How to Prevent and Detect Fraud: Implementing Internal Controls

Office of the State Auditor
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Office of the State Auditor
Role and Responsibility

- Financial oversight includes:
  - Counties
  - Cities
  - School Districts
  - Towns
  - Police and Volunteer Fire Relief Ass’n Pension Funds
  - Soil and Water Conservation Districts
  - Port Authorities
  - TIF Districts
  - As well as approximately 150 other special districts
Office of the State Auditor

Divisions

- Audit Practice
- Pension
- Tax Increment Financing
- Government Information
- Legal/Special Investigations
The Legal/Special Investigations Division investigates allegations of theft or misuse of public funds. It also provides legal compliance information and training to local government officials.
Suspect Fraud?  
Reporting Requirement

Minn. Stat. § 609.456

- County employee/officer who discovers evidence of theft, embezzlement, unlawful use or misuse of public funds or property
- Must *promptly* report to state auditor (in writing) and to law enforcement
- Identity of 609.456 reporter is private data (Minn. Stat. § 6.715, subd. 2)
- Reporting form is on OSA website
Types of Fraud Reviewed by the Office of the State Auditor

- **Theft**
  - Minn. Stat. § 609.52
  - Includes temporary taking
  - Even small amount of public funds is a felony

- **Embezzlement**
  - Minn. Stat. §§ 609.445 and 609.54
  - Refusing or omitting to turn over public funds
  - Felonies
Types of Fraud (continued)

- False Claims
  - Presenting (Minn. Stat. § 609.465)
  - Allowing or paying (Minn. Stat. § 609.455)
  - Felonies

- Forgery
  - Check forgery (Minn. Stat. § 609.631)
  - Altering a public record with intent to defraud (Minn. Stat. §§ 609.625 or 609.63)
  - Felonies

- Misuse of Public Funds/Assets
The Fraud Triangle

- Motive/Incentive (Financial Pressure)
- Rationalization
- Opportunity
Increased Risk of Fraud

- Economic Downturn
  - Increased motive/incentive
  - Increased “opportunity”
    - Increased “fees”
    - Staff reductions eliminate internal controls
  - Increased rationalization with bad financial news
  - “Ponzi” schemes collapse

- ACFE Study
Reduce Risk of Fraud: Tools of Protection

Reduce “opportunity” with:

- Segregation of Duties
- Internal Control Procedures
- Environment
Tools of Protection: Segregation of Duties

- One person does not control an entire transaction
- No employee should be in a position to commit fraud and then conceal it
- Build double-checks into process
- Cross-training (assignment/job rotation)
- “Trust but verify”
No Segregation of Duties: Employee Writes Self Check

- Check written to employee
- Recorded in records as “void” or as written to a vendor
- Amount changed from that approved
- Phantom vendor/employee
- No one notices
Solution: Check Writing Procedures

- Do not pre-sign checks or deposit slips
- Obtain all required signatures on checks (> 1) (e.g., Minn. Stat. § 384.13)
- Beware of signature stamps
Solution: Someone Else Reviews Bank Statements

- Review of bank statement and canceled checks (optical images) by someone not involved with check writing
  - Amount altered?
  - Void check cashed?
  - Unauthorized checks written?
  - Checks out of sequence?

- Compare with claims approved

- Especially important in small departments with own checkbook (Recorder? Sheriff?)

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Solution: Review Payroll & Vendor Lists

- Prevent phantom employees & vendors
  - $1 million theft from MN Medical Assistance program (payments to fictitious medical providers)
  - $2 million alleged theft from West Virginia Auditor’s Office (payments to dummy corporations)

- Separate incompatible duties:
  - Authorize vendor to be established
  - Authorize payments to vendor
  - Enter payments into accounting system
  - Take custody of payment
No Segregation of Duties: Receipts Not Deposited

- **Skimming**
  - Cash removed prior to deposit (unreceipted cash)

- **Lapping**
  - Receipted cash replaced with unreceipted checks
Solution: Build in Double Checks

- Someone other than person collecting money compares items sold to money collected (movie theatre example)
- Person collecting money is not person preparing deposit
- Person collecting money receives periodic report of deposits
- Second person OKs all voids/refunds
- Small departments: involve other employees
Tools of Protection: Internal Controls

- Safeguard funds
- Efficient & effective management of assets
- Maintain integrity of financial systems
Weak Internal Controls: Special Risk of Cash Receipts

- Permits
- Fees
- Fines
- Solid waste/recycling centers
- Park & recreation
- Licenses
- Copies of records
- Risk increases in small departments

- Skimming
- Lapping
Solution: Internal Controls for Receipts

- Reconcile receipts with deposits daily
- Daily deposits
- Do not leave receipts unattended
- Know the amount in any change fund (starting balance)
- Consolidate cash collection points
- Person depositing funds should receive a numbered receipt from Auditor/Treasurer
- Periodic report of deposits to department collecting payments
Solution: Internal Controls for Receipts (continued)

- Pre-numbered receipts for all payments/sales
- Note if payment is by cash or check (& check number); compare to deposit
- Beware of voids & refunds
- Deposits made intact
- No cashing of personal checks out of undeposited receipts
- No “borrowing” from public funds (no IOUs or “markers”)
Weak Internal Controls: Unauthorized Payments

- County funds used for personal purchases
  - Credit card
  - Petty cash
  - Expense reimbursements
  - Electronic fund transfers
Solution: Internal Controls for Credit Card Purchases

- County board authorization required for credit card use (Minn. Stat. § 375.171)
- Purchase must meet all purchasing laws & policies
- If county board does not approve purchase, officer/employee is liable for purchase
- Specific vendors, not just credit card company, on claims list approved by county board
- Not a method for creating debt (pay off credit card charges monthly)
Solution: Internal Controls for Credit Card Purchases (continued)

OSA’s Statement of Position -

- Identify who may use credit card and for what purchases
- Restrict the dollar amount of charges permitted
- Require original invoices & original itemized receipts for credit card purchases (“slice & dice”)
- Set up a review process for all credit card purchases
- Prohibit use of the credit card for personal purchases
Solution: Internal Controls for Petty Cash ("Imprest Cash Fund")

- Cash funds established by county board with appointed custodian to be used if "it is impractical" to pay claims in other manner or for travel (Minn. Stat. § 375.162)
- See OSA’s Statement of Position
- Disburse funds
  - Reimbursement method preferred over advance method
  - Advance method specifically authorized for travel – but board must authorize out-of-county travel in advance
- Replenish funds
  - Present claim itemizing disbursements to county board at next meeting (if travel fund advance, claimant then repays amount advanced per Minn. Stat. § 375.162, subd. 2)
  - Custodian personally liable for non-approved claims
Solution: Internal Controls for Employee Expenses

- Detailed, original receipts
- Reference claims approved (with amounts) in minutes
- Approved by supervisor (county board for county administrator)
- Minn. Stat. § 471.38
Solution: Internal Controls for Travel Expenses

- Adopt a travel policy
  - Out-of-state travel policy required (Minn. Stat. § 471.661; OSA Statement of Position)
  - Approve out-of-county travel in advance (Minn. Stat. § 375.162, subd. 2)

- Determine in advance:
  - What travel expenses are reimbursable or prohibited (e.g., limit to lesser of mileage or airplane fare)
  - Who may approve travel expenses
  - What supporting documentation is needed

- Have supervisor sign claim forms

- Require documentation of:
  - Method of mileage determination
  - Date, time and purpose of travel
Solution: Internal Controls for Fuel Purchases

- Maintain fuel purchase log for County vehicles
  - Who is making purchase
  - Type & amount of fuel purchased
  - Vehicle being fueled & odometer reading
  - Date, time & location of purchase
  - Require original, detailed receipts

- Monthly review
  - Calculate fuel consumption
  - Unleaded fuel for diesel vehicle?
Weak Internal Controls: Misuse of County Property/Time

- Timesheet fraud
- Personal use of County vehicles/equipment
Solution: Written Policies on Internal Controls

- Use of county property
  - Cell phones
  - Computers
  - Tools
  - Vehicles
- Check handling procedures
- Cash collections
- Credit cards & petty cash

- Why?
  - Avoid problems
  - Allow discipline where appropriate
  - Consistency for all employees
  - Sets environment
Tools of Protection: Environment

- Set the tone at the top
- Create a culture of accountability
- All employees understand the importance of internal controls & their role
Weak Control Environment

- Disengaged or otherwise engaged county board
- Employees reluctant to voice concerns
- No action taken when noncompliance with internal controls, late deposits or reports
- County board and management fail to set the “tone at the top”
Solution: Control Environment

- The same rules apply to all
- Don’t belittle internal control procedures
- Don’t allow management to override procedures
- Appropriate discipline for violations
- Be alert to employee’s outside interests
- It’s the public’s money
Solution: Watch Those Per Diem Payments

- OSA Statement of Position
- Decide what is “necessary” in advance
- No payments for attendance at parties, county fairs, festivals, parades, or other social events
- No payments for meetings with groups unless
  - Authorized in minutes
  - Subsequent report on meeting
- Sets the tone at the tops
Common Myths

- “It can’t happen here.”
- “Only big entities (with big budgets) can have internal controls.”
- Reality: Small entities are particularly vulnerable to fraud (ACFE 2010 Report)
Common Myths (continued)

- “We had an audit, so no fraud here.”
- Reality: Entities over-rely on external audits to detect fraud
- ACFE 2010 Report for gov’t entities:
  - 46.3% tips (almost half from employees)
  - 11.6% management review
  - 15.1% internal audit
  - 7.4% external audit
Common Myths (continued)

- “The accountants/auditors are responsible for internal controls.”
- “Sound internal controls will eliminate all fraud.”
- “We have an accounting policy & procedure manual, so we’re all set.”
  - “We copied the neighboring county’s manual, so we’re all set.”
Suspect Fraud? Other Considerations

- 609.456 reporting requirement
- Criminal?
- Disciplinary action?
- Insurance coverage?
- Get advice
Website:
www.auditor.state.mn.us

- Statements of Position
- Investigative Reports
- Internal Control Letters
- E-Updates (Avoiding Pitfalls)
- 609.456 Reporting Forms
- And More . . .
Contact Information

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