



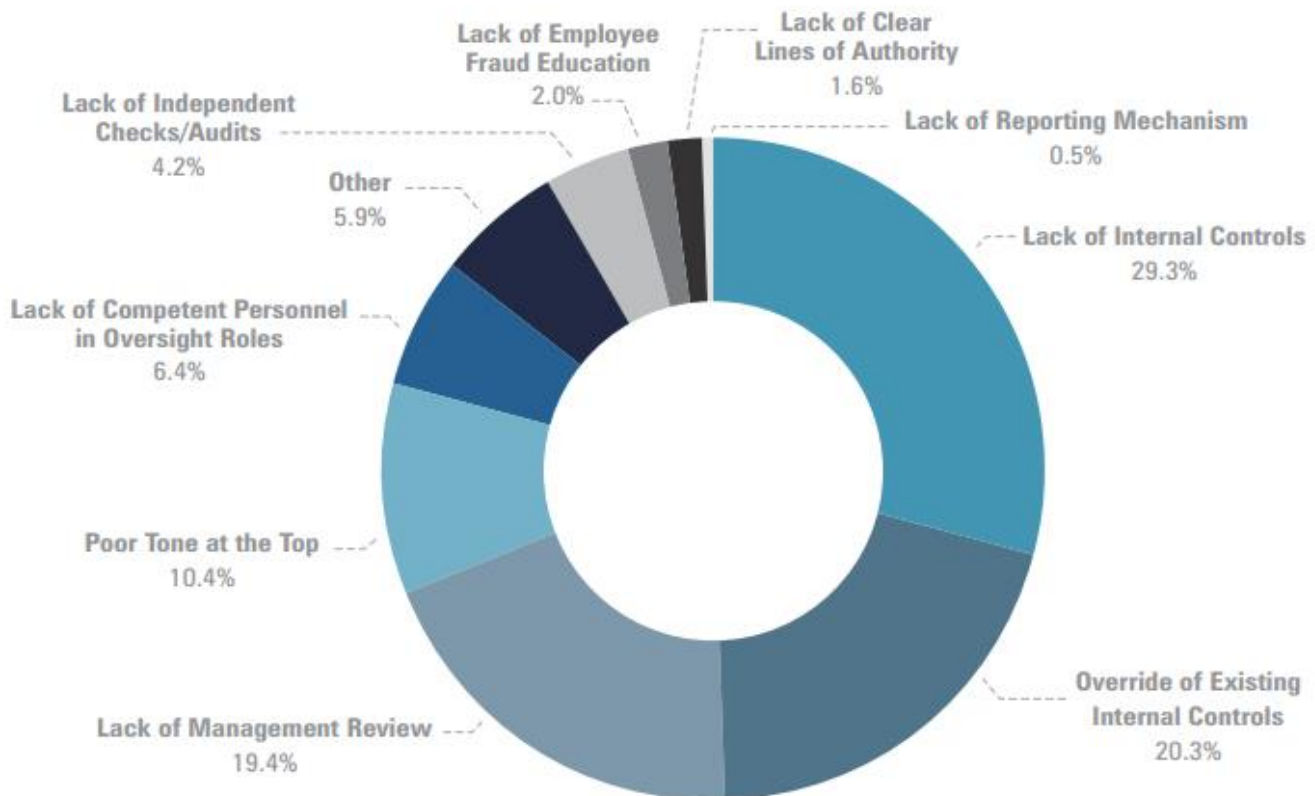
RISK CONTROL SOLUTIONS

A Service of the Michigan Municipal League Liability and Property Pool and
the Michigan Municipal League Workers' Compensation Fund

Preventing Fraud and Abuse of Public Funds: Local Governments Need to Do Better

Local officials need to be more vigilant and improve their internal controls to prevent fraud and abuse from occurring, and to promptly detect it if it does. Simple things, like properly separating duties, enacting active supervisory oversight, and thorough internal audits of properly maintained books and records, could go a long way toward preventing fiscal malfeasance. According to the Association of Certified Fraud Examiners' (ACFE) 2016 Report to the Nations on Occupational Fraud and Abuse, 39% of frauds were detected through tips, while only 23% were detected through internal controls that were in place.

Internal Control Weaknesses that Contribute to Fraud



Red Flags for Fraud

Local officials must be alert to situations that may be indicative of a problem. They must be able to identify “red flags for fraud” – that is, a set of circumstances that are unusual in nature, or vary from the normal activity – and be able to use them as signals that something may be out of the ordinary and needs to be investigated further.

Here are some examples of behavioral red flags of perpetrators (In order of frequency):

| | |
|--------------------------------------------------|---------------------------------------------|
| Living Beyond Means | Refusal to Take Vacations |
| Financial Difficulties | Excessive Pressure from Within Organization |
| Unusually Close Association with Vendor/Customer | Past Employment-Related Problems |
| Wheeler-Dealer Attitude | Social Isolation |
| Control Issues, Unwillingness to Share Duties | Past Legal Problems |
| Divorce/Family Problems | Excessive Family/Peer Pressure for Success |
| Irritability, Suspiciousness or Defensiveness | Complaints About Lack of Authority |
| Addiction Problems | Instability in Life Circumstances |
| Complaints About Inadequate Pay | |

Set the Tone

Local officials must educate their employees about what constitutes fraud, how to report fraud, and have a zero-tolerance for fraud within the organization. The checklist below is designed to help organizations test the effectiveness of their fraud prevention measures.

1. Is ongoing anti-fraud training provided to all employees of the organization?

- Do employees understand what constitutes fraud?
- Have the costs of fraud to the organization and everyone in it – including lost revenue, adverse publicity, job loss, and decreased morale and productivity – been made clear to employees?
- Do employees know where to seek advice when faced with uncertain ethical decisions, and do they believe that they can speak freely?
- Has a policy of zero-tolerance for fraud been communicated to employees through words and actions?

2. Is an effective fraud reporting mechanism in place?

- Have employees been taught how to communicate concerns about known or potential wrongdoing?
- Is there an anonymous reporting channel, such as a third-party hotline, available to employees?
- Do employees trust that they can report suspicious activity anonymously and/or confidentially and without fear of reprisal?
- Has it been made clear to employees that reports of suspicious activity will be promptly and thoroughly evaluated?
- Do reporting policies and available reporting mechanisms extend to vendors, citizens and other outside parties?

3. To increase employees' perception of detection, consider publicizing the following proactive measures taken to employees:

- Aggressively seek investigations of fraudulent conduct, rather than doing so passively. Make it clear that the organization actively seeks out fraudulent conduct through fraud assessment questioning by auditors.
- Perform surprise fraud audits in addition to regularly scheduled audits.
- Use software to detect fraud if available and, make it known that such software is being used throughout the organization.

4. Is the management climate/tone at the top one of honesty and integrity?

- Survey employees to determine the extent to which they believe management acts with honesty and integrity.
- Ensure employee performance goals are realistic.
- Incorporate fraud prevention goals into the performance measures against which managers are evaluated. Establish, implement and test a process for oversight of fraud risks by the Council, Supervisor or audit committee.
- Implement employee support programs to assist employees struggling with addiction, mental/emotional health, family or financial problems.
- Establish an open-door policy that allows employees to speak freely about pressures, providing management the opportunity to alleviate such pressures before they become acute.
- Conduct anonymous surveys to assess employee morale.

5. Are fraud risk assessments performed to proactively identify and mitigate the municipality's vulnerabilities to internal and external fraud?

- Identify scenarios in which theft or loss could occur, and determine if existing control procedures effectively manage the risk to an acceptable level.

Basic Anti-Fraud Controls

1. Separation of Duties

- Segregate employees with cash receipt responsibility from those with cash disbursement and bank reconciliation responsibilities.
- Segregate employees with cash disbursement responsibility from those with check signing authority and invoice approval responsibilities.
- Segregate employees who can enter vendors (with valid W-9's) into payment system from those that can initiate payments or sign checks.

2. Proper Authorizations

- Require ALL vendors to be authorized in payment system by securing valid W-9, and do not allow payments to be mailed to an address other than in the authorized vendor's record.
- Institute management-level review of W-2's and 1099's issued.
- Require two persons to authorize wire or electronic transfers
- Require dual signatures for disbursements exceeding agreed-upon amount.
- Check signers verify that approved invoice total(s) match check amount and invoice total.
- Require supporting documents (originals when possible) for all expense reimbursements and credit card charges.

3. Physical Safeguards

- Stamp all incoming checks, “For Deposit Only” immediately upon receipt.
- Ensure check stock, check printing machines and signature plates are kept in a secure location not accessible by those initiating check payments.
- After signature, checks should not be returned to the preparer.
- Review payments made to employees for appropriate authorization and approval by designated individual(s).

4. Management / Review Functions

- Management/ Council / Audit Committee review of original financial institution statements (can be accomplished online, including review of cancelled checks and compare them to check register).
 - Review of receivable write-offs.
 - Review of vendor account details and transactions, looking for amounts/ payees that don’t look right.
 - Verify cash receipts are in sequential order. Reconcile register receipts to drawer cash at least weekly.
 - Compare cash received receipts against bank deposits.
 - Look for and investigate any duplicate check numbers, invoice numbers, invoice amounts, out-of-sequence check numbers, checks issued on weekends, checks marked as void, etc.
 - Look for duplicates resulting from repeated requests to issue the same invoice.
 - Designate a “watch-dog” over all significant procedures.
 - Review and approve reconciliations at the supervisory level on a monthly basis.
- **For additional specific internal controls on cash handling, refer to the Risk Control Solution – “Handling Revenue”**

Human Resource Controls

1. Job Rotations

- **Mandatory vacations**

Require that persons involved in any part of the disbursement cycle take at least one consecutive week of vacation annually. Don’t assume a person’s unwillingness to take vacations means that they are just working hard.

2. Ensure hiring policy includes the following (where permitted by law):

- Past employment verification
- Criminal and civil background checks
- Credit checks
- Drug screening
- Education verification
- Reference checks

3. Payroll Processing Controls


- Restrict payroll clerk's access to human resource module, thereby preventing input of new employees or rate changes.
- Segregate employees with preparation responsibilities from those who approve and create payments. For smaller organizations, at least have someone review and authorize before issuing payroll checks.
- Approve all time sheets at a level above the employee.
- Require written and signed authorizations to change an employee's payroll information.
- Review payroll registers, direct deposit listings, and deductions report for accuracy.
- Checks should be distributed by someone other than the payroll clerk.
- Hand checks directly to employees, or if mailing, match check address to employee addresses.
- Review payment details made on behalf of employees for retirement options.
- Lock up employee files and payroll records at all times when not in use to prevent unauthorized access.

Well-designed internal controls, education to bring greater awareness to the issue, and constant vigilance by local officials who are on site every day are necessary components to safeguard the public's money and provide assurance to all citizens that their funds are being used only for legitimate purposes.

Remember:

- Trust is not an internal control!
- Trust but verify!
- Random and periodic reviews!
- Ask questions and get answers!
- Set the Tone at the Top!

For more information, contact the MML's Risk Management Services or the League's Loss Control Services. As with all issues that affect employment practices, we encourage you to discuss your employment related concerns with an attorney.

|  Important Telephone Numbers | |
|-----------------------------------------------------------------------------------------------------------------|------------------------------|
| MML Risk Management Services | 734/662-3246 or 800/653-2483 |
| Loss Control Services | 800/482-0626 |

Note: This document is not intended to be legal advice. It does not identify all the issues surrounding the particular topic. Public agencies are encouraged to review their procedures with an expert or an attorney who is knowledgeable about the topic.