

Fraud Forthcoming 2009

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Case in Point

EARTH QUAKE REVEALS BOGUS WATER RIGHTS RIP OFF

On April 25, 2008 a 4.7 magnitude earthquake struck in the area of Flume #14 on the Highland Canal, northwest of Reno, Nevada. This water flume was constructed in the 1800's and supplied the Chalk Bluff Water Treatment Plant with large quantities of water for municipal and regional use. Early water flumes were large troughs built of wood used to carry water. Because of the substantial earthquake damage to Flume #14 and the impact on the municipal water supply, a countywide review of available water rights and resources was undertaken in order to determine how this water supply interruption might be remedied. This earthquake caused the region many millions of dollars in unexpected expense, but what the quake revealed was a multi-million dollar fraud being craftily executed by a long time water engineer working inside the Washoe County Water Resources department. Jaclyn O'Malley of the Reno Gazette Journal reported on October 14, 2008 that in the span of two years, Paul Orphan successfully embezzled over \$2.2 million dollars.

SHAKE-UP CAUSES REVIEW

When the Washoe County Water Resources Department audited potential water sources in its inventory of purchased water well capacity rights they discovered inadequate documentation of purchased well rights. KOLO8TV reporter Ed Pierce reported on June 10, 2008 that a suspicious county clerk had begun to voice concerns about the county's chief water engineer. Orphan had been employed with Washoe County's Department of Water Resources since 1988 and was the Utility Division's Engineering Manager. The suspicious clerk had a relative working at John Ascuaga's Nugget Casino and Resort who mentioned that Orphan was a frequent gambler, losing large sums of money and that he received spa treatments and concert tickets because of his "high roller" status.

GAMBLER REVEALED



Luckily in March 2007, an alert accounts payable person told the finance director, Bill Hutchins that Paul Orphan had approved a request to purchase well capacity rights without the proper permissions. Hutchins then confronted Orphan concerning the improper purchase and he denied any wrongdoing. Then on May 12th, Hutchins received an email from Orphan asking him to approve a water capacity purchase for \$48,500. In the email, Orphan suggested the water rights might be resold for \$110,000 and that it would be in the county's best interest to complete the purchase. This urging caused Hutchins to "dig deeper" into the transaction records created by Paul Orphan. The probe revealed that the water engineer had been inappropriately exercising transactions from his office computer.

Law enforcement authorities were quickly notified and the legal case was made against the trusted water engineer. On more than one occasion, authorities stated that Orphan had "hijacked" the computer identities of his supervisors to override the SAP system and approve the fraudulent transactions according to Jaclyn O'Malley's report in the Reno Gazette Journal dated June 20, 2008. The county did have a strict policy requiring password secrecy, which Orphan evidently circumvented.

CONTROLS MIGRATED IN SAP

Washoe County, like many other governmental agencies, implemented SAP Enterprise System software to replace payroll, financial accounting and the human resource systems legacy systems. Prior to the 2003 SAP "go live", maintenance was a significant cost for more than 20 "legacy systems". Because there was little integration, communication between departments was not easy. Legacy systems are typically older, stand-alone systems that have outlived their usefulness. According to Cory Casazza, WINnet service center manager, Washoe County wanted to modernize its internal business processes, improve data sharing between departments and improve services to its citizens – SAP for Public Sector pamphlet.

SAP is structured on three essential elements, master data that are relatively fixed, transactional data and business rules. Master data includes information about vendors, customers and materials such as name, address, phone, identification number, etc. Transactional data represent the information used or gathered when sales, purchases, payments or other events occur. Business rules incorporate logic based on what is necessary for the organization, limits of financial transactions and other controlling metrics.

When the county implemented SAP, they reviewed the organization's business rules, internal controls and procedures to see if they should be included in the new system. One such rule was that the Chief Water Engineer could authorize unplanned purchases for repairing broken water mains, etc. in emergencies. For example, if a major water main ruptured over a weekend and water service ceased to citizens, Orphan could independently authorize a repair and get service restored quickly.

When SAP was implemented, the emergency purchase business rule was retained and configured with the new system. Orphan could override the computer's checks and balances to approve emergency purchases up to \$5000. Additional controls were in place for amounts exceeding \$5000. For example, on purchases greater than \$5,000, Orphan needed permission from the county finance director, Bill Hutchins and water resource department director, Rosemary Menard. For expenditures greater than \$25,000, even stronger controls were required. In this case, the county's purchasing department approval was required and the legal department or district attorney might review purchases.

In May of 2006, the county needed someone to explore well capacity purchases and trusted water engineer Paul Orphan was the natural selection for this work. He was asked to focus on two areas south of Reno, in the Tessa and Calamont developments. It didn't take long for Orphan to develop a sophisticated and deliberate scheme to embezzle funds. Orphan created two bogus companies, D&B Enterprises and PKE Holdings, and setup bank accounts to receive county funds in payment for non-existent water capacity. From August of 2006 through March 2007, he produced false agreements between the county and the two bogus companies for water rights that did not exist. Payment occurred frequently, every week or so, and these transactions would involve funds less than the \$25,000 control threshold. Because of his authority as water

engineer, Orphan was able to authorize checks written by the county for water rights, as long as they were under the \$25,000 limit. Typically, Orphan would approve checks through the county's SAP computer systems. Then he would have clerical personnel in the water department pick up the vendor checks with payroll from the accounts payable department. Rules in place required developers and other vendors receiving checks to appear, provide identification, and sign for receipt. By having clerical personnel pick up the fraudulently generated payments, Orphan was able to bypass this control. He then deposited the checks in the D&B Enterprises or PKE Holdings bank accounts.

FORENSICS INVESTIGATION

Almost immediately, the county manager, Katy Simon requested an external fraud examination and issued a memo to county employees on June 10, 2008. Unfortunately, the county internal auditor, Bill Mikawa, informed the manager that the well capacity records were so convoluted that he was not sure what well capacity rights the county owned. According to a June 18, 2008 article by Susan Voyles of the Reno Gazette Journal, Washoe County Commissioners subsequently approved an amount to exceed \$100,000 and hired the international CPA firm, Grant Thornton, to provide forensic accounting services focusing on 41 transactions amounting to more than \$2.2 million dollars. These dealings involved the water engineer and his fabricated companies. In addition to examining Orphan's purchases, the forensic auditors were contracted to cover any sale of water well capacity or other intangible assets to the county water resources department. County water resources department director, Rosemary Menard, affirmed the scrutiny of a total of \$6.4 million in transactions.

The county manager initiated an administrative investigation of every business process. She publicly stated at an Organizational Effectiveness Committee meeting of Washoe County on

June 11, 2008 that the County had recently strengthened controls by approving a policy requiring the review of every transaction in every department but added that employees having knowledge and criminal intent can misuse a system for a long time. Further, she added the prior internal audits of the Department of Water Resources had focused on a sampling of procedures and that Orphan's transactions were compliant with current policy and procedure. This administrative review caused the County Audit Committee to demand tighter controls over purchasing authority.

LESSONS LEARNED

Members of the audit committee pushed for a review of purchasing practices, more checks on transactions and verification that goods are real including checks on business licenses, Internal Revenue Service records and business address verifications. In addition, the County Audit Committee Chair, forensic examiner Ron Nicholson CFE, suggested 1) using an escrow agent for future capacity purchases, 2) implementing a software monitor to report suspicious and repetitive issues, and 3) creating a fraud hotline for employees.

This case clearly reveals the internal control deficiencies that allowed fraudulent transactions within the water resources department. The major deficiencies were a) the handling of water right intangible assets, b) the creation of new vendor accounts, and c) violation of existing policies and procedures concerning check issuance.

Paul Orphan was given the authority to purchase well capacity water rights, an intangible capital asset. He was then able to create documents representing the sale of bogus water rights by a fictitious company. The transactions were processed through the county's financial reporting system and approved by multiple levels of management.

How could this happen? It occurred because there were inadequate internal control procedures in place to validate the receipt and authenticity of the water rights by someone other than the person initiating the purchase, Paul Orphan. There was no second party verification that these water rights as well as the vendor contract were in fact, valid.

In Nevada, this should have been a simple procedure because there are a limited number of water rights. The Nevada Division of Water Resources maintains a water rights database for the entire state. The data includes information about current ownership, the point of diversion and place of use of the water right, diversion rates, manner of use, well log information, protest and ruling information, as well as dates required for filing various proofs. The Division in fact facilitates the purchases and sales of all water rights.

Forensic auditors performing the Washoe County Annual Report dated June 30, 2008 recommended that internal controls procedures include the validation of these water rights by someone other than the person initiating the purchase of these rights and that the county should consider obtaining an independent appraisal of value for assets in the purchasing process.

Paul Orphan created two fictitious companies, D&B Enterprises and PKE Holdings. He also set up bank accounts where he could wire or deposit checks from the county for payments of the water rights. Since he created these companies, he also had signing rights to withdraw the funds from these companies. When Orphan approved the purchase of water rights from his fabricated companies, the contracts passed through the financial reporting system that included creating vendors by the accounts payable department. The accounts payable employee then established these as new vendors in the vendor master file. The accounts payable department assumed that these were proper vendors. In fact, Orphan had provided false IRS documentation. No physical verification of existence occurred and this was not the standard at that time.

As previously noted, the auditors felt that verification of the contract information would have prevented this scheme from going forward and would have resulted in exposing the fake vendors. On the other hand, the creation of fictitious vendors is one of the more common fraud schemes. Verification of vendors in some form acts as a preventive measure of possible fraud schemes. This is especially true with enterprise systems like SAP, which allows online electronic approval. An argument can be made that an employee not directly involved in the creation of vendors, perform a double check of all new vendors.

When the organization has inadequate staff to verify every new vendor, it would be appropriate to develop vendor verification criteria. Common approaches are 1) to verify existence of all vendors being paid over a certain dollar amount, or 2) that a random sample of all new vendors be tested. In addition, all vendors receiving payments to PO Boxes must provide a physical address and phone number that are then can be verified.

Paul Constantine Orphan pleaded guilty to stealing millions of dollars from Washoe County and stated that he was sorry. On October 14th, 2008, Orphan was sentenced to 30 years for the embezzlement of over \$2.2 million - . The district attorney, Dan Greco stated that it is likely the county's bond rating would decline causing an increased rate of interest for county bonds to complete future public works projects.