

FRAUD RISK ASSESSMENT REPORT

INTRODUCTION

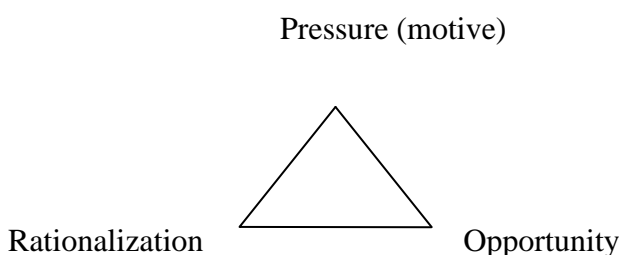
Internal Audit is confident that the vast majority of City employees are competent, ethical people doing a great job for the citizens of Sioux Falls.

The term “fraud” has a very specific legal meaning. However, in this report we use the term in a general way to refer to such things as an employee stealing cash from an organization, an employee receiving kickbacks from a vendor, an employee converting organization assets to their own use, falsifying time cards to receive unearned overtime, stealing equipment and converting it to cash, etc.

The Association of Certified Fraud Examiners (ACFE) is the premier organization studying fraud and providing training and certification in fraud prevention and detection. In their 2004 *Report of Occupational Fraud and Abuses*, the ACFE reports a typical organization loses 6% of its annual revenues to fraud. The ACFE’s figure is just a best guess; many companies do not report frauds and many corporate scams go unnoticed.

We have no reason to believe that the City of Sioux Falls is losing anywhere near 6% of its annual revenues to fraud; however, fraud is a real risk in any organization with over 1,400 full-time and temporary employees and a budget of over \$360,000,000.

The Fraud Triangle



Those who study fraud say that all three elements of the fraud triangle must be present for a fraud to occur. Any employee could be stealing from the City. A thief or fraudster can be male or female, long-time employee or new hire, educated or not. However, unbearable financial pressure can be the common factor. People define “unbearable” differently. For some, it is unbearable not to vacation at an expensive resort every year. Most employees rationalize their stealing. They may believe the organization “owes them” or that “everyone does it”. When they are finally caught they may say they were intending to pay back what they took. Finally, opportunity is the most important piece of the fraud triangle. If there are loose internal controls or if there is a perception of loose controls, the organization is vulnerable to fraud. Our goal as internal auditors is to help management create and maintain an environment hostile to fraud.

METHODOLOGY

The American Institute of Certified Public Accountants (AICPA) has developed and made publicly available a “fraud risk assessment checklist”. The checklist was designed for use primarily by publicly-traded corporations but we used it as good starting point for our assessment. We also found a good fraud risk assessment checklist from the Inspector General’s office, State of Georgia. This checklist was developed in cooperation with the Governor’s Office of Texas. These checklists, and several others, provided a basis for our fraud risk assessment. Also helpful was formal training received in fraud prevention and detection.

Completing the checklist required talking to management and relying upon the Lead Auditor’s knowledge of City operations after more than 24 years City employment as an accountant and internal auditor. We interviewed directors and managers in the following major organizational units: human resources, finance, and central services (information technology and risk management). We also examined documents such as City policies, ordinances, and the employee handbook.

We also researched available professional literature on fraud assessments and fraud prevention and detection.

WHAT THE CITY OF SIOUX FALLS IS ALREADY DOING

1. Internal controls such as segregation of duties, bank reconciliations, management monitoring, written policies and procedures etc.

Internal controls, or management controls, are the first line of defense against fraud. Of all the internal controls that the City has, the most important is segregation of duties. This means one employee doesn’t perform all the steps in any given process. Management is responsible for internal controls. Internal audit assists management by testing and evaluating internal controls and making recommendations to improve them.

2. Created an independent internal audit function

In 2006 the City Council authorized an internal audit function, appointed members of an audit committee, and approved an internal audit charter. The City Council was responding to recommendations from both the City’s external auditor and the South Dakota Department of Legislative Audit. The Association of Certified Fraud Examiners reports that organizations without an internal audit function have a median loss due to fraud of \$130,000 a year. Organizations with an internal audit function have a median annual loss of \$80,000. This is because internal auditors are in a position to evaluate fraud risks and controls and to recommend action to mitigate risks and improve controls.

3. Treats its employees well

A positive work environment can reduce the risk of fraud. Employees who feel they are treated fairly and are well compensated are less likely to steal from their employer. City employees enjoy good pay and numerous benefits such as pensions, paid vacations and holidays, and medical/dental insurance. Typically, the City receives over 200 applicants for job openings. The City has professionally administered compensation programs and equal employment opportunities. When employees leave City employment they are offered the opportunity for an exit interview with Human Resources. Exit interviews are a good way to monitor the way employees are being treated and the reasons why someone is leaving his or her job.

4. Human Resources use several screening methods to avoid hiring inappropriate employees

Depending on the position applied for, there are several screenings of potential employees:

- Criminal background check
- Drug screen (urinalysis)
- Credit check
- Educational verification
- Sex offender list (the list published by the SF Police Department is checked)

Human Resources also checks references. When the City employment opportunities are advertised, the required screens for that position are mentioned. We believe this is effective in discouraging inappropriate people from considering City positions.

5. Accounts payable checks have a number of security features

Advances in technology have increasingly helped fraudsters to commit check fraud. Photocopiers, scanners, and software allow fraudsters to alter existing checks or produce counterfeit checks. Finance has been proactive in using more fraud-resistant check stock. City check stock has a number of security features to address the problem of check fraud. Some of these features include:

- Watermarks
- “Void” pantograph (which displays the word “void” when the check is photocopied)
- Fluorescent fibers
- Chemical coatings that react to attempts at alteration

Additionally, blank check stock is carefully controlled.

6. Information Technology managers use various IT controls

Some of the IT controls used are:

- Physical security of the computer room
- Authentication and access security
- Passwords
- Firewalls

IT controls help mitigate fraud risk by making it more difficult for outsiders to “hack” into the City’s IT network or for insiders to manipulate electronic records for fraudulent purposes. Additionally the process of printing checks is tightly controlled with access limited to a few employees and has management oversight.

7. Human Resources has developed an Employee Assistance Program (EAP)

The EAP offers employees reasonably priced, strictly confidential counseling services and assessments. Family Services, Inc. has a long standing agreement to provide programs and services such as:

- Alcohol/drug assessments
- Alcohol/drug counseling
- Marital/family counseling
- Individual therapy
- Police stress management program

Employees receive up to three counseling sessions which are billed to the City. Fees for additional counseling service are computed on a sliding fee schedule. A 1998 fraud survey by the CPA firm KPMG found that abuse of drugs, alcohol, or gambling is a significant factor in many internal frauds. An EAP effectively addresses this problem.

RECOMMENDATIONS

1. Complete a City of Sioux Falls fraud policy and disseminate to all employees

A fraud policy, in and of itself, does not prevent fraud from happening. However, a well-written fraud policy that is made known to all employees is considered a “best practice” and can do several things:

- Communicates clearly that the organization does not tolerate fraud
- Communicates that the organization will prosecute and seek restitution in all fraud situations
- Indicates exactly who is responsible for handling alleged fraud situations; for example, who investigates and who monitors restitution

Studies have shown that employees are less likely to commit fraud if they perceive that an organization is committed to fraud prevention. A fraud policy can help accomplish this. A fraud policy should be a completely separate document from a “Code of

Conduct”. Ideally, the fraud policy should be distributed to all employees and have the endorsement of the Mayor and the City Councilors. High level endorsement emphasizes the policy’s importance. It should be introduced in a positive way: *we need your help to fight this threat.*

2. Conduct fraud awareness training for all managers and supervisors

A knowledgeable, hands-on manager is an excellent deterrent to fraud. Managers and supervisors would benefit from training in why and how fraud occurs and what the symptoms of fraud might look like. This training could be done by hiring an outside consultant or in-house with Risk Management and Internal Audit. The advantage of in-house training is little cost compared to hiring a consultant. The training need not be extensive to have value. A one-hour training session every two years, for example, might be sufficient to give managers and supervisors the information they need.

3. The City Council should consider establishing a fraud, waste, and abuse hotline using a third-party provider

In 2002 Congress passed the Sarbanes-Oxley Act in response to corporate scandals such as WorldCom and Enron. One requirement of Sarbanes-Oxley is for corporations to provide some sort of anonymous whistle-blower system. Many public corporations have gone to third-party providers to give their employees a way of reporting wrongdoing without fear of retribution. At the federal level of government, many agencies have had fraud, waste, and abuse hotlines since the 1980’s. Many state and local governments have established or are seriously considering establishing such hotlines.

The existence of a hotline can function as an excellent internal control to prevent and detect fraud and other illegal acts. The Association of Certified Fraud Examiners (ACFE) in its *2006 Report to the Nation on Occupational Fraud & Abuse* reported that agencies detect fraud most often through tips and that an anonymous hotline represents a valuable tool for consistently collecting them. **Agencies with a fraud hotline suffered a median loss of \$100,000 in fraud schemes, whereas agencies without hotlines suffered a median loss of \$200,000.**

The ACFE reported the following statistics in their 2006 report:

DETECTION OF FRAUD IN GOVERNMENT AGENCIES

Tip	48.5%
Internal Audit	32.4%
By Accident	14.7%
Internal Controls	11.8%
External Audit	5.9%
Notified by Police	1.5%

(total is more than 100% because of multiple detection methods in some cases)

The American Institute of Certified Public Accountants (AICPA) also endorses the idea of an anonymous hotline. The AICPA recommends all agencies establish a whistleblower system, ideally by using an external provider in order to increase the perception of confidentiality. Several national firms such as *The Network* and *Silent Whistle by Allegiance* will provide a 24/7 365 toll-free hotline with a trained, live operator. These national firms will provide a service for approximately \$3,000 to \$4,000 annually. Typically, about 1% of employees will call the hotline annually. Hotlines protect organizations and build public confidence along with the confidence of employees and elected officials.

4. Internal Audit should continue proactively looking for fraud and suspicious transactions

We have completed numerous specific antifraud procedures as part of our 2007 Annual Audit Program and a separate report will soon be issued to the City Council. With the endorsement of the Audit Committee and approval of the City Council, we will include antifraud procedures in every annual audit program.

5. Internal Audit should expand their antifraud activities to management companies that manage City facilities.

The City of Sioux Falls has formal agreements with organizations to manage the following City-owned facilities:

- Sioux Falls Transit
- Washington Pavilion of Arts and Science
- Great Plains Zoo and Delbridge Museum
- Municipal golf courses: Elmwood, Kuehn, and Prairie Green
- Sioux Falls Convention Center
- Sioux Falls Arena

These formal agreements normally contain a standard “right-to-audit” clause giving the City the right to inspect all financial records related to the agreement. However, we believe a cooperative approach between the City and these management companies would be the best approach when considering using internal audit for antifraud work.

Some services that Internal Audit could provide might be:

- Assisting in reviewing and developing financial internal controls
- Monitoring for red flags and other fraud indicators
- Unannounced cash counts
- Unannounced examinations of bank statements and bank reconciliations
- Examining payroll records
- Reviewing signatures and endorsements on accounts payable checks
- Examining organization credit card purchases

Several of the management companies are small organizations that cannot afford a full-time internal auditor and concentrate most financial duties in one or two individuals. The

assistance of the City's internal auditors could provide assurance to the City's elected officials and the board of directors of these organizations that fraud risk is being mitigated.

6. The City should consider requiring mandatory one-week vacations in sensitive positions.

Many fraud schemes, especially embezzlements, require the constant presence of the fraudster at their workplace. Records have to be manipulated on a daily or almost daily basis. Therefore, the fraudster never takes much time off from work and will often show up early and stay late. Banks routinely require employees to take a mandatory one-week vacation each year so that another employee performs their duties in their absence.

We recommend that City management consider requiring that employees in certain positions take at least five consecutive days off from work each year. City employees normally accrue at least 6.75 hours of vacation each month (two weeks vacation each year). Positions that should be considered for mandatory one-week vacations would be those where the employee's duties involve maintaining financial records of any type, receiving payments from customers, or approving requisitions, purchase orders, or contracts.

Certain employees in these positions are represented by a labor union. This would be something to be discussed during the next round of union negotiations.