



Office of the Chief Internal Auditor

Fraud Risk Management Program Review

*South Carolina Department of
Transportation's Implementation of a
Fraud Risk Management Program
CIA-FIN 09-001*

December 3, 2009

Table of Contents

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TABLE OF CONTENTS

	<u>Page</u>
Transmittal Letter	1
Executive Summary	3
Detailed Methodologies and Recommendations	8
Department's Response	12

Transmittal Letter



OFFICE OF THE CHIEF INTERNAL AUDITOR

December 3, 2009

Commission of the South Carolina Department of Transportation

The Honorable Lawrence K. Grooms, Chairman
South Carolina Senate Transportation Committee

The Honorable Hugh K. Leatherman, Sr., Chairman
South Carolina Senate Finance Committee

The Honorable Phillip D. Owens, Chairman
South Carolina House Education and Public Works Committee

The Honorable Daniel T. Cooper, Chairman
South Carolina House Ways and Means Committee

Dear Gentlemen:

The Office of the Chief Internal Auditor has conducted a Fraud Risk Analysis of the SC Department of Transportation as recommended by Scott McElveen LLP in their Audit for the Year Ended June 30, 2007 dated October 1, 2007. In addition, we have assisted management in developing a framework for a continuing Fraud and Enterprise Risk Management Program. In accordance with Section 57-1-360, we are transmitting to you the report on this review.

We conducted this review utilizing the outline in the guide book, "Managing the Business Risk of Fraud: A Practical Guide" published jointly by The Institute of Internal Auditors (IIA), American Institute of Certified Public Accountants (AICPA) and Association of Certified Fraud Examiners (ACFE).

Please don't hesitate to contact us if you have any questions or comments.

Respectfully submitted,

Robert W. Wilkes, Jr., CPA
Chief Internal Auditor

Executive Summary

Executive Summary

In 2006 and 2007 as part of their annual financial statement audits, Scott McElveen LLP recommended the South Carolina Department of Transportation (SCDOT) conduct a Fraud Risk Analysis. The recommendation in the report stated “In light of the spate of notorious frauds involving large companies in the last few years, such as Enron, WorldCom, and HealthSouth, there may be a misperception that fraud affects only large publicly owned companies. However, fraud occurs in entities of all shapes and sizes, and almost any employee may be capable of perpetrating a fraudulent act given the right set of circumstances...” As a result, The Office of the Chief Internal Auditor (Internal Audit) conducted a Fraud Risk Analysis and assisted management in establishing a Fraud Risk Management Program.

According to The Institute of Internal Auditor (IIA) Standards, the System of Internal Control is the responsibility of management to maintain. As a result, once this initial review is done, the Fraud Risk Management Program will be turned over to agency management for their continuous review and evaluation and establishment of the necessary internal controls.

During our research, we determined that a Fraud Control Policy should include the following framework according to the publication “Managing the Business Risk of Fraud: A Practical Guide”

- 1) Executive Summary consisting of:
 - Definition of fraud
 - Statement of attitude to fraud
 - Code of conduct (relationship to)
 - Relationship with entity’s other plans
 - Roles and accountabilities
- 2) Summary of Fraud Control Strategies consisting of:
 - Appointment of fraud control officer (Risk Manager)
 - External assistance to the fraud control officer
 - Fraud control responsibilities
 - Fraud risk management (including fraud risk assessment)
 - Fraud awareness
 - Fraud detection
 - Fraud reporting
 - Investigation of fraud and other improper conduct
 - Internal control review following discovery of fraud
 - Fidelity guarantee and criminal conduct insurance
 - Internal audit program
- 3) Fraud Risk Management Program consisting of:
 - Regular program for fraud risk assessment
 - Ongoing review of fraud control strategies

- Fraud risk assessment
 - Implementation of proposed actions
- 4) Procedures for Reporting Fraud consisting of:
 - Internal reporting
 - Reports by members of staff
 - Protection of employees reporting suspected fraud
 - External anonymous reporting
 - Reports to the police
 - Reports to external parties
 - Administrative remedies
 - Recovery of the proceeds of fraudulent conduct
 - Reporting requirements
 - 5) Employment Conditions consisting of:
 - Pre-employment screening
 - Annual leave
 - 6) Conflict of Interest consisting of:
 - The impact of conflicts of interest
 - Register of interests
 - Conflict of interest policy
 - 7) Procedures for Fraud Investigation consisting of:
 - Internal investigations
 - External investigative resources
 - Documentation of the results of the investigation
 - 8) Internal Audit Strategy consisting of:
 - Internal audit capability
 - Internal audit fraud control function
 - 9) Review of Fraud Control Arrangements

To help build the Framework at SCDOT the following steps have been taken:

- 1) The Secretary of Transportation issued a letter entitled, "Important Fraud and Ethics Statement" dated January 23, 2009, which details that the citizens of South Carolina have entrusted us to provide safe and effective transportation systems. It further explains that our individual and the Department's reputation are built on this trust and as a result, we are expected to perform our duties in an honest and efficient manner. This trust requires that we maintain the highest level of integrity.

The letter also instructs employees that suspect fraud, unethical conduct or violations of law or regulations to report it to the Office of the Chief Internal Auditor using the Fraud Hotline or PO Box.

This letter was required to be communicated to all employees. A "Confirmation of Distribution" signed by each department, division, section, district or other group head was required to be sent to Internal Audit.

- 2) The Secretary of Transportation included with the above letter a revised Departmental Directive 6 entitled, "Fraudulent and Unethical Conduct Policy." This directive reiterates the contents of the letter sent by the Secretary of Transportation and defines fraudulent activity.
- 3) At the SCDOT Commission's March 19, 2009 meeting, the Commission adopted a resolution in support of the Fraud Risk Management Program and established a "no-tolerance" policy concerning fraudulent and unethical conduct. This helped "set the tone at the top" for the Agency.
- 4) Internal Audit created a Toll-Free Fraud Hotline and a PO Box to receive fraud tips. The information on how to report frauds is available to employees on the agency's intranet site and to the public via the internet website. Internal Audit has also established a system to track the incoming fraud tips.
- 5) The SCDOT Legal Department has completed Ethics Training for all SCDOT employees. This training was conducted by various trainers within the agency who were given an outline and videos by the Legal Department. During this training, the Fraud Hotline and other methods of reporting fraud were reiterated to all employees. This training is required every two (2) years for all employees.
- 6) Internal Audit held 18 Focus Group meetings with employees of SCDOT which were open exchanges of ideas to identify potential ways that fraud could be committed and any related internal controls that help prevent the fraud from occurring. During these sessions, we also discussed risks of activities that may not be fraudulent but could negatively affect the agency, called Enterprise Risks.
- 7) Internal Audit summarized the fraud risks provided by the Focus Groups and is identifying any related controls to prevent these risks from occurring.
- 8) In the future, an annual questionnaire will be disseminated by Internal Audit to randomly selected employees asking them if fraud could occur; where; are they knowledgeable of any fraudulent acts being conducted by employees; and how they feel the control environment in their respective department and in the agency as a whole is operating.

To enhance these pieces in the framework, Internal Audit feels that the most important item the agency needs to address is:

The appointment of a Risk/Ethics Manager who would have the responsibility of completing and managing an Enterprise Risk Management Program.

Since the System of Internal Control is the responsibility of SCDOT management, Internal Audit recommends that the agency identify a Risk/Ethics Manager to be responsible for the Fraud Risk Management Program and complete the

implementation of the fraud control framework as well as consider expanding the program to address all Enterprise Risks.

In summary, we believe that the South Carolina Department of Transportation has taken and is continuing to take appropriate steps toward establishing a Fraud Risk Management Program which will not only address the recommendation of our External Auditors but provide a comprehensive and proactive program to identify and help prevent fraudulent activity before it occurs.

*Detailed Methodologies and
Recommendations*

Detailed Methodologies and Recommendations

Below are our detailed methodologies related to the Fraud Risk Analysis at the South Carolina Department of Transportation (SCDOT). Focus Groups were used to obtain the employee's thoughts on where the risks are within the agency and what controls, if any, are in place to assist with controlling the risk. The risks provided during these Focus Groups were not all inclusive and are expected to be dynamic as the agency matures, thus requiring updates on an annual basis.

The first step in the Fraud Risk Analysis was to hold these Focus Groups with various employees of the agency. The Deputy Directors provided Internal Audit with the names of individuals to assist in our effort to identify risks within the agency. The individuals were a good cross section of employees from Headquarters and the Districts. Internal Audit scheduled the group meetings and sent an outline to the participants in advance explaining what would be discussed to help maximize the use of time. The individuals in the groups came from the following departments as well as other areas to ensure we obtained coverage across the agency. The departments covered by the Focus Groups included:

- Accounting
- Administration
- Assets Management
- Engineering - Preconstruction
- Engineering – Construction
- Engineering – Maintenance
- Engineering - Traffic
- Contract Audit
- Human Resources
- Information Technology
- Mass Transit
- Payroll
- Planning
- Business Development and Special Programs
- Several other interviews with individuals

Following the completion of the Focus Group interviews, Internal Audit summarized the risks mentioned in the Focus Groups along with any preventative controls mentioned to help control the risk.

It is Internal Audit's plan to select and perform audits using the overall perceived risk combined with other knowledge we have about the agency.

Continuing Steps

In addition to using the publication, "Managing the Business Risk of Fraud: A Practical Guide," as an outline to aid with the development of a Fraud Risk Management Program, Internal Audit is working with other state agencies and sources to ensure that the program is the most effective possible.

In private enterprise, the Internal Control Framework is incorporated into an Enterprise Risk Management Framework that helps capture other areas of risk not usually considered in a Fraud Risk Assessment Program. This new approach in State Government involves looking at all types of risks facing the agency and ensuring that corresponding controls are in place to mitigate the risks. Some of the risks include political, economic, technological, operational, safety, personnel, reputational and environmental risks. During the Focus Group interviews, Internal Audit gathered information pertaining enterprise risks and will provide this information to the Risk/Ethics Manager for Phase II of the Risk Assessment Program (Phase I being the Fraud Risk Analysis). Internal Audit envisions the Enterprise Risk Management concept being incorporated at SCDOT in the future as well as establishing specific risk tolerances in each department.

Also, Internal Audit sees the need to work with the Commission and management in developing a comprehensive approach to evaluating the risks identified and addressing them in a consistent manner to ensure that the concerns of all parties are taken into account.

Internal Audit recommends the following action:

Internal Audit believes SCDOT management should appoint a Risk/Ethics Manager to implement an Enterprise Risk Management Program.

With the System of Internal Control under the responsibility of the SCDOT management to implement and Internal Audit being an independent, objective assurance and consulting activity, it is recommended that SCDOT identify a Risk/Ethics Manager. In most entities this individual would be responsible for updating the Fraud Risk Management Program, implementing an Enterprise Risk Management Program, identifying new risks, and ensuring that the corresponding controls are in place. This person could also be involved in the typical risk areas of insurance and claim management.

Also, Internal Audit would recommend the following be considered in the short term:

- 1. SCDOT should consider having all employees sign a Conflict of Interest Statement during Ethics Training conducted every two years.**

Potential conflicts of interest were explained in the training regarding Departmental Directive 6, "Fraudulent and Unethical Conduct Policy." However the training could be further reinforced having employees sign a Conflict of Interest Statement.

- 2. SCDOT should consider pre-employment verifications on final employment candidates based on their level of responsibility in the organization.**

Internal Audit understands the cost associated with pre-employment verifications but feels that it is important to verify the background of applicants before hiring them into positions of trust.

Department's Response



South Carolina
Department of Transportation

December 3, 2009

DEPARTMENT'S RESPONSE

Robert W. Wilkes, Jr., CPA
Chief Internal Auditor
South Carolina Department of Transportation
955 Park Street
Columbia, South Carolina 29201

Dear Mr. Wilkes:

The South Carolina Department of Transportation submits the following responses to the Audit Findings and Recommendations included in the Fraud Risk Management Report.

Internal Audit believes an important SCDOT management action to take initially is appoint a Risk/Ethics Manager and implement an Enterprise Risk Management Program.

With the System of Internal Control falling under the responsibility of the SCDOT management to implement and Internal Audit being an independent, objective assurance and consulting activity, it is recommended that SCDOT consider appointing a Risk/Ethics Manager. In most entities this individual would be responsible for updating the Fraud Risk Management Program, implementing an Enterprise Risk Management Program, identifying new risks and ensuring that the corresponding controls are in place. This person could also be involved in the typical risk areas of insurance and claim management.

Department Response: We agree that the continued review of risk areas of the Department as well as implementation of a risk management program is important. We are considering procuring the services of a consulting firm which specializes in this area to coordinate with Department staff to identify risks and determine appropriate controls.

On a lesser note, Internal Audit would also recommend the following be considered in the short term:

- 1. SCDOT should consider having all employees sign a Conflict of Interest Statement during Ethics Training conducted every two years.**

Potential conflicts of interest were explained in the training regarding Departmental Directive 6, "Fraudulent and Unethical Conduct Policy." However the training could be further reinforced having employees sign a Conflict of Interest Statement.

Department Response: Employees who are in a position of authority within SCDOT are already required to file an annual Statement of Economic Interest Form with the State Ethics Commission which requires full disclosure of all business interests, gifts and other related items. In addition, the Department requires all employees who are seeking outside employment to notify the Department so a determination can be made as to whether the outside employment may be a conflict. A reminder of this requirement will be sent to all employees.



2. SCDOT should consider pre-employment verifications on final employment candidates based on their level of responsibility in the organization.

The Office of the Chief Internal Auditor understands the cost associated with pre-employment verifications but feels that it is an important to verify the background of applicants before hiring them into positions of trust.

Department Response: We concur with the recommendation.

Respectfully Submitted,



Debra R. Rountree
Deputy Secretary for Finance and Administration