BUILDING TRUST: STRATEGIES TO COMBAT FRAUD IN MUNICIPAL MANAGEMENT

By:

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A White Paper

In response and related to my pursuit of Sallisaw, Oklahoma’s open position:

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Abstract

This white paper, written by John A. Honeycutt, outlines how to spot and reduce potential fraud in small and medium cities, specifically in Sallisaw, Oklahoma. The need for this paper comes from citizen complaints and worries about possible wrongdoing in the town. While it doesn't assume there are current problems, it stresses the importance of preventing fraud and misconduct in the future.

The paper identifies key signs and red flags that could indicate fraud in city financial transactions, making it a useful tool for local governments. It highlights patterns and behaviors to watch out for, such as unusual transaction amounts, frequent changes in vendor relationships, and inconsistent transactions. The paper encourages cities to improve their oversight and internal controls.

It also offers practical recommendations, such as using automated transaction monitoring, educating employees about proper expense reporting, and creating clear ways for people to report suspicious activities. Regular audits and good documentation practices are emphasized to promote accountability and protect city resources from being misused.

While the suggestions don't cover every possible sign of fraud, they help raise awareness and encourage good financial management. The goal is to empower city governments, like Sallisaw, with the tools they need to spot potential fraud, which can help build public trust and ensure responsible use of community resources. Overall, this paper promotes a careful and informed approach to managing city finances to prevent future issues related to financial integrity.

Keywords: municipal fraud, internal controls, transaction monitoring, financial management

Quick Start

This white paper attempts to provide a reasonably broad set of ideas. Some would want to start immediately with a few easy ideas. These are the top five quick wins that can be done immediately in a low-cost/no-cost rollout.

1. Scrutinize transactions involving round dollar amounts.
2. Educate employees about proper expense reporting to minimize unnecessary changes.
3. Create a process or system where employees can report suspected wrongdoing anonymously.
4. Create clear lines of communication for reporting suspicious activities or behaviors.
5. Validate vendor contracts and payments for consistency and compliance with established terms.

Since problems like waste, misuse of money, abuse of power, and fraud are being revealed in the public sector, having a strong internal control system is very important to help reduce these issues. While these controls can't completely stop fraud, a good system can discourage bad behavior, protect assets, and ensure operations run smoothly. It also helps ensure accurate financial reports and that laws and regulations are followed.

On the other hand, a weak or poorly designed internal control system can lead to waste, misuse of funds, abuse of power, and even fraud. If there are areas for improvement in internal controls, it could mean problems within a city government (Peterson, 2018).

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Section I: Identification and Mitigation

Red Flags and Indicators

1. Unusual Transaction Patterns

Unusual transaction patterns can indicate irregularities that may warrant further investigation. Be vigilant about transactions deviating significantly from established norms, such as unusually high amounts or atypical frequencies, particularly outside regular business hours.

Monitor transaction logs for anomalies and flag any transactions that appear inconsistent with usual activity for further review.

Mitigators

a) Automated Transaction Monitoring: Set up systems to flag transactions that deviate from established patterns.

b) Regular Reconciliation: Conduct reconciliations to identify discrepancies promptly.

2. Round Dollar Amounts

Transactions that consistently involve round dollar amounts, like $1,000, suggest an effort to obscure the true nature of payments. Such patterns can simplify record-keeping but raise red flags regarding their legitimacy.

Scrutinize transactions with round figures and seek additional documentation or explanations for these payments.

Mitigators

a) Approval Processes: Require additional scrutiny for transactions involving round dollar amounts.

b) Document Retention Policies: Ensure that all such transactions have proper supporting documentation.

3. Multiple Transactions to the Same Vendor

Frequent small transactions to the same vendor, especially those cumulatively exceeding set limits, may indicate collusion or kickback schemes. It's essential to determine if legitimate business needs justify these payments.

Analyze transaction history with the vendor and establish clear thresholds for monitoring frequent payments.

Mitigators

a) Vendor Management Systems: Implement thorough vendor verification and monitoring processes.

b) Segregation of Duties: Ensure that different individuals are responsible for purchasing and approving vendor payments.

4. Changes in Behavior

A sudden change in an employee's transaction behavior, such as a significant increase in expense claims, can be a warning sign of misconduct. Monitoring these changes is crucial for identifying potential fraud risks.

Conduct regular audits of employee transactions and investigate any notable shifts in expense patterns.

Mitigators

a) Internal Audits: Regular audits can help identify shifts in behavior that might indicate potential fraud.

b) Training and Awareness Programs: Educate employees about proper expense reporting to minimize unnecessary changes.

5. Lack of Supporting Documentation

Transactions that lack proper supporting documentation, such as invoices or receipts, can strongly suggest impropriety. Missing approvals or authorizations can further exacerbate concerns regarding transaction authenticity.

Institute rigorous documentation requirements for all transactions and conduct periodic reviews to ensure compliance.

Mitigators

a) Document Retention Policies: Establish and enforce strict documentation requirements for all transactions.

b) Approval Processes: Ensure all transactions are processed with appropriate approvals and documentation.

6. High-Risk Transactions

Certain transactions, such as cash transactions, refunds, and adjustments, carry a higher risk of fraud, especially if they are not justified. Monitoring these can help uncover potential misappropriations of funds.

Establish stricter controls and approval processes for high-risk transactions and regularly assess their justification.

Mitigators

a) Stricter Controls: Implement additional review and approval processes for high-risk transactions, such as cash payments.

b) Segregation of Duties: Reduce risk by separating responsibilities for initiating and approving such transactions.

7. Vendor Anomalies

Transactions involving unusual or newly created vendors may signal potential fraud, particularly if the payment amounts are significant relative to organization size. This requires scrutiny to ensure these vendors are legitimate and credible.

Implement a vendor verification process and conduct background checks for new vendors, particularly when their payments are unusually high.

Mitigators

a) Vendor Management Systems: Conduct background checks and regular reviews of new and existing vendors.

b) Approval Processes: Ensure that any material changes regarding vendors are reviewed and approved.

8. Employee Relationships

Transactions where employees have close relationships with vendors or customers may pose conflicts of interest, creating opportunities for fraud. It is essential to monitor these interactions closely to maintain integrity in financial dealings.

Review transaction histories involving employee-vendor relationships and establish clear conflict-of-interest policies to manage such risks.

Mitigators

a) Training and Awareness Programs: Address potential conflicts of interest in training sessions.

b) Whistleblower Policies: Encourage reporting on relationships that may lead to biased transactions.

9. Inconsistent Data

Discrepancies between different data sets or records, such as expense reports not aligning with budgeted amounts, can indicate potential fraud or errors in financial reporting. Addressing these inconsistencies is vital for accurate financial oversight.

Regularly reconcile data across different reports and investigate any discrepancies thoroughly.

Mitigators

a) Regular Reconciliation: Regular comparisons of different financial records help identify inconsistencies.

b) Internal Audits: Conduct audits to analyze financial trends and discrepancies thoroughly.

10. Frequent Changes to Payment Details

Frequent updates to payment details, such as bank accounts or addresses, can signal attempts to divert funds or conceal fraudulent activities without clear justification. This practice raises concerns and requires further investigation.

Monitor changes in payment details closely and require validation or approval for any updates to established payment methods.

Mitigators

a) Access Controls: Limit who can change payment details and require update validation.

b) Approval Processes: Require managerial approval for changes to payment information to ensure scrutiny.

Section I Summary

Section I of this white paper emphasizes the critical importance of identifying and mitigating potentially fraudulent activities within financial transactions in small and medium municipalities. It outlines key red flags and indicators that may signal irregularities, including unusual transaction patterns, round dollar amounts, multiple transactions to the same vendor, changes in employee behavior, lack of supporting documentation, and high-risk transactions. Each indicator is accompanied by suggested mitigators designed to enhance internal controls and promote accountability.

The Section underscores that the presence of these red flags does not automatically imply wrongdoing but serves as a call for further examination and due diligence. Municipalities can better safeguard their resources against misuse or fraud by enhancing awareness and implementing robust oversight practices.

As we transition to the next Section, we will delve deeper into specific strategies and best practices for implementing risk assessment and management frameworks. This will build on the foundational understanding established in Section I, providing practical steps for municipalities to strengthen their financial integrity and operational resilience.

Section II: Recommended Accounting Controls

Introduction

Whereas Section I focused on identifying key indicators and red flags that may signal potentially fraudulent activities, Section II emphasized the implementation of recommended accounting controls to mitigate these risks and enhance overall financial integrity.

Here, we delve into practical strategies municipalities can adopt to strengthen their financial oversight and enhance their internal control systems. Building on the identification of potential red flags outlined in the previous Section, this part of the white paper focuses on implementing proactive measures designed to mitigate the risks associated with financial impropriety.

By establishing structured controls, such as segregation of duties and automated transaction monitoring, organizations can foster a transparent environment that deters fraudulent activities and promotes accountability among employees. The recommendations herein serve as a framework for creating a robust financial governance structure, ensuring municipalities can effectively safeguard their resources and maintain public trust.

Actions

Segregate Duties

Your municipality should ensure that no single individual is responsible for initiating and approving transactions.

Degree of Difficulty: (*This will Ruffle Feathers*)

This organizational process may require buy-in from various departments and may ruffle some feathers among staff.

Conduct Regular Reconciliation

Your city should regularly reconcile accounts by comparing reported expenses and revenue with bank statements and ledgers.

Degree of Difficulty (*Straightforward-this is a must-do*)

This involves adding a task within the finance department, which is generally straightforward but requires consistent diligence and accuracy.

Implement Approval Processes

Your workplace should establish strict approval processes for all transactions, especially those exceeding a certain threshold.

Degree of Difficulty (*You'll get visible resistance even from leadership*)

This involves some organizational restructuring and can create additional layers of bureaucracy, which may face resistance from employees accustomed to quicker decision-making.

Create Vendor Management Systems

Your municipality should develop a robust vendor management system that includes verification and background checks for all vendors before engaging in business.

Degree of Difficulty: (*This isn't very easy but doesn't have to be elegant, just robust*)

This can be quite complex, requiring time and resources to set up a comprehensive system and monitor vendor relationships on an ongoing basis.

Establish Document Retention Policies

Your city should set clear policies for document retention that require all financial transactions to have proper supporting documentation.

Degree of Difficulty (*Dreaded but doable… this is a "must do" for government*)

This is moderately difficult, as it requires collaboration to develop policies and a shift in culture to ensure compliance during audits.

Provide Training and Awareness Programs

Your workplace should offer regular employee training on ethical practices and the importance of internal controls.

Degree of Difficulty (*Easy but with uncertain payback*)

This can be relatively easy to implement, though it requires commitment from leadership to allocate time and resources for effective training.

Utilize Automated Transaction Monitoring

Your municipality should use accounting software with automated monitoring features to flag unusual transaction patterns.

Degree of Difficulty (*Mostly a technology issue. This is a minor "people" change.*)

This may require investment in new software and staff training, making it moderately difficult but beneficial in the long run.

Conduct Internal Audits

Your city should perform periodic internal audits to assess process adherence and identify control weaknesses.

Degree of Difficulty (*This is difficult, disruptive, and also a must-do*)

This is a more complex and resource-intensive task that requires skilled personnel and can disrupt daily operations during the audit process. An alternative to this is audit sampling (random)–but cautiously avoid "convenience sampling."

Limit Access Controls

Your workplace should restrict access to financial systems and sensitive information based on employees' roles.

Difficulty (*Low: Primarily a physical space and technology change.*)

This can be straightforward to implement with appropriate software but may require continuous management to adjust access as staff roles change. Some of the changes can be in policy only or in reconfiguring the workspace environment.

Establish Whistleblower Policies

Your municipality should create a confidential whistleblower policy encouraging employees to report suspicious activity without fear of retaliation.

Degree of Difficulty (*Moderate: Requires legal and other input*)

This is moderately difficult, as it involves drafting clear policies and fostering an environment of trust and support, which can take time to develop.

Section II Summary

By following these directives, your organization can significantly reduce the risk of financial impropriety and enhance its overall financial integrity while being mindful of the varying degrees of difficulty involved in each action.

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APPENDICES

Appendix A

Transaction Monitoring and Approval

1. Set up systems to flag transactions that deviate from established patterns.
2. Conduct reconciliations to identify discrepancies promptly.
3. Scrutinize transactions involving round dollar amounts.
4. Confirm transactions have proper supporting documentation.
5. Ensure that no transactions are processed without appropriate approvals and documentation.
6. Establish stricter controls around high-risk transactions.
7. Implement systems that monitor high-risk transaction types routinely.
8. Monitor vendor contracts and payments for consistency and compliance with established terms.

Examples:

A. The City of Dixon, Illinois: In 2012, the city controller was discovered to have embezzled nearly $54 million over several years. Without stringent controls and regular reconciliations, the fraud went undetected for a long time. The absence of oversight allowed the comptroller to manipulate records and divert funds without appropriate documentation or approvals (Hancox, 2014).

B. The Town of Bell, California: This case involved significant salary overpayments to city officials. The lack of monitoring and controls allowed officials to set their salaries without proper documentation or approvals. As a result, the town faced a financial crisis, and multiple officials were indicted for corruption.

C. April 2021, Jessica Banks, a woman from Newport News, Virginia, pleaded guilty to laundering money from a pandemic relief loan program. Banks withdrew $33,030 from a Wireless Queen bank account and laundered the funds. She is scheduled to be sentenced on January 29, 2025, and faces up to 10 years in prison.
(United States Attorney's Office Eastern District of Virginia, 2024).

Appendix B

Vendor and Employee Verification

1. Implement thorough vendor verification and monitoring processes.
2. Ensure that different individuals are responsible for purchasing and approving payments to vendors.
3. Conduct detailed audits on high-risk transactions to verify legitimacy.
4. Regularly assess operational processes to identify vulnerabilities where fraud could occur.
5. Monitor employee performance closely, especially regarding financial duties.

Examples

A. Misappropriation of Funds in Procurement: A municipality could experience fraud if a procurement officer colludes with a vendor to falsify invoices. For example, there are no thorough vendor verification processes in place. In that case, the officer might approve payments for goods or services that still need delivery or are significantly overpriced. This could lead to substantial financial losses for the municipality.

B. Kickback Schemes: When different individuals are not responsible for purchasing and approving vendor payments, a purchasing agent may approve payments to vendors with whom they have a personal relationship. If proper oversight and separation of duties are not enforced, the purchasing agent could receive kickbacks from those vendors, ultimately costing the municipality more than fair market value for the services or products purchased.

C. Fraudulent Payroll Schemes: A municipality may experience fraud if it fails to monitor employee performance closely, particularly concerning financial duties. Employees might set up fake employees in the payroll system and process payments for non-existent workers. Without regular audits and assessments to identify vulnerabilities in the payroll process, this fraud could go undetected for an extended period, resulting in significant financial impact.

Appendix C

Employee Education and Culture

1. Educate employees about proper expense reporting to minimize unnecessary changes.
2. Reinforce the importance of ethical behavior through regular reminders and training sessions.
3. Provide ongoing training for employees on fraud detection and prevention measures.
4. Encourage a culture where employees can report suspected wrongdoing anonymously.
5. Create clear lines of communication for reporting suspicious activities or behaviors.

Examples

A. City of Bell, California (2010): In Bell, city officials paid themselves very high salaries, much more than others in similar jobs. They needed to educate workers about how to report expenses properly, which led to the misuse of taxpayer money. As a result, many officials were charged with corruption after the scheme was uncovered.

B. Jefferson County, Alabama (2009): Jefferson County ended up in massive bankruptcy because of fraudulent practices by public officials who mismanaged funds related to sewer projects. There was a lack of training in detecting fraud. Without a culture of accountability, these problems went unchecked for years, leading to a $4 billion bankruptcy.

C. Cleveland, Ohio (2008): A city official in Cleveland was caught misusing city funds for personal expenses like luxury items and vacations. The problem worsened because employees weren't educated on proper expense reporting, and there were no safe ways to report suspicious activity. This allowed the fraud to continue for a long time.

Appendix D

Documentation and Compliance

1. Establish and enforce strict documentation requirements for all transactions.
2. Require periodic certification of compliance with financial policies from all employees.
3. Develop a comprehensive policy for managing and approving employee reimbursements.
4. Regularly update and review financial policies to reflect current fraud risks.

Examples

A. City of Oklahoma City (2009): A former accountant was convicted of embezzling over $120,000 from the city. The accountant manipulated financial records, created fake invoices, and diverted city funds to personal accounts. Weak internal controls and insufficient oversight allowed the fraud to continue for several years before it was detected.

B. City of Lawton (2018): A former city employee was charged with stealing over $50,000 through a fraudulent reimbursement scheme. The employee submitted falsified receipts and documentation for reimbursements related to travel and expenditures that never occurred. The lack of thorough review processes and regular audits contributed to the ability to execute this fraud.

Appendix E

External Assessments and Audits

1. Work closely with external auditors to gain an objective assessment of internal controls.
2. Conduct routine unannounced audits to deter potentially fraudulent activities.
3. Use data analytics tools to identify anomalies in transaction patterns.

Examples

A. City of Tulsa (2010): A former Parks Department official was indicted for embezzling more than $100,000. The individual exploited a lack of oversight and inadequate documentation processes by creating fake vendors and approving fraudulent invoices for non-existent services. The absence of strict documentation and compliance requirements allowed the official to process these payments undetected over an extended period.

B. Garvin County (2018): A former county treasurer was arrested and charged with embezzling over $400,000. The treasurer manipulated financial records and used a lack of proper documentation and compliance checks to funnel money into personal accounts. The county's failure to enforce strict monetary policies and regularly review transactions allowed the fraud to persist over several years before it was uncovered.