

WHAT IS YOUR LOCAL GOVERNMENT'S FRAUD RISK EXPOSURE?

How Proactive Detection And Prevention Can Help You Mitigate Fraud

by Ron Steinkamp

No local government is immune to internal fraud. Offices that take a wait-and-see approach are risking severe financial and reputational damage along with the loss of constituent confidence. The fact is that every organization, including government entities, are subject to fraud at some level. If not prevented or detected at an early stage, fraud can have a devastating impact on local governments.

Corruption, employee misappropriation of assets, and financial statement abuse are significant problems. Local governments need to take a proactive approach to identify and mitigate the risk of fraudulent activity.

WHAT IS THE IMPACT OF FRAUD?

Local governments are especially vulnerable to fraud due to their lack of internal controls, including effective and adequate segregation of duties. According to the Association of Certified Fraud Examiners' (ACFE) 2010, "Report to the Nation on Occupational Fraud & Abuse," government is one of the most victimized industries. Here are some interesting facts about fraud from the ACFE study:

- It is estimated that fraud was responsible for more than \$2.9 trillion in losses in 2009 throughout the world.
- Government was the third highest industry victimized by fraud of the 16 industries reviewed. Banking and financial services are responsible for 16.6 percent of the cases, followed by manufacturing at 10.7 percent, and



then government at 9.8 percent.

- \$100,000 was the median financial loss in governmental fraud cases reviewed.
- Lack of adequate controls are the most commonly cited factor in allowing fraud to occur, followed by lack of management review and overrides of existing controls.

WHAT TYPES OF FRAUD HAVE SIGNIFICANT AND DETRIMENTAL IMPACT ON LOCAL GOVERNMENTS?

The three primary categories of fraud include: corruption, asset misappropriation, and fraudulent financial statements.

- Corruption occurs when an individual uses their influence in a business transaction that violates their duty to their employer in order to obtain a benefit for themselves or someone else. This could include bribery and other improper uses of power.
- Asset misappropriation occurs when a perpetrator steals or misuses

resources. Common examples include stealing cash or assets (supplies, inventory, equipment and information), payment for fictitious goods or services and payroll fraud.

- Financial statement fraud is the intentional misstatement or omission of material information from the organization's financial reports. This type of fraud often involves reporting fictitious revenues or concealing expenses or liabilities.

In government, the ACFE study found that corruption was the type of fraud most commonly reported. Asset misappropriation ranked second, but was determined to be the least costly event. Fraudulent financial statements are the least commonly reported type of fraud, but the most costly per occurrence.

Over time, these fraud schemes create a severe financial impact. Often, under-the-radar fraudulent activity is not detected until serious damage has occurred. Any type of fraud creates a major risk for organizations from a financial and reputational perspective. This is why assessing risks and developing controls to prevent internal fraud are paramount in today's government and business environments.

HOW CAN A LOCAL GOVERNMENT REDUCE THE RISK OF FRAUD?

There are a variety of proactive fraud tools and techniques available to help deter and prevent fraudulent activity. Some of these include fraud prevention checkups, fraud risk as-

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assessments, data analysis using audit command language (ACL) software, development of fraud policies and reporting mechanisms, fraud training, tool kits and scorecards for detecting internal fraud. More local governments are shifting toward partnering with a licensed certified fraud examiner (CFE) to utilize these tools and techniques. Government entities are encouraged to engage a CFE or a certified forensic accountant to perform, at a minimum, a quick fraud prevention checkup.

WHAT'S INVOLVED WITH FRAUD PREVENTION CHECKUPS, FRAUD RISK ASSESSMENTS, AND ACL DATA ANALYSIS TOOLS?

One of the best uses of time and money for local government officials on a limited budget is a tailored fraud prevention checkup. These projects are generally completed by a licensed CFE and can be conducted in a few business days for most organizations with a revenue less than \$250 million. The checkup involves interviews with management and key employees. Questions are designed based on the size of the entity and the employees' role in the organizations. That information is compiled and a report is prepared that provides an overview of the entity's fraud prevention performance.

In contrast, fraud risk assessments dig deeper and can require compiling certain records (i.e., gratuity logs, beginning and ending trial balances, etc.) in advance. The interview process is more detailed. Finally, data analysis tools such as ACL have the capability to electronically analyze data for suspicious behavior based on the industry and entity size. An experienced fraud professional then works with management to help change processes and/or mitigate potential risks for fraud based on unusual patterns, anomalies or outliers of data that may have been identified.

The current state of the economy has increased the risk of compromised employee and vendor behavior. The fraud prevention methods mentioned above can shed light on the vulnerabilities government decision-makers must address if they want to prevent fraudulent behavior before it begins. □

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