

PROTECTING AGAINST FINANCIAL RISK

Steve Mermell, City of Pasadena

Douglas Farrow, KPMG

Andy Belknap, Management Partners

Moderated By:

Ken Striplin, City of Santa Clarita

February 10, 2017

League of California Cities
City Managers Department Meeting

Overview

- Pasadena's \$6 Million Embezzlement
 - ▣ Steve Mermell, City of Pasadena
- Fraud and Misconduct in the Public Sector
 - ▣ Douglas Farrow, KPMG
- Addressing The Organizational Roots of Fiscal Distress: Tools and Techniques
 - ▣ Andy Belknap, Management Partners

Pasadena's \$6 Million Embezzlement

Steve Mermell

City Manager, City of Pasadena

Embezzlement Overview

- May 20, 2014 – City Council Committee questions staff regarding Utility Underground Fund expenses
 - ▣ City collects approximately \$5 million per year
 - ▣ Fund balance of approximately \$45 million
- May 21st – HR Director informs City Manager of questionable transactions in Public Works regarding the Utility Underground Fund
 - ▣ Multiple payments made to churches
 - ▣ Other questionable payments
- Principal suspect was on leave pending termination for unrelated issue
 - ▣ Suspect was a preacher, well liked and trusted in the organization

Initial Response and Investigation

- Limit Internal HR Review to protect evidence for possible prosecution and recovery
- May 30th meet with LA Deputy District Attorney
 - Directed not to share information with anyone, including City Council
- Select “Big 4” accounting firm to conduct forensic audit
- Develop Public “holding” statement

Initial Response and Investigation

- KPMG Investigation
 - Backup all related paper and electronic files
 - 20 member CSI-like team
 - Data review going back 10 years
 - Forensic analysis
 - Focus on four vendors 296 invoices; 189 payments = \$6,432,810 (August 2003 – March 2014)
 - Collins Electric – 163 invoices \$3.5 million
 - SCEJ – 98 invoices \$2.1 MILLION (Wooten affiliated church)
 - NCCF – 33 invoices \$712,810 (Wooten affiliated church)
 - Melody Jenkins – 2 invoices \$43,985
 - Tracking where the money went
 - Report was completed in November 2014

It's Public

Pasadena Star-News

EMBEZZLEMENT

News Sports Entertainment Lifestyle Obituaries Opinion Special Reports

Home News Crime Embezzlement

Pasadena ex-employee suspected of stealing \$6M in city funds; scandal larger than Bell case

- December 30, 2014 press conference
- January 5, 2015 Special City Council meeting
 - ▣ Prepared and presented detailed response to embezzlement - which backfired

Pasadena Star-News


Pasadena City Council to question city manager over alleged \$6.4M embezzlement case



Pasadena City Manager Michael J. Beck, right, speaks as Mayor Bill Boggs looks on during a press conference about the embezzlement and misappropriation of public funds by former city employees during a press conference in the city council chambers at Pasadena City Hall in Pasadena, Calif., Tuesday, Dec. 30, 2014.

Response

- Mayor and City Manager establish Internal Audit and Financial Controls Citizen Task Force
 - ▣ Prepared public report
- Council District forums
- Independent personnel investigation
- Two directors were terminated, three other employees separated (in addition to the suspect employee who was terminated earlier)
- Webpage created



Office of the City Manager

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EMBEZZLEMENT INVESTIGATION

The City of Pasadena is providing a variety of documents and information to help keep the public informed about the arrest of a former City employee regarding the theft of public funds and steps that the City has – and will – take.

A four-member City Council ad hoc committee has been established. The following city council members are on this ad hoc committee: Steve Madison, Chair, Victor Gordo, John Kennedy and Margaret McAustin. The mission of the ad hoc committee is to do the following:

- o Oversee, with the assistance of staff and outside counsel, the restitution of funds through civil/criminal litigation, insurance claim, or other means.
- o Receive updates on the personnel investigation being conducted by staff and outside investigator, and
- o Work collaboratively with the full City Council and the Citizen Task Force.

Additionally, a Task Force on Financial Administration and Internal Controls composed of seven highly qualified and respected community members has been created. The meeting dates of the Task Force and documents related to its work are listed on the link below.

A civil lawsuit has been filed by the City of Pasadena in Los Angeles Superior Court seeking recovery of funds. The Los Angeles District Attorney's Office is handling the criminal prosecution arising from this matter. Finally, the City is conducting a personnel investigation into issues related to the theft of public funds. Because of the pending criminal prosecution, as well as the required confidentiality surrounding the personnel investigation, not all aspects of the investigation may be made public and it will take an undetermined period of time before this matter is concluded.

As more information becomes available, additional postings to this webpage will occur.

- [City Files Lawsuit Seeking Recovery of Embezzled Funds 06/23/15](#)
- [City of Pasadena's Official News Release](#)
- [City Manager's Letter to Employees](#)
- [City Manager's Letter to Employees, November 12, 2015](#)
- [Letter to City from District Attorney's Office](#)
- [KPMG Audit Report](#)
- [LA District Attorney's Press Release](#)
- [Audit Investigation Press Conference](#)

Department Home

Embezzlement Investigation

OIR Report - McDade

2015 Adopted Budget

Public Affairs

Economic Development

Northwest Programs

Film Office

Special Events

Legislative Resources

CM's Weekly Newsletters

2015 Annual Report

Internal Audit

CITY LINKS

Most Requested

Departments & Agencies

Mayor, Council & Commissions

How Did It Happen?

- Single person responsible for all aspects of program; excessive responsibility
 - Operated as a “reimbursement” program, no formal contracts
 - Was a “good employee” = limited supervision
- Finance and Purchasing Policies were not being enforced
 - Walked through payment requests, maintained full custody
 - Forged signatures and changed dollar amounts
 - Requested expedited payment/check pick-up
 - Non-verified vendors
- Everyone thought someone else was responsible
 - No checks/balances, no segregation of duties; requestor signed for the department head
 - Expenditure review focused on sufficient money in the fund, not a focus on what was being spent

Moving Forward

- Created Internal Audit Group in City Manager's Office
 - ▣ Periodic reports to Council Audit Committee
 - Strong sense of independence
 - ▣ Citywide Fraud Risk Assessment
 - ▣ Established Fraud Hotline
- Reinforce Financial Controls
 - ▣ Update and train on policies and procedures
- Recovery
 - ▣ \$5 million from insurance, \$200k from Auditors
- Rebuild community trust and employee morale
 - ▣ Event was incredibly damaging to the City's reputation and had a significant impact on the organization
 - ▣ Ongoing...

Fraud and Misconduct in the Public Sector

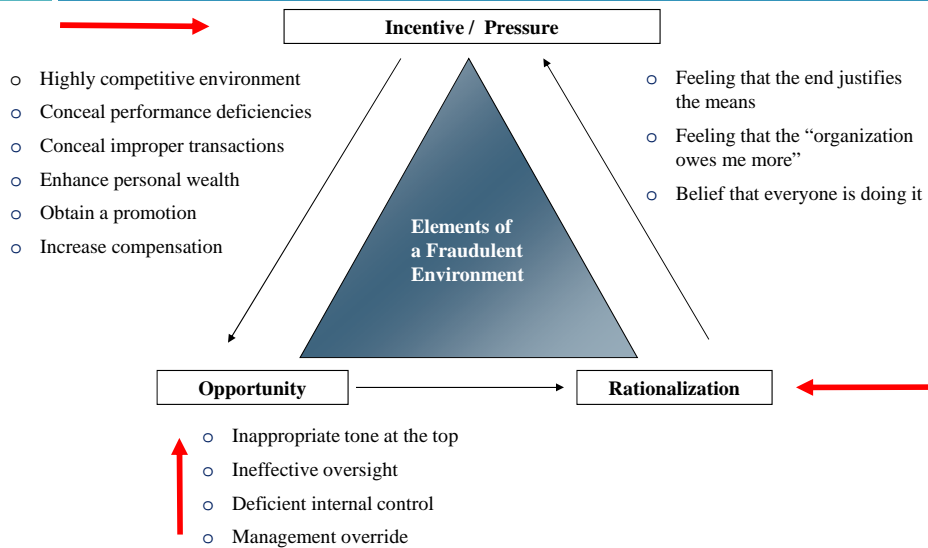
Douglas Farrow
Partner, KPMG

Fraud in the Media – Recent Headlines

Recent headlines from local news media reporting of public agency fraud and misconduct:

- December 8, 2016, *Los Angeles Times*: **FBI investigates allegations of embezzlement against Compton’s deputy treasurer**
- July 28, 2016, *Los Angeles Times*: **“Envelopes stuffed with cash: South El Monte mayor admits to taking bribes from a city contractor”**
- July 20, 2016, *Ventura County Star*: **“Former Thousand Oaks city manager fired for dishonesty, documents show”**
- May 31, 2016, *KHTS AM 1220*: **“A Santa Clarita employee has been accused of stealing more than a half-million dollars from city coffers by writing phony invoices”**
- May 17, 2016, *Banning-Beaumont Patch*: **“Six Jailed in \$43 Million Beaumont Public Corruption Case”**
- April 14, 2016, *Los Angeles Times*: **“Placentia financial manager arrested, accused of embezzling \$4.3 million from city”**
- April 13, 2016, *Southgate-Lynwood Patch*: **“Former Lynwood City Employee Charged With Embezzling Employees’ Union Funds ”**
- March 18, 2016, *Pasadena Now*: **“Ex-Pasadena City Employee, Two Others to Stand Trial for Alleged Embezzlement”**

Fraud Triangle



Common Fraud Types

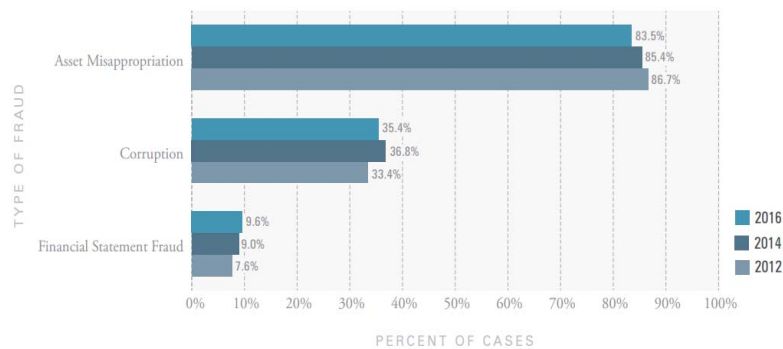
Misappropriation of Assets	Other Misconduct and Fraud	Fraudulent Financial Reporting
<ul style="list-style-type: none"> • Procurement fraud • Payroll and pension fraud • Expense fraud • Theft of entity funds and property • Falsification of timesheet information • Forged cheque signatory 	<ul style="list-style-type: none"> • Bribery and corruption • Conflict of interest • Kickbacks/gifts • Bid rigging • Supplier favoritism 	<ul style="list-style-type: none"> • Improper revenue recognition • Understatement of expenses • Overstatement of assets • Conceal liabilities / expenditures • Omission / improper disclosures • Deliberate misapplication of accounting standards

Cost & Impact of fraud:

- Jeopardizes the entity's welfare
- Diversion of management resources
- Cost of external resources
- Damage to organization's reputation and image
- Negative impact on service delivery

Prevalence by Fraud Type

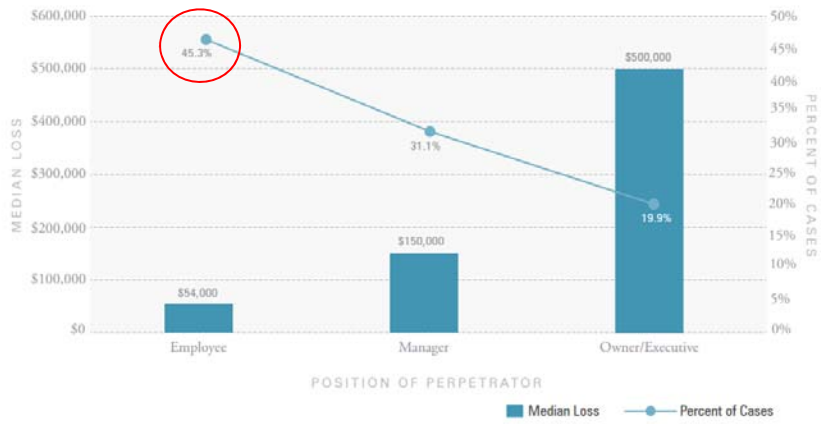
Figure 4: Occupational Frauds by Category—Frequency



Source: 2016 Association of Certified Fraud Examiner Report to the Nations on Occupational Fraud

Position of Perpetrators

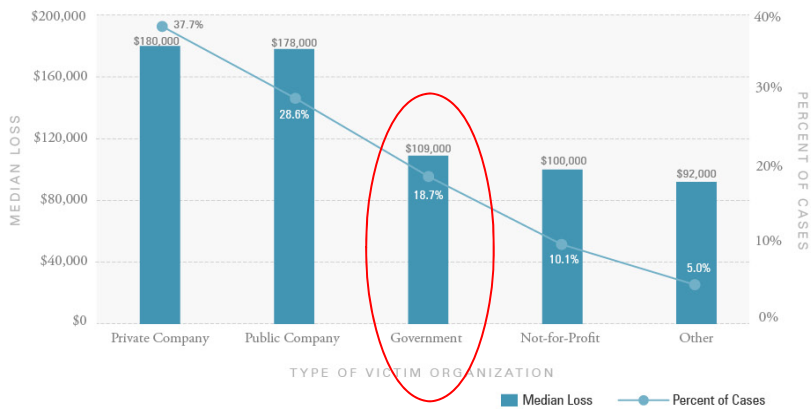
Figure 67: Frequency and Median Loss Based on Position of Perpetrator—United States



Source: 2016 Association of Certified Fraud Examiner Report to the Nations on Occupational Fraud

Type of Victim Organization

Figure 38: Type of Victim Organization—Frequency and Median Loss



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Investigative Overview

- Considerations
 - Communication / Privileged issues
 - Project Scope
 - Reporting
 - Timing
- Assemble the team
 - Forensic Accountants
 - City Representative
 - City Attorney
 - Other experts if necessary
- The role of the investigation team
 - Develop the investigation scope and process
 - Conduct the investigation
 - Report to the City Council or City Attorney
 - Manage the constituencies – the independent auditors and other government agencies (e.g. District Attorneys and State & Federal Agencies)



Investigation Approach – Basic Steps

- Obtain an understanding of the critical issues
 - Understand underlying issues and organizational environment to develop an approach to investigate and resolve issues
- Compile and develop an inventory of key documents
 - Organize, manage, and identify documents to assist with resolving the matter(s) quickly
 - Utilize technology to search and recover digital data (e.g. email, hard drive, general directories, and voice mails, etc.)
 - Assist with document discovery requests
- Assist in interviews of key company personnel
 - Identify and interview key personnel that often times provide valuable discoveries on the issues
- Review of accounting documents
 - Review of various types of documentation such as financial statements, underlying supporting ledgers, and source documentation

Investigation Approach – Basic Steps (Continued)

- Analyze significant accounting transactions and account balances
 - Systematic review of accounting system(s) and internal controls to identify potential areas of weakness
 - Analyses and testing for the existence of unusual or irregular transactions
- Estimate or determine financial impact
 - Quantify impact of financial losses (i.e. embezzlement amount)
- Communicate our findings
 - Oral vs. written



Recovery of Fraud Losses – Insurance Considerations

- What insurance covers embezzlement or theft or addresses the financial risks of fraud and embezzlement by an insider?
 - Recover losses via a commercial crime insurance policy – Insurance that addresses the risk of insider theft is referred to by various names:
 - Fidelity bond
 - Crime coverage
 - Employee dishonesty coverage
- Many public sector organizations purchase this coverage as part of a package policy that addresses other property exposure. It is also possible to obtain the coverage as a standalone policy.
- Take steps to ensure your organization has adequate insurance coverage before a loss occurs.



Protect Your Organization

- Set the right tone and create the proper environment
- Enhance and communicate a reporting mechanism
- Perform fraud risk assessments
- Develop clear, written policies and procedures
- Provide regular training
- Develop a robust internal audit function
 - Segregation of duties, proper documentation and audit trail, appropriate authorization and approvals, review of reconciliation process, whistleblower policy and hotline, and rotation of personnel, etc.
- Develop a heightened awareness of lifestyle, morale, attitude changes



Addressing The Organizational Roots of Fiscal Distress: Tools and Techniques

Andy Belknap
Management Partners

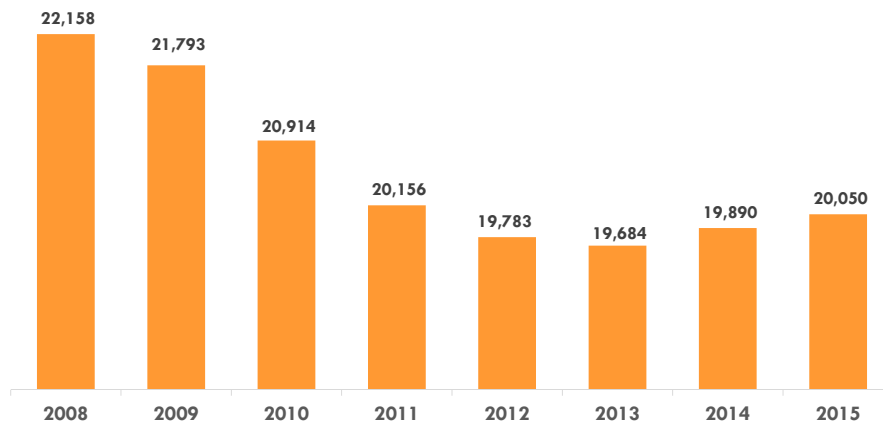
Organizational Roots of Fiscal Distress



Management
Partners

Decreasing Staff Levels

Local Government Employees per Million People in California

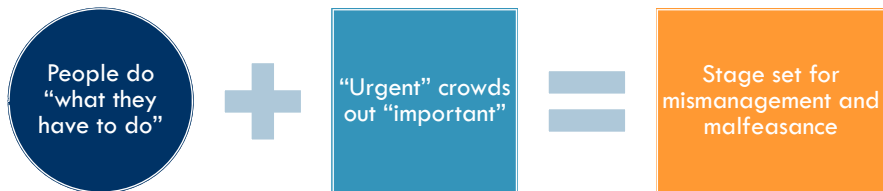


Management
Partners

Worse Than the Numbers Alone

The Fallacy of Direct Service

Services and management require support,
but when support functions are cut...



What to Do?

Step 1

- Reject direct-service paradigm

Step 2

- Create an accountable organization

Step 3

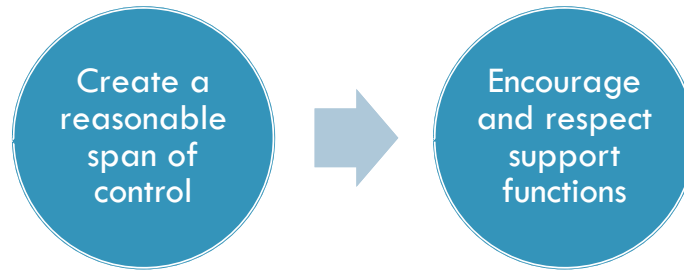
- Maintain institutional memory

Step 4

- Promote healthy organizational culture

Step 1

Reject Direct-Service Paradigm



Step 2

Create an Accountable Organization



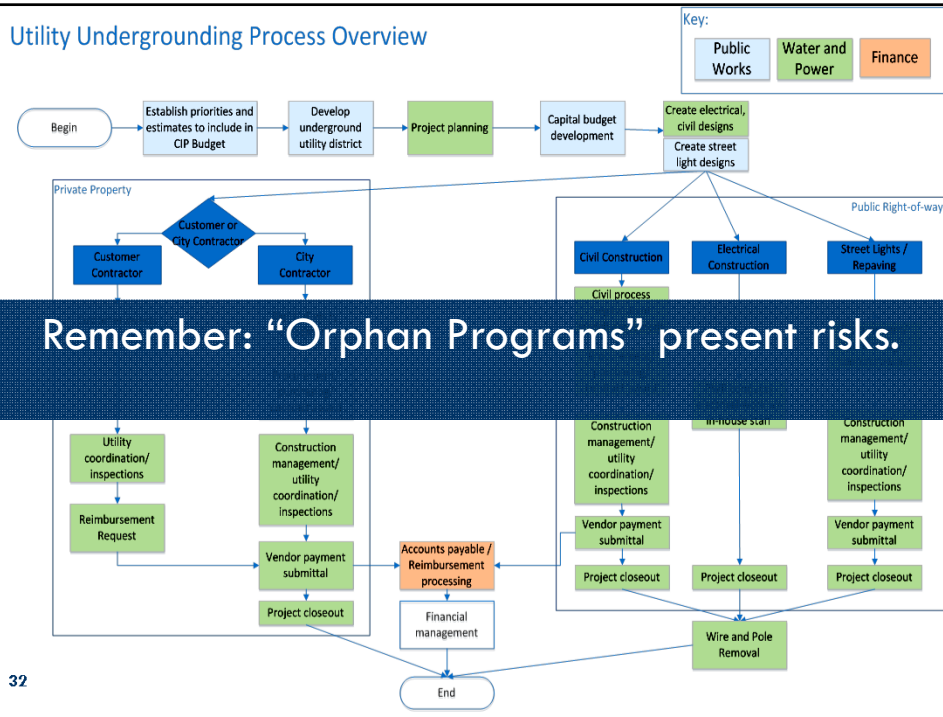
Regularly review accountability

Ensure transparency

Encourage questioning

Put someone in charge

Utility Undergrounding Process Overview



Step 3

Maintain Institutional Memory

- Take retention, recruitment and succession planning **seriously**
- **Excessive turnover** is a danger signal
- Consultants **cannot be** your institutional memory



What to Do? – Recap

Key Strategies

- A. • Ensure sufficient staffing for finance professionals and support functions
- B. • Assign responsibility for every program
- C. • Allocate enough funds for administration and management
- D. • Require and review management reports regularly
- E. • Put good management practices in place
- F. • Model ethics and hold people accountable

Conclusion

Mistakes, mismanagement and malfeasance can happen anywhere, *but...*

Management matters.

- Attending to the basics can prevent potential career-ending headlines

Internal controls matter.

- They are not fail-safe and can result in bureaucracy

Protecting yourself matters.

- Build a strong organization that welcomes questions

THANK YOU

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