



Fraud Prevention & Detection for State and Local Governments

State of Vermont

April 14, 2022

WEALTH ADVISORY | OUTSOURCING | AUDIT, TAX, AND CONSULTING

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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 how to build awareness and the types of fraud, the profile of a fraudster, and common red flags
- Identify current practices and incident response strategies





Speaker Introduction

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Speaker Introduction

Principal

CLA's Forensic Practice

Over 20 years of experience leading fraud investigations, forensic accounting projects, and internal control reviews for large government organizations, education institutions, and commercial businesses.



**Jenny
Dominguez**

CPA/CFF, CFE

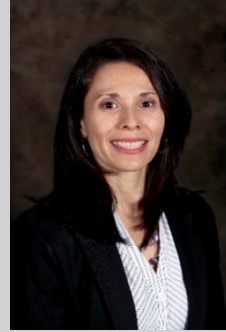


Speaker Introduction

Manager

CLA's Forensics Practice

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



**Ana
Rodriguez**

CPA, CFE

Polling Question #1

What is your profession/position in your organization:

- a. Management
- b. General accounting
- c. Audit (internal or external)
- d. Investigator
- e. Compliance
- f. IS/IT
- g. Administration
- h. Legal
- i. Other





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



ACFE *Report to the Nations* 2022

- Report to the Nations 2022 Global Study on Occupational Fraud and Abuse
- Bi-Annual Report
- Analysis of 2,110 cases of occupational fraud across 133 countries
- Results based on 2021 *Global Fraud Survey* opened to CFEs about their single largest fraud case investigation completed between January 2020 and September 2021
- First ACFE Report to the Nations was issued in 1996



<https://legacy.acfe.com/report-to-the-nations/2022/>



What is Occupational Fraud?

The term “occupational fraud” may be defined as:

“The use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.”



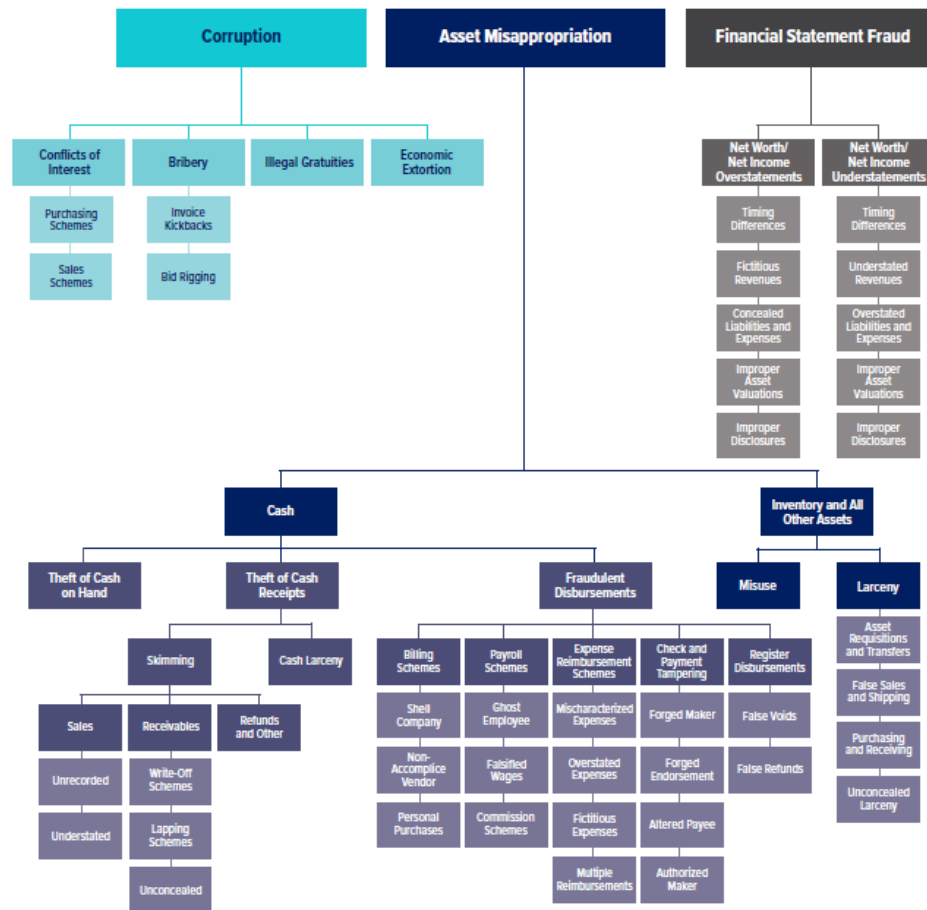


The Fraud Tree

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The Fraud Tree



2022 Report to the Nations.
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Types of Fraud Schemes

Corruption

- Involves an employee's use of his/her 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 involves collusion between an internal employee and an outside party
- Can be difficult to detect



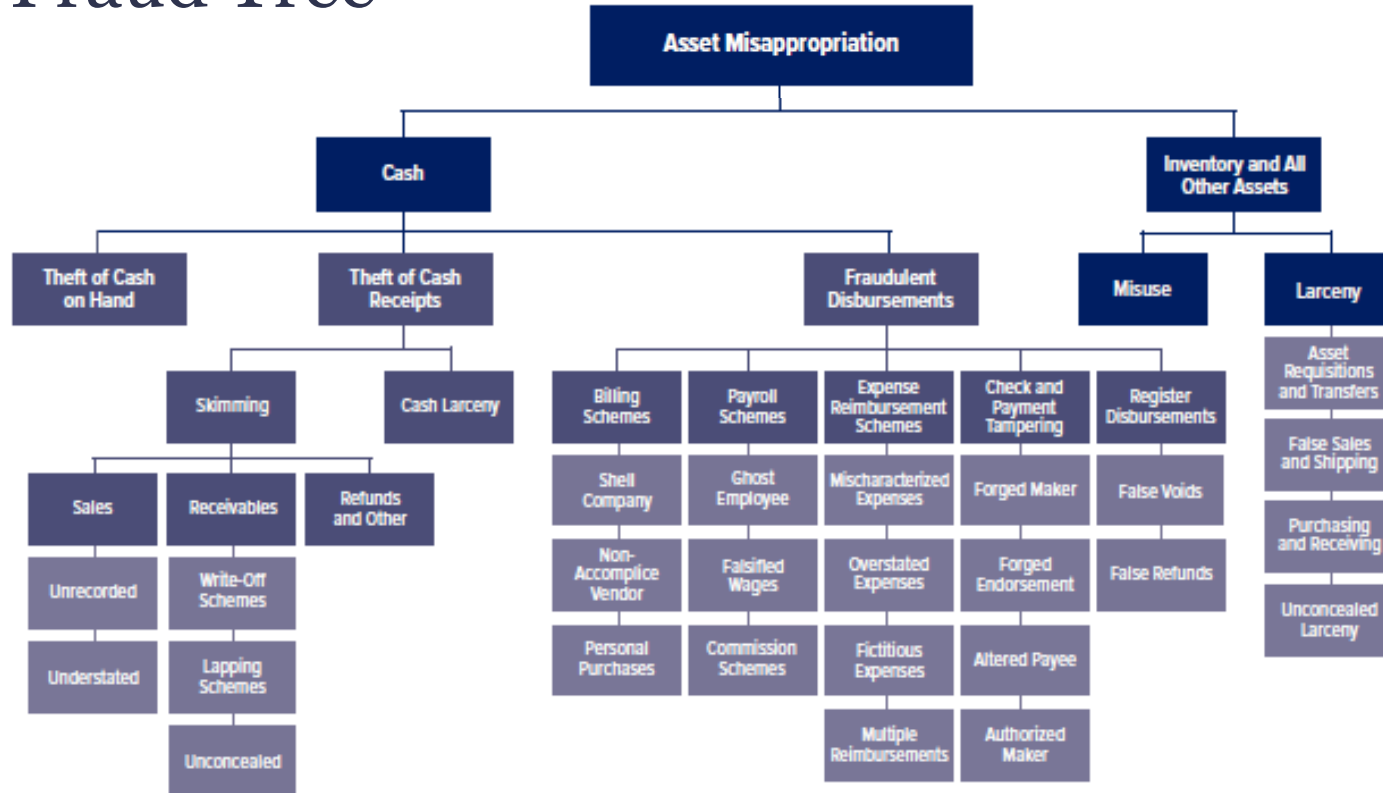
Types of Fraud Schemes

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



The Fraud Tree



Polling Question #2

According to the 2022 ACFE Report to the Nations, what is the most common occupational fraud scheme globally?

- a. Corruption
- b. Financial Statement Fraud
- c. Fraudulent disbursements



Occupational Fraud by Organization Type

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

	INDUSTRY	Cases	Billing	Cash larceny	Cash on hand	Check and payment tampering	Corruption	Expense reimbursements	Financial statement fraud	Noncash	Payroll	Register disbursements	Skimming
2022	Government and public administration	198	21%	8%	7%	9%	57%	12%	8%	16%	16%	3%	8%
2020	Government and public administration	189	18%	5%	9%	4%	48%	17%	4%	17%	17%	0%	7%

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Eight Important Facts of Fraud

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Fraud is Deception - Seven Elements

- A representation about a material point, which is false and intentionally or recklessly so, which is believed and acted upon by the victim to the victim's damage.



Basic Facts of Fraud

1. A typical organization loses 5% of revenue in a given year as a result of fraud
2. Fraud exists in every organization and every industry type – **top 5** industries with the highest occurrence of fraud:
 - Banking & financial services (351 cases; median loss: \$100,000)
 - Government & public administration (198 cases; median loss: \$150,000)
 - Manufacturing (194 cases; median loss: \$177,000)
 - Health care (130 cases; median loss: \$100,000)
 - Energy (97 cases; median loss: \$100,000)
3. Prominent weakness – lack of internal controls or override of existing controls

Source: ACFE 2022 Report to the Nations 



Basic Facts of Fraud

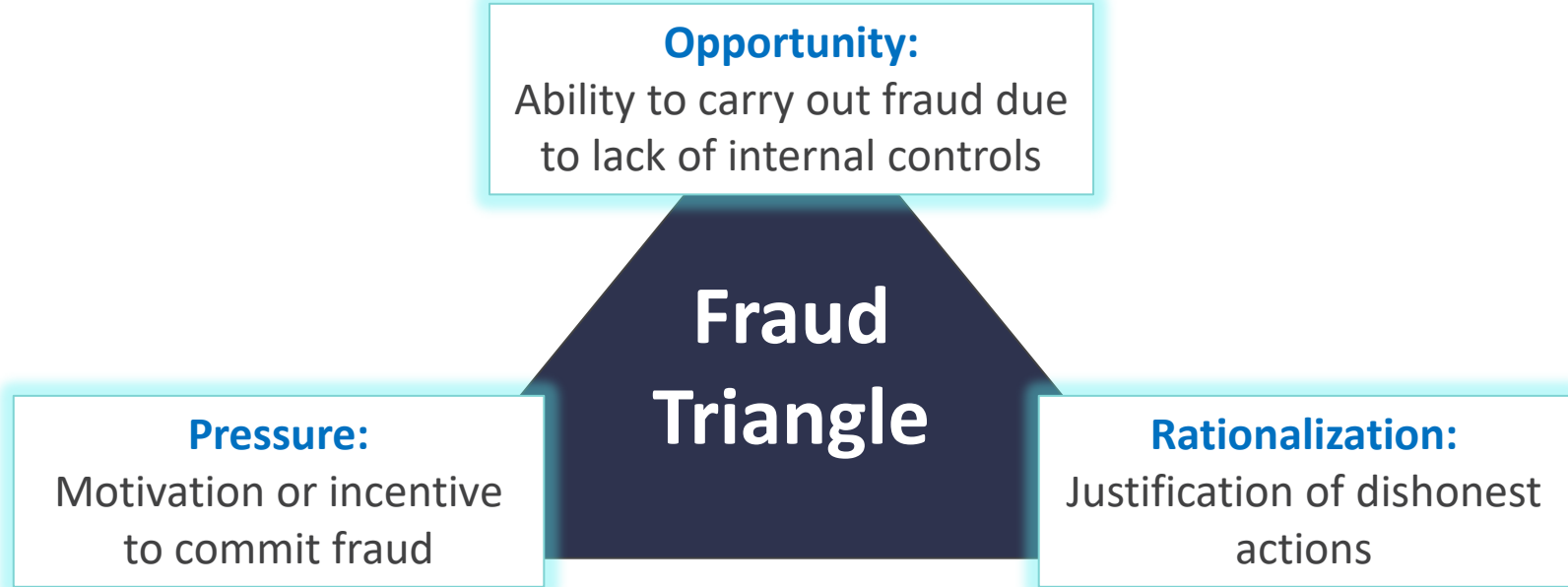
4. Most common form of occupational fraud – asset misappropriation
5. Check/payment tampering and billing schemes represent the greatest risk
6. Most perpetrators are first time offenders (only 6% had prior convictions)
7. Frauds with highest frequency occur in operations, accounting, executive/upper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



How Does Fraud Occur?



The Fraud Triangle



Understanding the Fraud Triangle is critical to:

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



The Fraud Diamond

Incorporates the human element - **CAPABILITY**



“Opportunity opens the doorway to fraud, and incentive (pressure) and rationalization can draw a person toward it; but the person must have the **capability** to recognize the open doorway as an opportunity and to take advantage of it by walking through, not just once, but time and time again.”

-David Wolfe & Dana Hermanson





Types of Frauds within State and Local Governments

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Fraud in State and Local Governments

Public Contract Fraud

Bid splitting

Failure to follow PCC

Purchasing & Disbursement Fraud

Conflicts of interest

Fictitious vendor

Fraudulent/misdirected refunds

Payroll Fraud

Unauthorized pay increases

Unauthorized bonuses/other

Failure to report PTO

Excessive overtime

Construction Fraud

Falsifying pay applications

Billing for unperformed work

Manipulating change orders

Cash Receipts

Theft of incoming receipts (particularly cash)

Fraudulent credit card refunds



Case Study #1

Fraudulent Disbursements/Refunds

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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



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

Fraud Scheme

Misappropriation Scheme #1 – Refunds (Primary)

Customers paid deposits that were held in an agency fund

As services performed, deposits were transferred to the department's operating account; unused deposits were refunded to customers

Created and approved claim requests for fictitious refunds to customers (attached fictitious supporting documentation)

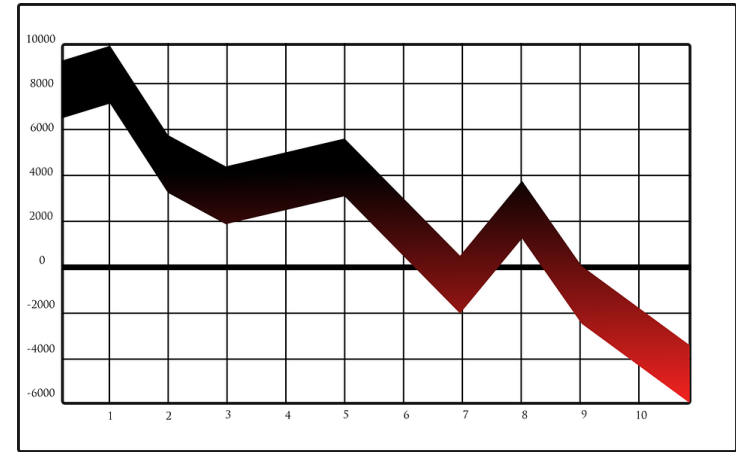
Used a "one-time" vendor number that allowed manual entry of payee name and address

Mailed checks to co-conspirator address; picked up checks from accounting

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
- She was responsible for reconciling all department funds, including project database to accounting records



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



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)



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

**Went back only 7 years.*



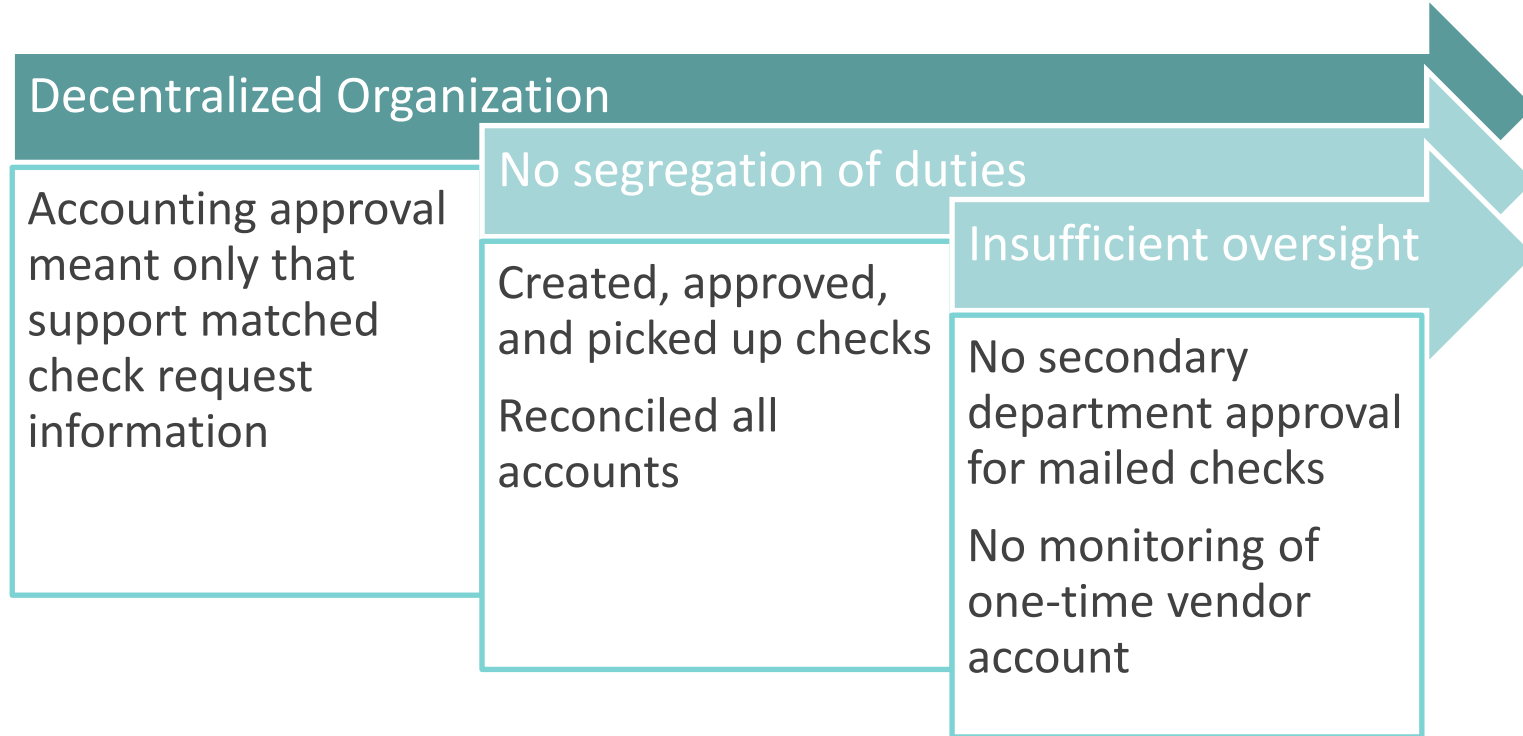
Investigative Techniques

- **Data Analytics**

- All activity in one-time vendor account
- All department disbursements
 - Identified payments under \$10,000 as they did not require a PO and she could be sole approver
 - Reviewed for appropriateness
- Compared refund activity to project database



How Subject Got Away With It



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



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



Preventative/Detective Controls



Secondary department approval required for all transactions

Different individual should have reconciled accounts

Separate deposit and disbursement functions

Monitor one-time vendor activity

Employees requesting payments should not be able to pick up checks, even with secondary approval



Billing/Disbursement Schemes

Red Flags & Risk Areas:

- 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
- Two systems do not interface



Billing/Disbursement Schemes



Internal Control Considerations:

- Segregate purchasing duties from payment duties
- Segregate cash receipts/deposit function from disbursement function
- Segregate reconciliation from individuals performing daily transactions
- Employees requesting payments should not be able to pick up checks or route back to themselves
- Reconcile different systems used
- Management review and oversight



Case Study #2

Fictitious Vendor

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Background

- **Entity:** K-12 School District
- **Type of fraud:** Billing scheme
- **Total theft:** \$369,000 (19 checks)
- **Time period:** School Years 2013/14 to 2017/18
- No other employees involved



Background

- **Employee:**

- Hired in August 2000
- English Teacher
- Promoted to assistant principal in 2002
- Promoted to Director, LEP/Title I in 2005
- Promoted to Director of Categorical Services 2013
- The Categorical Services office provided support to special education programs at the school sites and District level

- **Investigation:**

- CLA retained October 2017



How the Fraud was Detected

- Account technician received a call from the bank about a suspicious check
 - Check was dated nearly a month prior to the opening of the bank account into which it was deposited
 - Address listed on the check had a small variation in the suite number
 - Name of payee was slightly different than name on the account (21 Century... vs. 21st Century...)
 - The bank provided the account holder name - a woman
 - The last name of the account holder matched the last name of the payment approver recorded in the accounting system
 - Account Technician called the Director to inquire – Director stated the owner of the company was a different person – did not acknowledge that he knew the woman with his last name
 - Google search for the name of the woman produced a picture of the woman with the Director



How the Fraud was Detected

- Director called the Superintendent and claimed he and his wife had separated and had not been in communication
- Claimed that his wife unbeknownst to him had recently taken over the business that had received the check in question and was previously owned by a family friend
- Claimed that the business had actually done the work for which it was paid – translation services



Scope of Investigation

- Determine validity of payments made to subject vendor
- Determine if red flags existed for other payments approved by this Director
- Determine whether anyone else within the organization was involved or had knowledge
- Identify breakdown in internal controls



Investigative Techniques – Day Of

- Interviewed District employees
 - Account Technician
 - Director of Purchasing
 - Superintendent
 - Head of Finance
- Obtained and reviewed
 - A vendor change report for that vendor
 - A schedule of all disbursements to that vendor
 - Contracts with and invoices from the vendor
- Spoke by phone with the bank representative that initially called the District



Investigative Techniques - After

- Public database searches and background checks
- Interviews of special education site coordinators
 - CLA could not interview the subject because he refused to meet with us and instead resigned
- Computer hard-drive image & search; email search
- Cell phone and iPad review (both owned by the District)
- Data analytics on disbursements approved by this Director
- Reviewed documentation for disbursements:
 - Contracts, invoices, check requests, and cancelled checks



Analysis of Documents

- Payment requests
 - Identified existing payment requests and verified payment approval by subject
- Maintenance of vendor information
 - Contractor details such as the TIN number and address were changed after the contract was prepared by the purchasing office
 - Address change was made in the system at the request of the Director
- Evidence of work performed
 - Translation services



Analysis of Documents

Vendor Master File Details

Period	Vendor No	Vendor Name	Tax ID # / License #	Vendor Address
1	045172-01	<div>████████████████████</div> Education & Achievement Collaborative	45-██████297	P.O. Box 663, City #1, CA 9XXXX
2	045172-02	<div>████████████████████</div> Education & Achievement Collaborative	45-██████297	P.O. Box 4332, City #2, CA 9XXXX
3	045172-03	<div>████████████████████</div> Education Coalition	45-██████297	2026 Riverside Ave. Suite C298, City #3, CA 9XXXX



Analysis of Documents

Signed Contract

CONTRACTOR:
ACCEPTED BY: Alia [REDACTED] Date: 30 June 2017

Print Name and Title: Alia [REDACTED], Managing Director

Proper Name of Contractor: [REDACTED] Education Coalition

License Number: 82-[REDACTED]756 Expiration Date: 6/15/2022

Address: [REDACTED]

Phone: () _____ Fax: () _____

Email: [REDACTED]@yahoo.com

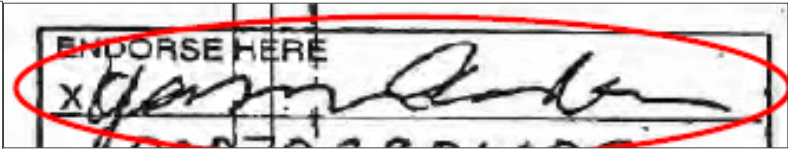
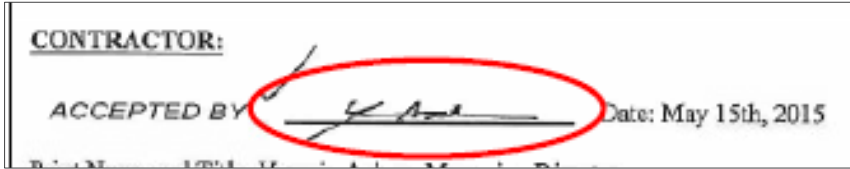
DISTRICT:
ACCEPTED BY: [REDACTED] Date: 7/25/17

[REDACTED]

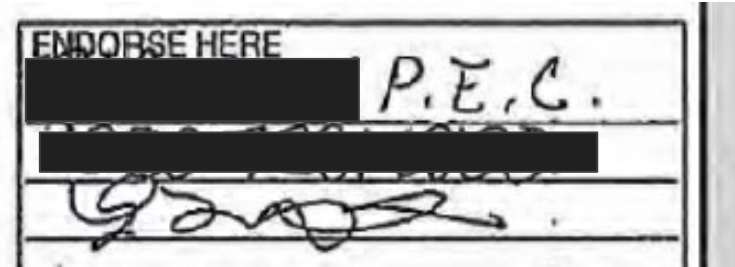


Analysis of Documents

- Analysis of signatures on a contract execution and check endorsements (vendor was a sole proprietor)



Check deposited into Director's wife's account



Analysis of Documents

Summary of Payments

Fiscal Year	Quarterly Invoices Based on Annual Contract	Itemized Invoices	Total Paid by District	Number of Checks
2011/12	\$ -	\$ 40,895.28	\$ 40,895.28	3
2012/13	-	72,074.85	72,074.85	9
2013/14	80,000.00	-	80,000.00	4
2014/15	80,000.00	-	80,000.00	4
2015/16	80,000.00	29,664.50	109,664.50	6
2016/17	80,000.00	-	80,000.00	4
2017/18	20,000.00	-	20,000.00	1
Total	\$ 340,000.00	\$ 142,634.63	\$ 482,634.63	31



Polling Question #3

What is not a red flag from the documents/information analyzed?

- a. Tax ID in the vendor master file did not match the tax ID listed on the contract
- b. Signature of District employee on contract matched to check endorsement signatures
- c. The email address on the contract was a Yahoo email address
- d. Significant round dollar payments were made



Analysis of Documents

- Results of public searches revealed:
 - Vendor registered with the State of CA in April 2012 (first check issued in February 2012)
 - Vendor had internet presence from only July 2013 to October 2016 (according to internet archives)
 - Address of (vendor) individual was owned by a 65 year old individual with the same last name as the Director (believed to be Director's mother)
 - Director's wife registered the revised business name as a DBA



Fraud Scheme

- Based on review of records and interviews conducted, it appeared that initially the vendor was a legitimate vendor and payments were appropriate
- In 2013/14, vendor was awarded an annual fixed-fee contract. After this point, there was no evidence that any work had been performed.
- The Director submitted address changes to Purchasing by forwarding an email he supposedly received from the vendor
- Checks were cut and mailed to an address to which he and/or his wife had access



Internal Control Weaknesses

- Director was the only one dealing with this “vendor”
- The purchasing office normally prepared the contract and sent to the Director for transmitting to vendor for signature
- The purchasing office did not verify to ensure that the contract had not been altered when receiving back from vendor/Director
- The Tax ID number had been changed on the contract but not in the system



Internal Control Weaknesses

- Director submitted an address change request to purchasing office and the purchasing office took no steps to verify the information
- Difficult to determine who had made the change since all staff in purchasing office were in the habit of sharing their passwords to help each other with the work in case of vacation or other time off





Case Study #3

Diversion of Vendor Disbursements

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Polling Question #4

My organization has a process in place to verify vendor change requests for addresses and banking information.

- a. True
- b. False
- c. I don't know



Diversion of Vendor Disbursements

The Scheme:

1. 3rd party pretends to be vendor and submits a request for a vendor change of address or bank information
2. The government agency believes they are communicating with the actual vendor and makes the change in the system
3. The next payment processed to that vendor goes to the fraudulent address or bank account rather than the actual vendor
4. The government agency usually becomes aware when the vendor calls inquiring about the status of their payment

Diversion of Vendor Disbursements

How do you protect your organization?

Require verification of the change via a mechanism other than how the request was received

Require a minimum period of time (i.e., 10 business days) before processing payments after a change is made

Ensure only appropriate staff can add and modify vendors

If available with your bank, implement bank account name verification

On a monthly basis, run a vendor change report to monitor and review for inappropriate or questionable changes

Train your employees



Building Awareness Around Fraud

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The Trajectory of Fraud



Until there is no way out!



Red Flags of Fraud



Living beyond one's means

Recent divorce or family problems

Bullying or intimidation

Excessive control issues or unwillingness to share duties

Unusually close association with a vendor or customer

Irritability, suspiciousness, or defensiveness

Source: ACFE 2022 Report to the Nations



Lifestyle Changes

Most people who commit fraud do so under financial pressure.

Once perpetrators meet the financial needs that motivated them to commit fraud, they usually continue to steal and then use the money to enhance their lifestyles.

- New cars
- Expensive toys
- Expensive homes



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.



Accounting Anomalies

Because accounting records are often manipulated to conceal fraud, anomalies and problems with accounting documents – either electronic or paper journals, ledgers, or financial statements – are common red flags of fraud.

- Missing documents
- Excessive voids or credits
- Common names or addresses of payees or customers
- Alterations on documents



Accounting Anomalies

These are relationships, records, or actions that are too unusual or unrealistic to be believed.

- Unexplained inventory shortages or adjustments
- Excess purchases
- Unreasonable expenses or reimbursements
- Significant increases or decreases in account balances



Internal Control Weaknesses

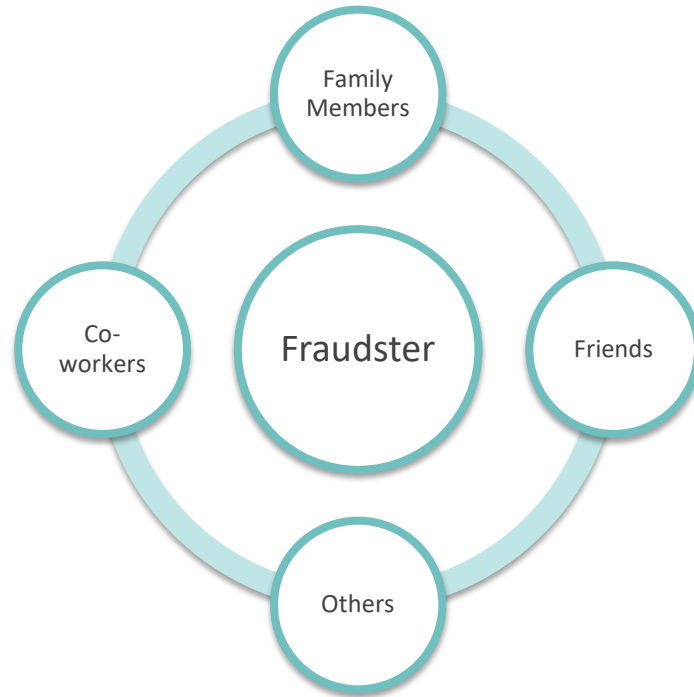
One of the main purposes of internal control procedures is to safeguard assets. When controls are absent or weak (or overridden) they can facilitate fraud.

- Lack of segregation of duties
- Lack of physical safeguards
- Lack of independent checks
- Lack of proper documents and records



Tips and Complaints

- People who are in the best position to detect fraud are usually those closest to the perpetrator - not the auditors or fraud examiner





Recommendations for Fraud Mitigation

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Fraud Risk Assessment

- Looks at business processes and controls and identifies areas of fraud risk
 - Organization-wide
 - Higher risk areas/processes
- Involve an anti-fraud professional
- Free tool (ACFE):
 - <https://www.acfe.com/fraudrisktools/guide.aspx>



Recommendations to Mitigate Fraud

- 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 reconciliations are reviewed



Recommendations to Mitigate Fraud

- 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

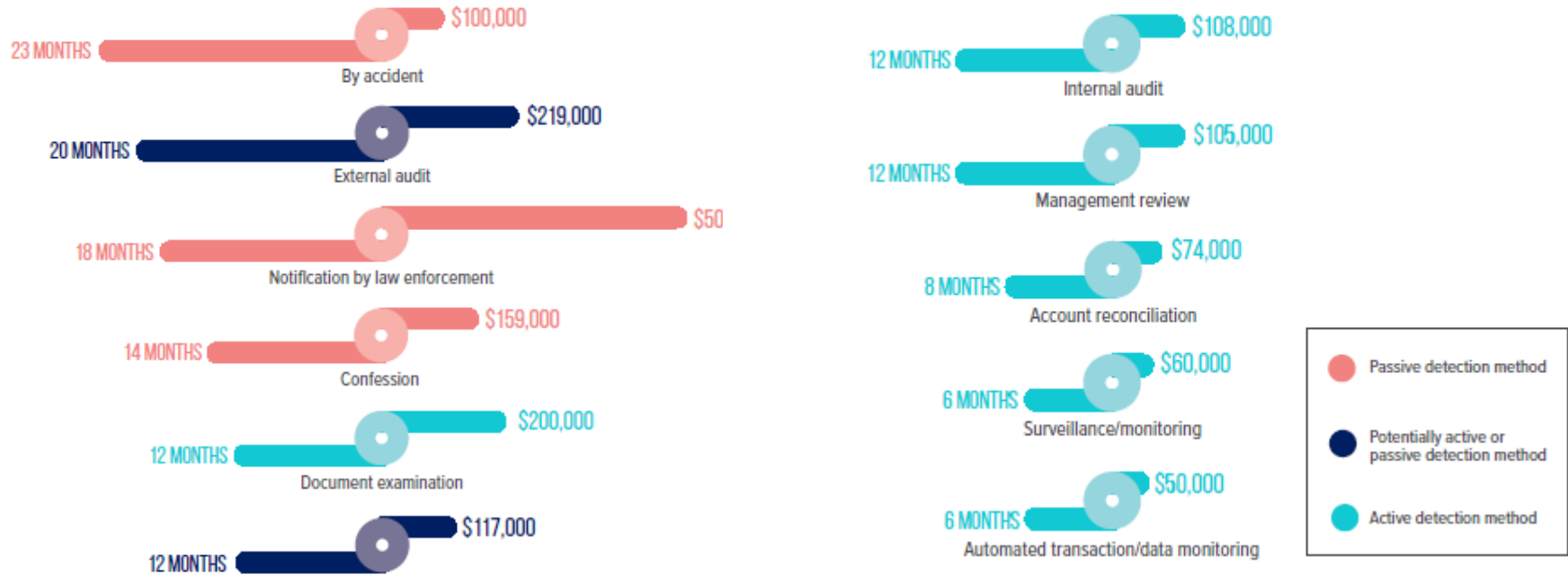


Limitations for Mitigating Fraud Risk

- There is no set of internal controls that is guaranteed to prevent the incident of fraud
- What is your fraud risk tolerance?
 - Lower tolerance = more controls
- Critical component – monitoring and management review
 - Vendor master change report
 - One-time/temporary vendor number
 - Manual check request/refunds
 - Payroll change report
 - Review reconciliations



Fraud Mitigation Cost Savings



Source:
ACFE 2022 Report to the Nations

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





Fraud Incident Response

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Polling Question #5

Does your organization have a fraud incident response plan in place?

- a. Yes
- b. No
- c. I don't know



Fraud Incident Response Preparedness

What can organizations do to prepare themselves for a potential fraud incident?

- Fraud Incident Response Plan?
 - If an employee has a fraud concern, do they know where to report it?
 - Is there a credible fraud concern?
 - Who should be making this assessment?
 - If investigation needed, who will be involved (internally/externally)?
 - Do you know what evidence to secure?
 - Is the fraud internal or external? Is there a possible data breach?



Fraud Incident Response Preparedness

- Unfortunately, loss due to embezzlement or other fraud can still occur, even with the best internal controls.
- When fraud occurs, organizations need to ensure they are ready to respond to an incident, including legal counsel, key contacts, forensic accountant/investigator (as needed), risk team, executives, etc. The response also needs to include education, awareness, systems/assets/resources, etc.

Have a plan, educate about the plan, update the plan



Develop an Incident Response Plan

- Establish a response team: Human Resources, Internal Audit, Risk/Compliance, Legal, Executive Leadership
- Include the appropriate procedures:
 - Ensure employees have a way to report fraud concerns (anonymously)
 - Assess credibility of the fraud concern and if investigation is warranted
 - Determine whether investigation will be conducted internally or externally
 - Is the alleged suspect known? If so, will the person be put on administrative leave?
 - Secure evidence (e.g., email, computer, paper files)



Develop an Incident Response Plan

- Include the appropriate procedures (cont.)
 - Remove user access rights
 - Confronting perpetrator:
 - Involve HR and/or legal
 - Document interaction and anything perpetrator said
 - Do not let the person have access to any systems or files



Develop an Incident Response Plan

- Establish relationships with key incident responders
 - Legal counsel (employment counsel)
 - Forensic accountant/investigator
 - Digital forensics provider (secure digital evidence if data breach involved)
 - Public relations



Open Ended Question

Does your organization have other procedures or steps in your fraud incident response plan?



Questions?



Jenny Dominguez, CPA/CFF, CFE
Jenny.Dominguez@CLAconnect.com
Office 626-387-8227

Ana Rodriguez, CPA, CFE
Ana.m.Rodriguez@CLAconnect.com
Office 626-387-8227



CLAconnect.com



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