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## Under the RADAR<sup>SM</sup> – Overcoming Challenges to Fiduciary Responsibility

Presented by: John B. Montoro, CPA  
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"I weigh 103 pounds using "Generally Accepted Accounting Principles" "

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### Agenda

- Doing what's right
- Compliance Trends
- Internal Control Models
- The Risk Assessment Process
- Fraud
- Examples of Life Without Controls
- Things You Can Do Today

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### Our Fiduciary Responsibility


- David Walker, Comptroller General of the United States
- In March of this year, he gave a speech at a conference on Public Service and the Law held at the UVA Law School
- The Topic was "Doing What's Right"

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### Our Fiduciary Responsibility

- On our profession: "Society expects public officials, lawyers, CPAs and other professionals to be models of good conduct"
- On leadership: "...Leaders must set the professional and ethical tone of the organization. Successful leaders also take seriously their stewardship responsibilities, not just to their organizations and its stakeholders but to society as a whole and to future generations."



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### Our Fiduciary Responsibility

- On Arthur Anderson:

“Arthur Anderson was in the trust business. And once this trust was lost, it was almost impossible for the firm to recover. Government agencies, universities, law firms, and charities need to remember that they are also in the trust business. It can take years to earn a solid reputation and a strong degree of trust, but a reputation can be lost almost overnight if people stray from the qualities that made them and their organization great.”


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### The Special Relationship of Governments

- The heightened degree of fiduciary responsibility over the private sector that is shared by most local and state governments, as well as the federal government is founded in their ability to engage in what we like to refer to as “**Nonexchange transactions**”


The power of taxation




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### COMPLIANCE TRENDS




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### SARBANES - OXLEY


Why was it passed?



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### Enron



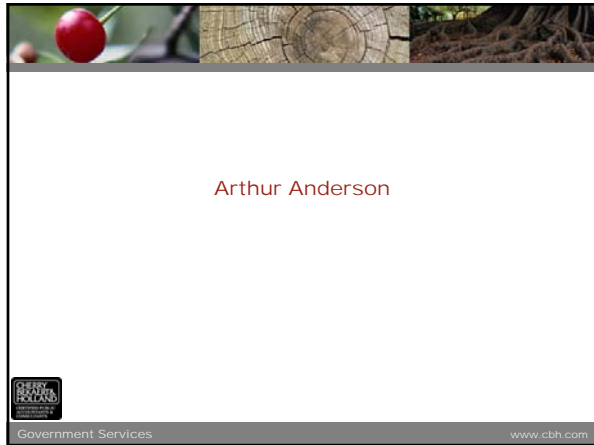
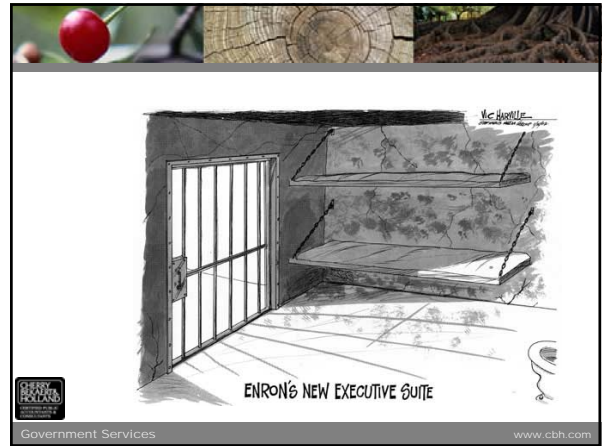
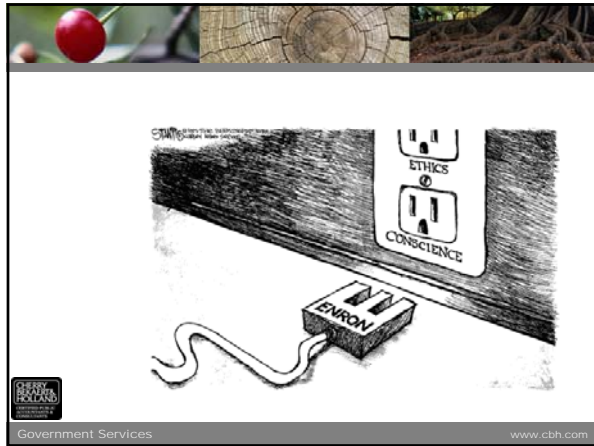
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### THE FINGER



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**ANDERSEN**

The Arthur Andersen partner was on his cell phone when he said,  
 "Ship the Enron documents to the feds,"  
 but his Secretary heard,  
 "Rip the Enron documents to shreds."

It turns out that it was all just a case of bad cellular.

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Let's Start with a Quiz Question...

Sarbanes-Oxley applies to:

1. All companies / entities that do business in the United States, whether publicly held, privately held, or public sector.
2. All companies that are required to file reports with the Securities and Exchange Commission.
3. Only publicly-held companies / entities that have their primary headquarters in the U.S.
4. Only privately-held companies that are headquartered in the U.S.

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Two aspects of SO that make the most news:

- Corporate governance requirements
- Internal control (management assertion and auditor opinion)
- So why are we talking about SO in a session on Government fiduciary responsibility?

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Sarbanes-Oxley Act Provisions with Implications for Governments

- Established PCAOB.
- Good Governance (Fiduciary) Practices.
  - Audit committees with defined responsibilities.
  - Specific communications between auditors and audit committees.
  - CEO and CFO certification of financial reports.
  - Code of Ethics for senior financial officers.
- Management attestation on the effectiveness of internal control over financial reporting (OMB A-123).
- Auditor opinion on the effectiveness of internal control over financial reporting?

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Compliance Trends - federal government

- Circular OMB A-123
  - Federal government's version of SOX.
  - Effective when Fiscal 2006 began (Oct 1, 2005).
  - Quote from *Compliance Week* (September 2005) article "Government Agencies Face New Internal Control Standards":


"The only significant departure [from SOX] is that agencies will not be required to obtain independent attestations of their controls, although the Office of Management and Budget might tell an agency with especially poor controls to get one."

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Should there be Internal Control Attestations for Governments?

<p><u>PROs</u></p> <ul style="list-style-type: none"> <li>• "Taxpayers" money should be subject to the same controls as that of investors (improve the confidence over use of taxpayer funds).</li> <li>• Process / Efficiency improvements.</li> <li>• Enhance executive level accountability and responsibility for financial reporting.</li> <li>• To improve the accuracy and reliability of financial information used by managers to run the business of government.</li> </ul>	<p><u>CONs</u></p> <ul style="list-style-type: none"> <li>• Cost Benefit isn't Proven (spending dollars to chase dimes).</li> <li>• Let the commercial world shake out the problems</li> <li>• Increase in material weakness.</li> <li>• Must allow plenty of time for management to complete an internal self-review, before subjecting to audit.</li> <li>• Risks and objectives of a government entity differ from a commercial entity.</li> <li>• Conspiracy by public accounting firms to create job security.</li> </ul>
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## INTERNAL CONTROL MODELS




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## RESPONSIBILITY for Internal Controls

	Public Company	Private Company	Federal Government	State and Local Government Some Not For Profit
Management is Responsible for Establishing a System of Internal Controls				
Auditor is Responsible for Gaining an Understanding of Management's System of Internal Controls				
Management is responsible for Asserting Effectiveness of Internal Controls System in Writing				
Auditor is responsible for Issuing an Opinion on Internal Controls (to include Managements evaluation process and the system itself)				



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## COSO – The Standard

Council of the Sponsoring Organizations of the Treadway Commission

- COSO 1: *Internal Control – Integrated Framework* (Issued 1992).
- COSO II: *Enterprise Risk Management Integrated Framework* (Issued in 2004).
- COSO Lite: *Internal Control – Integrated Framework – Guidance for Smaller Public Companies on Internal Control Over Financial Reporting* (October 2005 for Public Comment).




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## COSO I: The Framework for Fiduciary Responsibility

- Favorable **Control Environment** – *tone at the top* \*
- Ongoing **Risk Assessment** – *Consequence and likelihood* \*
- Properly designed and maintained control related policies and procedures that address risks - **Control Activities**
- Adequate **Information and Communication**
- Ongoing **Monitoring** and follow-up



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## CONTROL ENVIRONMENT – Audit Committee

- Responsibilities
  - Assessing the adequacy of internal controls and risk management system (including anti-fraud risks).
  - Overseeing the financial and compliance reporting at interim dates and year-end.
  - Overseeing the audit process.
  - Selecting the independent auditor.
  - Monitoring work of internal audit function
- Do you have financial expertise on the audit committee?
- Resources to the audit committee:
  - <http://www.aicpa.org/Audcommctr/toolkits/homepage.htm>
  - Government Finance Officers Association Recommended Practices, *Establishment of Audit Committees, 1997 and 2002 AND 2006*




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## Time for a Little Quiz....

A major section of Sarbanes-Oxley relates to the audit function. Among other things, the law requires that the audit committee of a board of directors of a public company:

1. Be comprised of entirely independent directors.
2. Approve the hiring and compensation of auditors.
3. Provide procedures to receive confidential, anonymous submission by employees of the company about possibly-questionable accounting or auditing matters.
4. Pre-approve any non-audit services provided by the auditor.
5. All of the above.



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Okay, one more question.....


A primary goal of the law as it relates to audit committees and auditors is to:

1. Ensure the independence of the auditor.
2. Be sure that auditors are fairly compensated – neither overpaid nor underpaid.
3. Increase the number of auditing firms and thereby increasing audit competition for audit business.
4. Expedite the audit process.

Yellow Book Independence Standards.....




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GFOA revises recommended practice RP on Audit Committees


- Every Government needs an audit committee
- Audit committee should be properly established and the independent auditors should report to it
- Audit committee should have certain basic knowledge of their own as well as access to expert knowledge.
- Only members of the governing body should serve as members
- The audit committee should provide a way to communicate information confidentially




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RISK ASSESSMENT PROCESS




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RADAR<sup>SM</sup> - Risk Assessment, Detection and Reduction

Risk assessment approach

- Step 1 AUDIT PLANNING.
  - Set up risk management team (RMT), discuss risks specific to the audit unit's industry
- Step 2 RISK IDENTIFICATION.
  - Determine risks
    - Professional literature,
    - risks noted in prior audits, or
    - areas identified by management




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RADAR<sup>SM</sup> - Risk Assessment, Detection and Reduction

Risk assessment approach

- Step 3 Risk Measurement.
  - Self assessment questionnaires.
  - Interviews
  - Evaluation by RMT – review responses and evaluate scores.
- Step 4 Weighting model
  - Ranks the risks based on a priority score assigned to the risk factor.




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RADAR<sup>SM</sup> - Risk Assessment, Detection and Reduction

Risk assessment approach

- Step 5 Develop and Audit Plan
  - Consider types of audits,
  - Audit frequency, intensity, and timing
  - Capacity of internal audit staff
- Step 6 Implement the plan
  - Design audit programs for areas and audits identified




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### RADAR <sup>SM</sup> - Staffing

- Within the Staffing Category, potential areas of consideration:
  - Adequacy of Staffing \*
  - Employee Turnover
  - Employee Morale
  - Segregation of Duties
- How is it performed?
  - Staff Interviews
  - Staff Surveys
  - Review of Documents
  - Facilitated Meetings



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### RADAR <sup>SM</sup> - Adequacy of Staffing


Description: The **Adequacy of Staffing** index measures the adequacy of the Department's staffing levels as related to the achievement of the Department's objectives.

Ranking Criteria for Adequacy of Staffing:

RANK	Description
1	Staffing level is appropriate to support the volume of transactions processed by the Department.
5	High turnover causes vacant positions, creating difficulty in supporting the volume of transactions by the Department.
9	Staffing level is not appropriate to support the volume of transactions processed by the Department.




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### RADAR <sup>SM</sup> - Result


- Prioritizes departments from most risky to least risky.
- Enables management to focus efforts in areas of greatest risk.
- Demonstrates a logical, consistent risk assessment process.
- Demonstrates the appropriate "tone at the top" to employees.
- Fits into the Risk Assessment component of Management's Internal Control System.
- Risk assessment results may surprise you...




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FRAUD

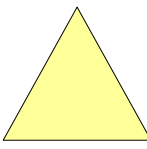


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### The Fraud Triangle

Opportunity  
(Created when  
lack of controls)




Incentive  
(Motive or  
Pressure)

Rationalization  
(Attitude)




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### COSTS OF FRAUD

Statistics on Fraud (ACFE 2004 report to the Nation and The Network statistics):

- 48% of fraud cases in government agencies are uncovered through a tip
- Government agencies lose an average of \$45,000 per fraud scheme
- Fraud losses are reduced by 58% when an effective hotline is put in place
- 47% of hotline calls happen overnight or on weekends



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## COSTS OF FRAUD (continued)

### Other ACFE observations

- The number of frauds committed by men and women are about the same, although the average loss from fraud committed by a man is 3x that by a woman (typically tied to higher position in the company)
- Schemes committed by managers and executives result in median losses of approximately \$250,000 which is 3.5x as high as those committed by rank and file employees
- Stats reveal that 80% of financial statement fraud is committed by CEO or CFO. In an anonymous survey, CFO's indicated that 2 of 3 were asked to "cook the books"; 1 in 3 admitted to doing it.



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## EXAMPLES OF LIFE WITHOUT CONTROLS



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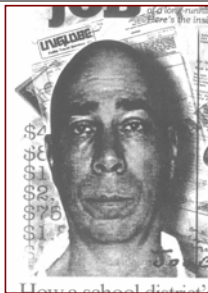
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## The Story of "King" Klein



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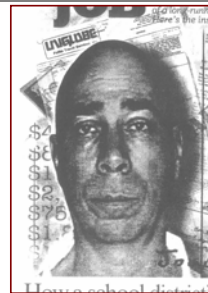


**Finance Director**  
**Sumter 17 School Board**  
**Sumter, South Carolina**



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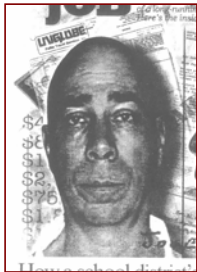
Once a month for 20 years inside the dark-paneled chamber of the Sumter 17 school board, Joe Klein stood with everyone to recite the Lord's Prayer, "*Lead us not into temptation,*" they said as board meetings began, "*but deliver us from evil.*"



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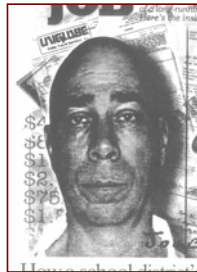
**Joe Klein did neither!**

**Over two decades he stole and/or diverted at least \$3.5 million dollars.**




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On his job application, he stated, *“the demand by the public for better accountability”* was one reason he wanted the job.

Fellow employees remember him as being kind and generous. *“He would give you the shirt off his back.”*




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He took money in a variety of ways:

- He stole from school activity funds.
- He stole from capital projects funds.
- He created fake companies and invoices.
- He paid deposits on school field trips, then cancelled the trips.




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At one point the travel agency had over \$1M credited to his account.

- Again, he was generous with his funds, taking the football coaches on two trips to Las Vegas after winning the state championship.
- *“Everyone knew that Klein wanted to do something for the coaching staff... for a job well done.”*




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**CLEAN AUDITS !**

- Building funds were hard to audit.
- *“The auditors look at pieces of paper, and Joe was good at having pieces of paper....He was also good at manufacturing pieces of paper.”*




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**The Final Insult.**

Days after being suspended, he took \$45,100 of the stolen money and bought 28 months of credit in the SC retirement system, thereby reaching 30 years of full benefits.



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## The STORY OF SALLY

Off Books Accounts Receivable




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### The Facts....

- Sally was the court administrator for the municipal court of a small city – responsible for collecting fines imposed by the court.
- She maintained the court's accounts receivable records from customers and collection agencies.
- The resulting A/R balance was journalized in to the City's general ledger.
- Amount stolen = \$290,000 (10% of the courts revenue).
- 6.5-year scheme (she started on her 25<sup>th</sup> day of employment).

BUT THAT'S NOT ALL.....




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### Why Sally?

- She began a second scheme – cash payment from night court fines (\$5,100 from 49 fines).
- She just didn't enter the fine or the collection of the payment
- This is how she was caught:
  - Temporary employee noticed a missing \$100 bill in the deposit the next day.
  - Initially she admitted this fraud, but after further questioning the bigger fraud was discovered.
- What went wrong...
  - No segregation of duties.
  - No independent monitoring of the "non-cash credit" reports (which would have been very inconsistent with levels of revenue earned).




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## THE STORY OF WAKE COUNTY SCHOOLS, NORTH CAROLINA

Conspiracy and Kickbacks




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### The Facts...

- At least \$3.8 million stolen
- School Transportation Department and Barnes Motor & Parts Company conspired to submit at least \$3.8 million in fraudulent invoices for parts – 1000's of fake invoices (kickback scandal)
- 6 people (4 Wake County BOE and 2 others) plead guilty
- How was it Uncovered? A TIP
- Red Flags (audit performed and findings):
  - TD payments to Barnes – Increased 342% from 2002 to 2003 (3.7 million),
  - All less than \$2500 thereby avoiding competitive bidding process
  - On 24 occasions, 50+ invoices with same date were submitted (466 dated 6/10/03 totaling \$909,266)




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### The Recommendations.....

- Recommendations from audit / investigation:
  - Increase size of internal audit staff (only 1 at time of fraud)
  - Fraud Hotline
  - Train staff on use of data mining software
  - Implement risk-based audit program and risk assessment
  - Forming an independent audit committee
- Commend school for taking a stand and sending out the message that this will not be tolerated




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## The Story of a Water District Utility Clerk

### Fictitious Account Adjustments




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### Facts.....

- Utility Clerk manipulated 23% of all customer accounts (4000 from a universe of 17500) and stole \$357,000
- Lapping Scheme PLUS she wrote off many of the account balances by processing fictitious transactions for pre-bill adjustment, post-bill adjustments, and adjustments to delinquent account balances.
- None of the write-offs had support.
- Able to conceal b/c same person handled customer complaints instead of going to an independent customer services representative
- Discovered.....
  - During cash receipt testing in an annual audit of the water district




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### Recommendations....to detect / prevent

- Employees should be required to take vacations
- Computer should produce a daily "exception report" listing all account adjustments and write-offs (that is, the universe of high risk transactions). Verify that all transactions are properly authorized, approved and supported.
- Customer service unit should be independent of accounts receivable.
- Delinquent accounts should be monitored closely. Where appropriate, customer account confirmations should be considered.




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## The Story of Turner

### Ghost Employees




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### Facts.....

- Turner was a payroll specialist for a large Florida Not-For-Profit (he was also experiencing health problems)
- Over 2 years he stole \$112,000 to cover his medical costs
- Segregation of Duties existed = posting of time and attendance (Turners job) was separate from adding / deleting employee master records. Furthermore, a supervisor reviewed all payroll distributions
- Turner stole user ID and password for other employee to create ghost employees, prepared fake payroll summary for supervisor approval, paychecks direct deposited into his account




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### Discovered...

- Created phony file copies of payroll checks (on white paper). Legitimate checks were on yellow paper.
- Annual audit transaction testing – staff accountant noticed the white paper and started asking questions
- Red Flags:
  - Infrequent change in passwords by payroll system administrator
  - SS# were for dead people
  - EE#'s were much higher than legitimate employees
  - None of fake EE's had personnel file
  - Net payroll expense was lower than funds actually issued because it did not include ghost employees
  - Payroll Summaries created were in different type face
  - Multiple direct deposits to the same bank account




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### Detection and Prevention....

- Look for paychecks w/o deductions
- Check payroll for presence of duplicate names, addresses and Social Security Numbers
- On occasion, hand-deliver paychecks to employees and require positive identification. If you have leftover paychecks, make sure they belong to actual employees, not ghosts
- Be wary of budget variations




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### Common Causes


- Lack of proper internal control
  - Poor segregation of duties.
  - Poorly designed records.
  - Lack of effective reconciliations.
  - Lack of periodic verification.
  - Poor supervision.
  - Assets and records not properly secured.
  - Other.




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### THINGS YOU CAN DO TODAY




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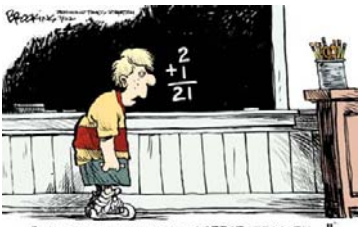


### SOX for Governments - Things to Consider


1. Does the government have an effective audit committee (<http://www.aicpa.org/audcommctr/toolkits/homepage.htm>)
  - Does at least one member of the audit committee have expertise in financial reporting specific to governments?
2. Has the government performed a risk assessment
3. Has the government established anti-fraud program and controls (HOTLINE)
4. Has the government established and documented an adequate system of internal control?
5. Has the government accepted full responsibility for the design and maintenance of its system of internal control?
6. Does the government follow a policy of full disclosure of all required financial information?



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"IT'S CLOSE ENOUGH FOR CORPORATE WORK..."




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"So, do you still think the government should be run like a business?."



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Questions?



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Solutions Character.  
Depth.



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