Confronting fraud and unethical behavior in government

September 19/20, 2007
Corporate scandals over the years

- South Seas bubble-1700’s
- Great Salad Oil Swindle-1960’s
- Late 2000 to date:
  - Excessive CEO pay
  - Insider trading scandals
  - Accounting scandals and restatements
  - Executive self-dealing
  - Corporate failures
  - Stock option backdating
Ex-bureaucrat to be jailed for defrauding government

A former assistant deputy minister with Health Canada is going to jail for a year, after admitting that he got more than $200,000 in kickbacks for channeling millions of dollars to an addictions treatment centre. He pleaded guilty in an Ottawa court to charges of fraud and breach of trust. The kickbacks included travel to Florida and the Caribbean, several SUVs and cash, which he used to buy condominiums in Mont Tremblant.
Mastermind of DND fraud pleads guilty

The great invoicing heist perpetrated on the Department of National Defence took a surprise turn yesterday as the man accused of orchestrating it pleaded guilty to fraud and breach of trust.
What is fraud?

According to the CICA:
“The term fraud refers to an intentional act by one or more individuals among management, other employees, those charged with governance, or third parties, involving the use of deception to obtain an unjust or illegal advantage.”
What is fraud?

Section 380 of the Criminal Code of Canada:

“Every one who, by deceit, falsehood or other fraudulent means, whether or not it is a false pretence within the meaning of this act, defrauds the public or any person, whether ascertained or not, of any property, money, or valuable security…”
What is fraud?

Fraud is lying, cheating and stealing for financial gain.

– FBI agent from Chicago
Fraud: common misperceptions

Fraudsters are geniuses who mastermind highly sophisticated crimes
Woman arrested in charity scam

A Cambridge women has been charged with fraud in a charity scam. Police allege that the women canvassed neighbourhoods last week to collect for a charity event that had taken place a month earlier. At least 16 people gave cash donations of $100 or more.
Fraud: common misperceptions

Fraud is usually committed by unstable, lazy, outcasts of the community
Former charitable organization president sentenced in charity fraud

The former president and chief executive of the nonprofit Millennium Charity Plus pleaded guilty to using money from the charity to buy real estate for himself in Southern California. The Minnesota Gambling Control Board has revoked Millennium’s charitable gaming license as a result of the former president’s actions.
Background on fraud and statistics

• Costs of fraud
  – Organizations lose 6% of their annual revenue to fraud
  – Fraud costs US organizations $600 billion annually
  – 1 in every 6 occurrences of fraud causes in excess of $1 million in damage

• Perpetrators of fraud
  – 37% of companies worldwide say they have suffered from fraud during in the previous two years
  – 70% of all perpetrators of fraud are first time offenders
  – 33% of all frauds involve collusion

Source: Association of Certified Fraud Examiners
Government fraud (ACFE statistics)

• This study covers 508 cases of occupational fraud totaling over $761 million in losses
• The typical organization loses 6% of its annual revenue to occupational fraud
### Government fraud – by scheme (ACFE statistics)

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<tr>
<th></th>
<th>Total Cases</th>
<th>Skimming #</th>
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## Government fraud – by scheme

(ACFE statistics)

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Government fraud – methods of detection (ACFE statistics)

- **Tip**: 48.5% (Government 39.6%, All Cases 23.8%)
- **Internal Audit**: 32.4% (Government 21.3%, All Cases 18.4%)
- **By Accident**: 14.7% (Government 10.9%, All Cases 11.8%)
- **Internal Controls**: 11.8% (Government 5.9%, All Cases 10.9%)
- **External Audit**: 5.9% (Government 0.9%, All Cases 10.9%)
- **Notified by Police**: 1.5% (Government 2.5%, All Cases 1.0%)
Perpetrators of fraud-collusion (ACFE statistics)

- Approximately two-thirds of the frauds in the study were committed by a single perpetrator, but when more than one person conspired to commit fraud, the median loss rose dramatically, more than tripling.
- This trend is expected because when multiple perpetrators conspire to commit a fraud, this makes it easier to circumvent anti-fraud controls.
Lack of legal action (ACFE statistics)
Perpetrators of fraud – tenure (ACFE Statistics)

- a direct correlation between the length of time a perpetrator had been employed with a victim organization and the size of the loss in the fraud scheme
How an organization can be victimized

External
• False invoicing
• Kick backs
• Corruption
• Electronic funds scams

The organization

Internal
• False financial reporting
• Kickbacks/bribes
• Phantom vendors
• Submission of fraudulent expense accounts
• Payroll Fraud
Findings of Justice Gomery re: sponsorship scandal

- Evidence of political involvement in the administration of the program
- Insufficient oversight at the very senior levels of the public service which allowed program managers to circumvent proper contracting procedures and reporting lines
- Secrecy in the administration of the program and an absence of transparency in the contracting process
- Fear of reprisal on the part of public servants to challenge a manager who was circumventing established policies and who had access to senior public officials
Findings of Justice Gomery re: sponsorship scandal (cont’d)

• Overcharging by suppliers to the program for goods and services provided and inflated commissions charged

• A lack of objectives, criteria and guidelines for the program

• Deliberate actions to avoid compliance with legislation and policies

• The existence of a “culture of entitlement” among political officials and bureaucrats involved with the program, including the receipt of benefits
Management’s responsibility

“Part of management’s responsibility when designing a company’s internal control over financial reporting is to design and implement programs and controls to prevent, deter, and detect fraud. Management, along with those who have responsibility for oversight of the financial reporting process (such as the audit committee), should set the proper tone; create and maintain a culture of honesty and high ethical standards; and establish appropriate controls to prevent, deter, and detect fraud.” (par. 25)

Source:
PCAOB Auditing Standard No. 2
An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements
Approved by the SEC on June 18, 2004
Factors that lead to fraud

“At any given moment, there is a certain percentage of the population that’s up to no good.”

J. Edgar Hoover
Elements of fraud

Opportunity:
• weak controls
• Management override

Pressure:
• Need
• Greed
• Fear of not making expected results
• Cutoff funding

Rationalization:
• Everybody does it
• I am underpaid
• I wanted to make plan

Source: Donald D. Cressey, "Other People’s Money: A Study in the Social Psychology of Embezzlement"
Factors that lead to fraud

- Organizational culture – main factor
  - Rapid changes in the size/structure of an organization
  - Executive incentives driven by financial performance
  - Employee sentiment that compensation and benefits are inadequate
  - Market pressures to meet revenue/earnings expectations, budget

- Technology & globalization
  - Constantly changing technological landscape, new and advanced ways to perpetrate fraud
  - More “local office” loyalty than “overall company” loyalty
Senior management fraud

- Senior management fraud very difficult issue for the Board/Audit Committee
- CEO involved in 72% of frauds examined by SEC 1987 to 1997
- The Board/Audit Committee must be alert to red flags that signal possible fraud, or illegal, improper or unethical actions and activities by senior management
- “Culture of Entitlement”
Fraud risk factors re: top management

• Significant portion of management compensation represented by bonuses, stock options or other incentives, the value of which is contingent upon the entity achieving unduly aggressive targets for operating results, financial position or cash flow

• Excessive interest by management in maintaining or increasing the entity’s stock price or earnings trend through the use of unusually aggressive accounting practices
Fraud risk factors re: top management (cont’d)

- Management commits to analysts, creditors and other third parties in achieving what appear to be unduly aggressive or clearly unrealistic forecasts.
- Management displays a significant disregard for regulatory or legislative authorities.
- Control has changed, especially if the price paid by new management was high.
Fraud risk factors re: top management (cont’d)

- Management does not effectively communicate and support the entity’s values or ethics, or management communicates inappropriate values or ethics
- Management dominated by a single person or small group without compensating controls such as effective oversight by those charged with governance
- Management does not monitor significant controls adequately
- Management fails to correct known significant weaknesses in internal control on a timely basis
- Management employs ineffective accounting, IT or internal auditing staff
Potential fraud schemes

- Vendor allowance manipulations
- Improper bill and holds
- Roundtrip transactions
- "Refreshed" receivables
- "Off-site" or fake inventory
- Undocumented rights of return
- Adjustments to estimations
- Quid-pro-quo arrangements
- Phony shipping documentation
- Moving inventory between locations
- Related parties that "create" transactions
- Splitting of multiple-element deals
- Unjustified consolidation entries
- Adding back O/S checks to cash
- Improper capitalization of expenses
- Improper asset valuations
- Holding periods open
- Phony "investment deals"
- Subscriber count/circulation frauds
- Provider reimbursements
- I/C manipulations affecting other accts
- Bribery, corruption & kickbacks
- Agreements to "sell through" product
- Money laundering
- Phony joint venture contributions
- Fraudulent audit confirmations
- Early recording of rebates
- Off balance sheet liabilities
## How fraud is detected

### How is it detected?

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<tr>
<th>Detection methods (all types of frauds)</th>
<th>Percent of cases</th>
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<td><strong>Employee tips</strong></td>
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<td>By accident</td>
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<tr>
<td>Tips from vendors</td>
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Source: Association of Certified Fraud Examiners  
2002 Report to the Nation Occupational Fraud and Abuse
Fraud risk assessment

- Formal/systematic process for assessing fraud risks
  - Brainstorming
- Consideration of internal and external factors
  - pressures & incentives, rationalization, opportunity
- Consideration of frauds
  - types of fraud, past occurrences
- Likelihood, significance, pervasiveness of fraud
  - resulting in misstatements
- Levels within organization
  - entity, significant business units and significant processes/accounts
- Risk of management override of controls
  - journal entries, bias of estimates, non-routine or unusual transactions
- Appropriate personnel involvement
  - management, business process owners, audit committee, internal audit
Government grant abuse

• Pressure to “spend” government grant money prior to year end
• “Use it or lose it” mentality
  “we found ways to justify the spending of year-end allocations. If we didn’t use it, we’d lose it.”
  (Former DND employee quoted in the Ottawa Citizen, July 24, 2007)
Scenario no. 1

• $1 million grant provided by government agency to NPO to finance renovations to facilities
• Funds received January 2002, had to be spent by March 31, 2002
• NPO signed a Request for Funds form in late March 2002 claiming it had spent $1 million on 10 suppliers
• NPO cut cheques to the suppliers, based on invoices received
• Government agency paid the NPO $1 million
Scenario no. 1 (cont’d)

• In early April 2002 all suppliers returned funds to NPO, NPO recorded funds as “security deposits payable”
• April 2002 to November 2002, suppliers performed the services, invoiced the NPO and the NPO paid the invoices
• Scheme was uncovered during the year end audit when questions were raised about “security deposits payable”
Scenario no. 2

- NPO received a series of government grants over several years to carry out a program
- Annually, NPO required to report on how funds were spent and apply for further funding
- In first three years of project, actual spending was significantly less than reported spending
Scenario no. 2 (cont’d)

- NPO instructed suppliers to render invoices dated prior to March 31 based on estimates for work to be done after March 31
- NPO paid invoices and recorded as expenses, not pre-payments
- Effect was to misstate both reports the NPO made to the government as well as its own financial statements
- NPO forced to maintain “second set of books” to keep track of what they had actually spent vs what had been reported
Grant abuse

• Common features:
  – Collusion with suppliers
  – Real fear over “use it or lose it”
  – Organizations put at potential financial risk
The case of the misspelled words

• Walt Johnson was the Parks and Recreation Director of Large Municipality
• He and an accomplice set up dummy companies to defraud the municipality
• The accomplice created the phony invoices and Walt personally delivered them to the accounts payable department
• Walt also picked up the cheques for these suppliers
• Scheme unraveled when an arena official saw an invoice for washroom painting which he knew was not done
# The case of the misspelled words

**Acme Contracting Ltd**  
ACL97-004  
P.O. Box 202  
Whitby, Ontario  
M7G 8J9  
(905) 975-3462  

Jan 15, 1997

Sold to:  
Large Municipality  
200 Eglinton Ave. East  
Toronto, Ontario  
M8G 3E4

<table>
<thead>
<tr>
<th>Description</th>
<th>Unit price</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Painteing washrooms in Northwest Arena</td>
<td>$435.00</td>
<td></td>
</tr>
<tr>
<td>GST</td>
<td>30.45</td>
<td></td>
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<td></td>
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<td><strong>465.45</strong></td>
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Confronting fraud and unethical behavior in government
The case of the misspelled words

Bosstown Renovations Inc
P.O. Box 305
Markham, Ontario
M7G 8J9
(905) 975-3564

Sold to:
Large Municipality
200 Eglinton Ave. East
Toronto, Ontario
M8G 3E4

May 15, 1997

<table>
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<tr>
<td>Paveing Civic Centre back-lot</td>
<td>1,985.00</td>
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<tr>
<td>GST</td>
<td>138.95</td>
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<td></td>
<td>2,123.95</td>
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The case of the misspelled words

Fenceing

Paveing

Installeing

painteing
The case of the misspelled words

Other red flags:

Why is the Parks and Recreation Director delivering supplier invoices? approving supplier invoices? picking up supplier cheques?

Watch for spelling mistakes and unfolded invoices!(means they haven’t been mailed)