The State Inspector General's Annual Report of Fraud Conducted by Executive Branch State Employees
Fiscal Year (FY) 2014-2015

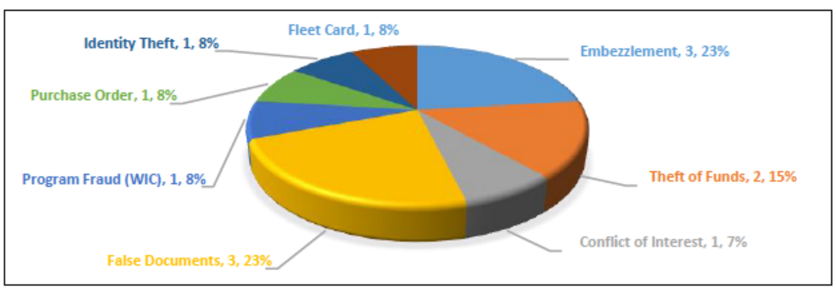
The State Inspector General (SIG) tracks fraud conducted by Executive Branch employees to assist State agencies in their investigations; serves as an indicator of integrity within the Executive Branch workforce; and transparently reports to the public to maintain its confidence in the integrity of State government. At this time, the SIG does not track frauds conducted by third parties against the State, such as tax, Medicaid, pharmaceutical diversion, SNAP, or contract fraud, most of which are investigated by sworn law enforcement personnel residing in the respective State agencies.

The SIG identifies Executive Branch employee fraud through mandatory reporting by each agency; reporting from SLED; agencies' annual reports to the Office of the Comptroller General; and open source reporting, to include the SIG's Hot Line. In FY 2014-2015, the SIG received thirteen (13) notifications of fraud involving fourteen (14) Executive Branch employees from nine statewide agencies, which resulted in estimated losses of $298,803.00. The median reported loss was $2,000.00, with one fraud scheme causing losses in excess of $256,527.00. The breakdown of the fraud categories and associated losses is as follows:

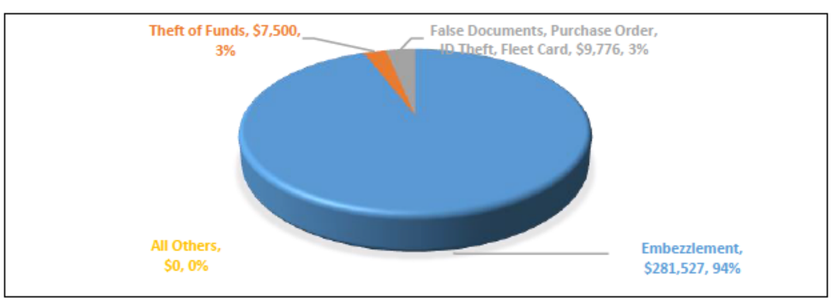
Fraud Scheme Category	Number of Reports	Fraud Losses by Scheme
Embezzlement	3	$281,527*
Theft of Funds	2	$ 7,500
Conflict of Interest / Business Relationship	1	$ 0
False Documents	3	$ 5,736
Program Fraud (WIC)	1	$ 0
Fleet Card Fraud	1	$ 2,000
Purchase Order Fraud	1	$ 540
Identity Theft (Unauthorized Access)	1	$ 1,500
TOTALS	**13**	**$298,803**

* One incident totaled $256,527.00, and is the second incident of this size at the same state agency.

FRAUD REPORTS BY CATEGORY (%)



FRAUD LOSSES BY CATEGORY (%)



A year over year comparison (FYs 2014-15 vs 2013-14) of the four recurring fraud schemes highlights the following:

Recurring Fraud Schemes between current and prior FYs	FY 2014-15 Events	FY 2014-15 Losses by Scheme	FY 2014-15 Average Loss Per Event	FY 2013-14 Events	FY 2013-14 Losses by Scheme	FY 2013-14 Average Loss Per Event
Embezzlement	3	$281,527.00	$93,842.33	1	$ 28,044.50	$ 28,044.50
Theft of Funds	2	$ 7,500.00	$ 3,750.00	6	$ 9,765.00	$ 1,627.50
Fleet Card Fraud	1	$ 2,000.00	$ 2,000.00	2	$ 110.98	$ 55.49
Purchase Order / Purchase Card	1	$ 540.00	$ 540.00	4	$425,669.86*	$106,417.47
Totals & Average Loss	**7**	**$291,567.00**	**$41,652.43**	**13**	**$463,590.34**	**$ 35,660.80**

*Purchase Card fraud in the amount of $414,976.68 was later prosecuted as an embezzlement crime.

Important observations of the FY 2014-15 fraud reporting, in comparison to the FY 2013-14 fraud report are:

- Embezzlement and Theft of Funds accounted for 38% of the fraud reports, while contributing to 97% of the reported losses; whereas, Purchase Card fraud accounted for 25% of the reported fraud and 78% of the reported losses in FY 2013-14.
- Recurring fraud schemes for the current FY experienced a decrease in the total number of reports and losses, but an increase of 17% in the average loss per fraud event over the prior FY.
- Subject employee levels: nine front line employees (64%); four supervisors (29%); and one executive (7%). A decrease in front line employees, but an increase in supervisory level employees over FY 2013-14.
- All four supervisors reported for fraud engaged in some form of false documentation or altering of records in order to receive a personal benefit; as opposed to one supervisor in FY 2013-14.
- Frauds identified by subject's work unit supervisor or co-worker(s) (50%); internal audit departments (43%); and external complaints (7%).

The most illustrative "lessons learned" were gleaned from examining the largest fraud of $256,527.00 which involved the altering of payroll system records by a finance department supervisor over a period of 15 years. This was the second such example in successive years at the same state agency, and again illustrates a long-term employee who was "trusted" by co-workers and upper management. First, the former supervisor exploited a gap in the agency's financial control environment while continuing to perform payroll duties he/she previously did as a front line employee. This was done without adherence to a segregation of duties or higher level of supervisory oversight. Second, the agency failed to restrict access to an archived financial management system when the new system was implemented, which the former supervisor later utilized in the embezzlement scheme by targeting discretionary funds set aside for overtime payroll. Third, payroll "exception reports" or issues with payroll were only reviewed and addressed by the former supervisor. Finally, budget directors in other departments within the agency did not stay on top of discretionary overtime spending which could have identified the embezzlement at an earlier stage of the scheme. The failure to identify these "red flags" provided the subject the opportunity to continue the scheme undetected for 15 years.

Fraud risk has traditionally been assessed by looking at opportunity, pressure on employee, and employee's ability to rationalize the fraud. In this case, the opportunity was high as described by the missing controls; the agency's failure to limit access to an archived financial management system; and the failure to segregate duties by supervisors and employees. Internal controls on finances are primarily designed to deter/prevent fraud, rather than detect fraud after the fact. The point is, employers are not good at discerning, much less predicting employees with high fraud risk, which underscores the need to diligently execute basic financial controls and avoid the temptation to solely rely on "trust" as a management control.

However, the SIG takes note of the fact that agencies may be underreporting fraud and choosing instead to terminate the employment of those found to have engaged in fraud against the state agency without further consequence. The Office of the Comptroller General (OCG) reported that <u>none</u> of the 75 statewide agencies reported fraud in response to Questions #52-55 of the annual master reporting to the OCG. This is in contradiction to the fraud reports received by the SIG from nine state agencies during FY 2014-15. In addition, during an interview unrelated to fraud, the SIG was made aware of a $50,000 voucher fraud which went unreported to the SIG, OCG and law enforcement. These two examples give credence to the anecdotal claims by some statewide internal auditors that agencies are underreporting fraud with the respective agency, and choosing to quietly terminate the employment as opposed to identifying internal control weaknesses which provided the opportunity for the employee to commit the fraud.

Frauds identified based on co-worker or supervisory concerns was 50%, which is consistent with fraud research. Forty-three percent (43%) of the fraud reports were identified by internal audit, an increase from the 19% in FY 2013-14. The fact that internal audit has increased in the identification of fraud, combined with those of employees, serves as a reminder that the best defense against fraud is providing employees with fraud awareness training, which then creates eyes and ears throughout an agency to better discern potential suspicious activity that should be reported, as well as to deter those contemplating fraud opportunities.

The overriding primary internal control weakness identified in all eight categories was ineffective supervisory oversight, in particular with supervisors requiring a higher level of supervisory review. Secondary contributing internal control weaknesses included: (1) lack of supervision of approved documentation; (2) failure to conduct timely review of budget expenditures by supervisors; (3) failure to implement dual controls and segregation of duties at the supervisory level; and (4) insufficient controls of incoming receipts and failure to make timely deposit of funds.

In summary, with one exception, the residual 12 frauds reported during FY 2014-2015 were nominal in nature and indicative of Executive Branch employees operating in a high integrity environment given its $25 billion budget and 66,000 employees. However, the increase in supervisory employees engaged in fraudulent behavior should remind every Agency Head that even though the frequency of major frauds potentially damaging an agency's reputation and undermining the public's confidence are low in the Executive Branch, it should be looking throughout its ranks, not just at front line employees. State government agencies are essentially a part of a large partnership, where a negative event caused by one agency has the tendency to undermine the public's confidence in all State agencies. Mandatory reporting to the SIG, OCG and law enforcement is there for a reason. Given State agencies' position of trust and fiduciary responsibility to the public, any fraud, regardless of dollar loss, impacts the public's confidence in State government; and therefore, Agency Heads should be proactive in measures to reinforce financial management controls. Ben Franklin's advice of "an ounce of prevention is worth a pound of cure" applies to following basic financial controls and fiduciary prudence.

ADMINISTRATIVE NOTE: The Vignettes describing the 13 frauds during FY 2014-2015 can be found at the following link: http://oig.sc.gov/Documents/Vignettes-Fraud%202014-2015.pdf