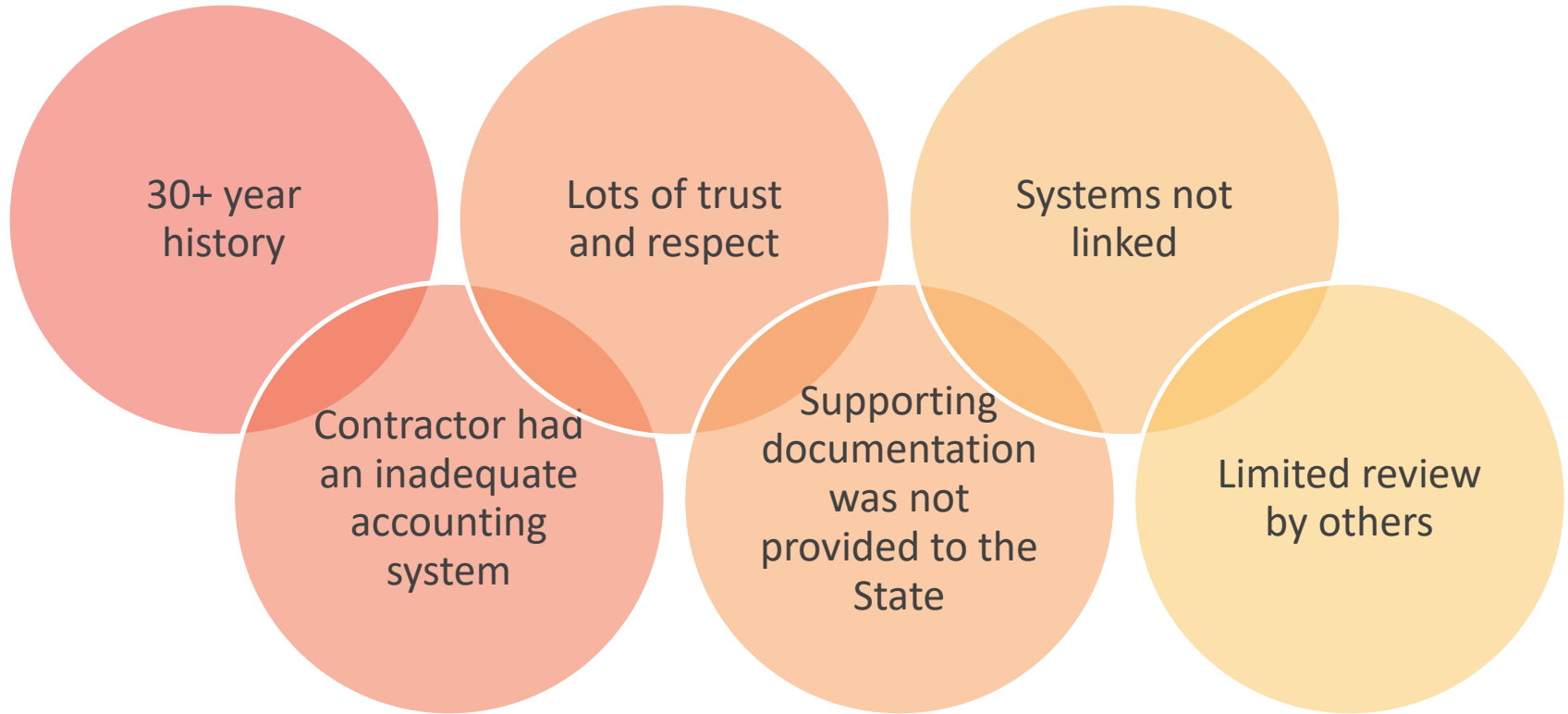


Overview – Transportation Coalition Service Contractor

- Contractor operated demand response transportation for the City as well as for urbanized areas
- Received payment for this contract by way of reimbursement requests submitted to the City and through the State Department of Transportation as a sub-recipient.
- The City owned the busses, and the contractor employed drivers and administrators to administer the bus route services
- Contractor was submitting reimbursement requests for the same expenses to both the City and the State resulting in \$285,000 in duplicate reimbursements paid to the contractor



Factors Leading To Fraud



Discovery Of Discrepancies

Discovered because of a Single Audit performed by the FTA

Forensic audit conducted by the City identified certain expenses that were duplicated

Prompted a more complete investigation of all reimbursement requests and payments



Forensic Investigation

Interview of staff at the City and the State transportation departments

Analysis of financial records, reimbursement requests and support provided for reimbursement

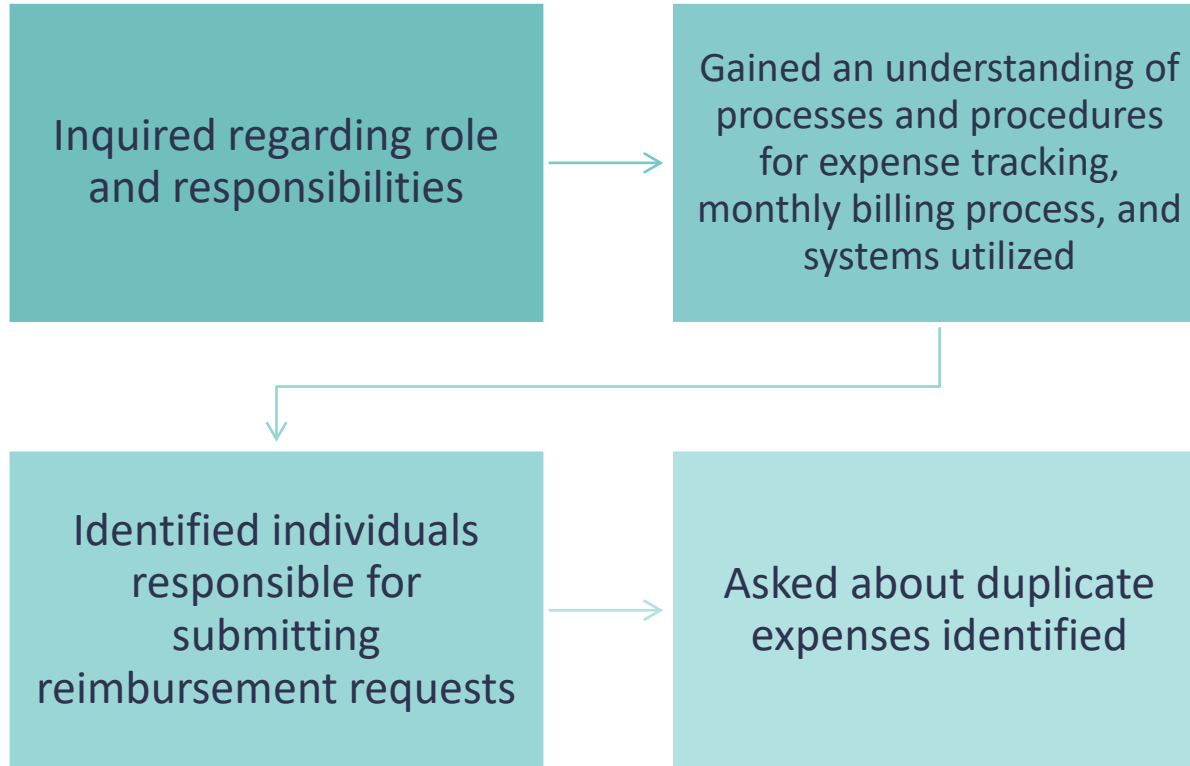
Identification of expenses submitted to both entities for reimbursement

Interview of subject

Report of findings, including recommendations



Interview Of Subject



Conclusions

Identified over
\$285,000 in
duplicated
expenses

- Reimbursement requests made for the same expenses to both the City and State
- Total expenses requested and reimbursed from both jurisdictions exceeded the total expenses in contractor's P&L for 12 of the 16 months

New procedures
were
implemented

- Require supporting documentation for all expenses
- Communication between jurisdictions prior to reimbursement of expenses
- Verification that vendors have adequate accounting systems in place to support any and all expenses associated with the project

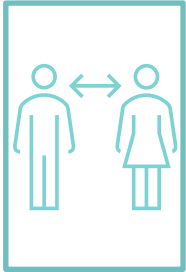




Key Concepts In Fraud Awareness & Prevention



Recommendations To Mitigate Fraud Risk



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



Ensure secondary approval by someone with knowledge of the business area



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



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

Recommendations To Mitigate Fraud Risk



Conduct regular monitoring and management review



Mandatory job rotation and/or vacations



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



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



Require confirmation when vendor change requests are received



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

Median Loss & Duration by Detection Method

FIG. 10 HOW IS OCCUPATIONAL FRAUD INITIALLY DETECTED?

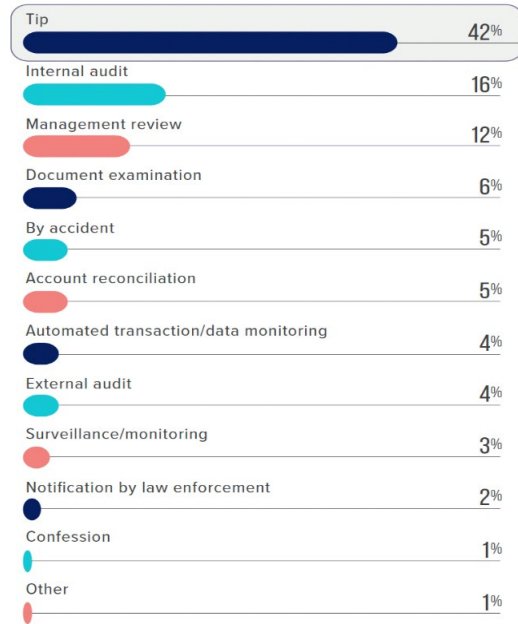


FIG. 12 HOW DOES DETECTION METHOD RELATE TO FRAUD LOSS AND DURATION?



Limitations For Mitigating Fraud Risk

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



Attributes of an Anti-Fraud Program

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



Attributes Of An Anti-Fraud Program (continued)

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





Questions?



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