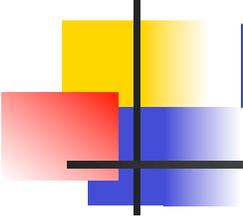


How to Prevent and Detect Fraud: Implementing Internal Controls

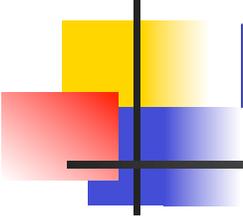
Office of the State Auditor
Nancy Bode, Assistant Legal Counsel
2009 MAWD Leadership Workshop
September 11, 2009



Office of the State Auditor

Role & Responsibility

- Financial oversight includes:
 - Counties
 - Cities
 - School Districts
 - Towns
 - Police & Volunteer Fire Relief Ass'n Pension Funds
 - Watershed Districts
 - Port Authorities
 - TIF Districts
 - As well as approximately 150 other special districts

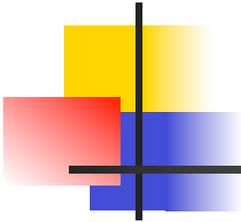


Office of the State Auditor

Divisions

- Audit Practice
- Pension
- Tax Increment Financing
- Government Information
- Legal/Special Investigations

Legal/Special Investigations Division



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.

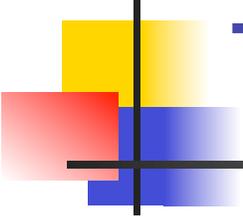


Suspect Fraud?

Reporting Requirement

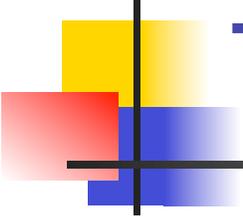
Minn. Stat. § 609.456

- Employee/officer of political subdivision 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



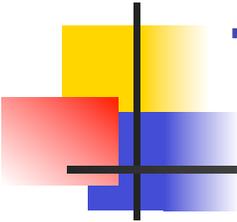
Types of Fraud

- 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
 - Refuse or omit to turn over public funds
 - Felonies



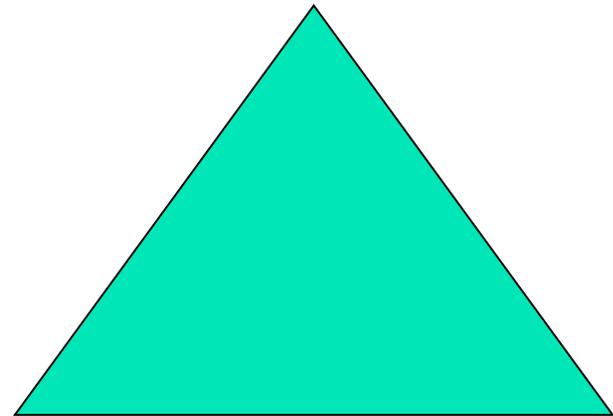
Types of Fraud (continued)

- 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

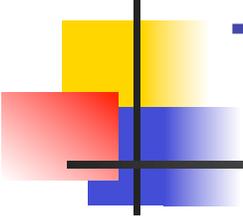
- Motive/Incentive (Financial Pressure)
 - Often gambling
- Rationalization
 - I'll pay it back
 - They don't pay me enough
 - They'll never miss it
- Opportunity
 - We can control



Increased Risk of Fraud



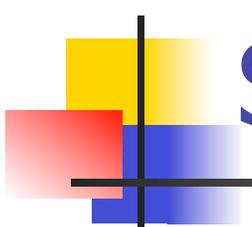
- Economic Downturn
 - Increased motive/incentive
 - Increased rationalization with bad financial news
 - Increased "opportunity"
 - Increased "fees"
 - Staff reductions eliminate internal controls
 - "Ponzi" schemes collapse
- ACFE Study
 - <http://www.acfe.com/documents/occupational-fraud.pdf>



Reduce Risk of Fraud: Tools of Protection

Reduce “opportunity” with:

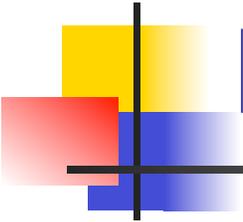
- Segregation of Duties
- Internal Control Procedures
- Environment



Tools of Protection: Segregation of Duties

- One person does not control an entire transaction (separate authorization, recording & custody)
- 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

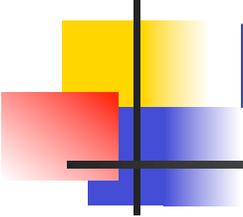


- Check written to employee
- Recorded in records as “void” or as written to a vendor
- Change amount from that approved
- Phantom vendor/employee
- No one notices

Solution: Check Writing Procedures

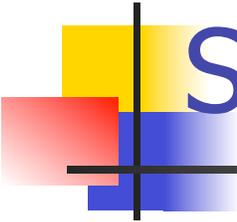
- Do not pre-sign checks or deposit slips
- Obtain all required signatures on checks (> 1)
- Beware of signature stamps





Solution: Someone Else Reviews Bank Statements

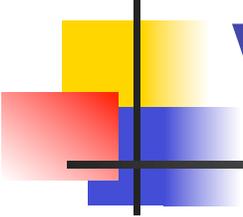
- Review of bank statement and canceled checks (optical images) by someone not involved with check writing
 - Amount altered?
 - Void check cashed?
 - Unauthorized checks written?
 - Checks out of sequence?
- Compare with claims approved
- In small districts, involve manager or other employee



Solution: Involve The Bank



- No cash withdrawals
- No cashing of checks written to district
- No fund transfers without written authorization
- Up-to-date authorized signatures
- All required signatures on checks



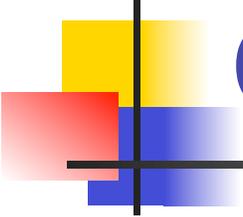
Solution: Review Payroll & Vendor Lists

- 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 districts: involve managers or other employees

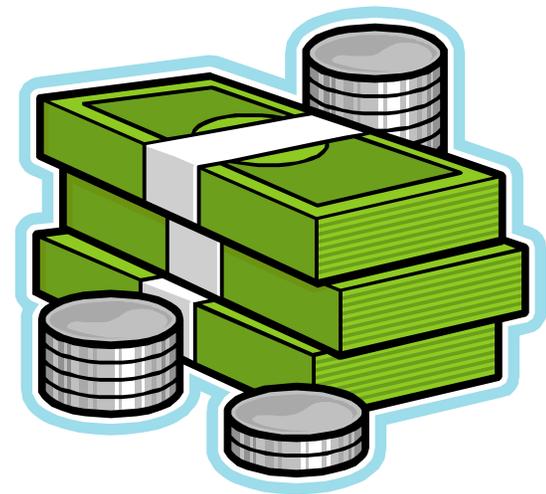
Tools of Protection: Internal Controls

- Safeguard funds
- Efficient & effective management of assets
- Maintain integrity of financial systems



Weak Internal Controls: Special Risk of Cash Receipts

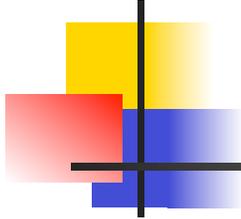
- Permits
- Fees (inspections, engineer reviews, wetland delineations, stormwater utility)
- Levies, special assessments, bond sales
- Skimming
- Lapping



Solution: Internal Controls for Receipts

- Daily deposits
- Reconcile receipts with deposits daily
- Do not leave receipts unattended
- Know the amount in any change fund (starting balance)





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
- Deposits made intact
- Beware of voids & refunds
- No cashing of personal checks out of undeposited receipts
- No “borrowing” from public funds (no IOUs or “markers”)

Weak Internal Controls: Unauthorized Payments

- District funds used for personal purchases
 - Credit card
 - Petty cash
 - Expense reimbursements
 - Electronic fund transfers



Solution: Internal Controls for Payments

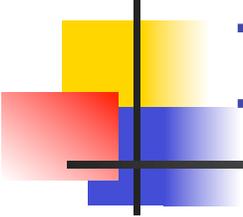


- Require original invoices & original itemized receipts (“slice & dice”)
- Reference claims approved (with amounts) in minutes
- Specific vendors, not just credit card company, on claims list approved by board (Minn. Stat. § 103D.325, subd. 4 – use of credit cards authorized)

Solution: Internal Controls for Fuel Purchases



- Maintain fuel purchase log for district 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?



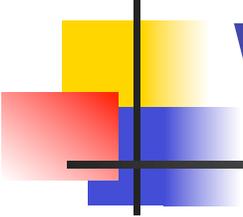
Solution: Written Policies on Internal Controls

- Use of district property
- Check handling, cash collections & EFT procedures
- Employee and travel expenses
- OSA Statements:
 - Credit cards
 - Petty cash
 - Timesheets
 - Per diem payments (for County Commissioners)
- Why?
- Avoid problems (determine what is “necessary” in advance)
- Allow discipline where appropriate
- Consistency for all employees
- Sets environment

Tools of Protection: Environment

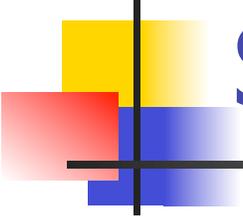


- Set the tone at the top
- Create a culture of accountability
- All employees understand the importance of internal controls & their role
- Transparency (complete, public records – see Minn. Stat. § 103D.315, subd. 5; importance of meeting minutes)



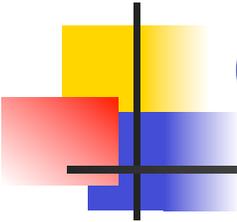
Weak Control Environment

- Board disengaged or otherwise engaged
- Employees reluctant to voice concerns
- No action taken when noncompliance with internal controls, late deposits or reports
- Board and management fail to set the “tone at the top”



Solution: Control Environment

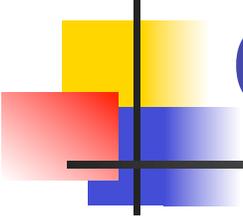
- The same rules apply to all
- Don't belittle internal control procedures
- Don't allow management to override procedures
- Avoid conflicts of interest (Minn. Stat. §§ 471.87 – 471.89)
- Appropriate discipline for violations
- Be alert to employee's outside interests
- It's the public's money



Common Myths

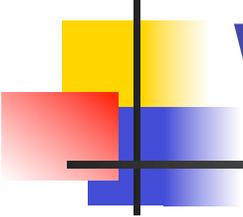
- The accountants/auditors are responsible for internal controls
- It can't happen here
- Only big entities (with big budgets) can have internal controls





Common Myths (continued)

- Sound internal controls will eliminate all fraud
- We had an audit, so no fraud here
- We have an accounting policy & procedure manual, so we're all set
 - We copied the neighboring district's manual, so we're all set



Top Audit Comments for Watershed Districts

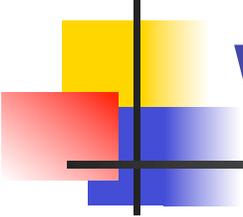
- Collateralization (all public deposits must be protected by deposit insurance, bond or pledged collateral; see OSA Statement of Position)
- Lack of written internal control & accounting procedures
- Segregation of duties
- Credit cards – lack itemization of claims
- Delay in depositing receipts

Suspect Fraud?

Other Considerations

- Criminal?
- Disciplinary action?
- Insurance coverage?
- Get advice

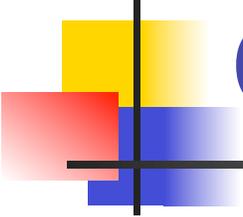




Website:

www.auditor.state.mn.us

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



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