

Legally (Relevant



by Gary Hanson, JD
Stumbo Hanson, LLP, Topeka, Kan.

Preventing Theft, Fraud and Embezzlement

A number of cities, rural water districts and other units of local government, large and small, have been victims of fraudulent schemes to embezzle money or property. Some of the more spectacular cases have occurred in places like California and Illinois, but a surprising number have happened right here in Kansas.

Some of these cases, such as unauthorized use of a credit card, have involved very simple plans that have been remarkably easy to do. Others have been elaborate,

Merely having an audit done each year is no assurance whatsoever that a fraud is not being perpetrated.

complicated cases of bank fraud that required multiple steps to successfully carry out, but which resulted in losses totaling hundreds of thousands of dollars. Unfortunately, for a variety of reasons, the smallest, most vulnerable units of government are often the victims.

A good place to start this discussion concerns some of the commonly held misunderstandings about employee fraud:

■ **Our auditor will find it before it can get too far.**

Most, although by no means all, cities and rural water districts have an annual financial statement audit completed by a Certified Public Accountant (CPA). The auditor will consider the measures in place to prevent fraud, and make recommendations as appropriate. Tests will be performed that may reveal a fraud occurring, and an experienced auditor may be able to detect a fraud or embezzlement in process. But, many such schemes will avoid detection during the course of a routine financial statement audit, so that merely having an audit done each year is no assurance whatsoever that a fraud is not being perpetrated.

■ **We have insurance to cover any loss.**

As a general matter, most insurance does not cover loss to the insured caused by fraud, theft or embezzlement by an employee or officer of the insured. A specialized type of "insurance", often called a fidelity bond, insures this risk. A fidelity bond is usually included as part of a typical package of insurance purchased by a city or district. Fidelity bonds may be divided into two types: a "position bond" that covers a specific position within the organization, like treasurer or city clerk; and a

“blanket bond” that covers all employees, officers and directors. The problem often lies in the adequacy of the coverage purchased. Even small cities and water districts may handle hundreds of thousands of dollars annually, yet it is very common to find

fidelity bonds in only minimal amounts. In one recent Kansas case, a loss to the city of almost \$200,000 was covered by a fidelity bond of only \$20,000. The other \$180,000 was uninsured.

■ **The bank will be responsible to replace any loss.**

Maybe, but the city or district had better catch it and notify the bank promptly. It is primarily the responsibility of the account owner, not the bank, to discover and prevent fraud. There are fairly short time frames in which to notify a bank that a check has been wrongfully paid, usually within six months if the bank was acting in good faith. In any event, a two year statute of limitations will generally apply.

Most consumers understand that they are not liable, either by law or as a result of their agreements with their card issuers, for charges fraudulently made on their credit cards. However, when a card is issued to a utility, and the utility then lets one of its employees use that card for “authorized business purposes”, it’s the utility’s job, not the card issuers, to monitor that use and prevent misuse. Unauthorized

In one recent Kansas case, a loss to the city of almost \$200,000 was covered by a fidelity bond of only \$20,000. The other \$180,000 was uninsured.

charges made by that employee will usually be owed to the issuing bank, whether they were for authorized purchases or not.

The bottom line is that responsibility for preventing theft, fraud and embezzlement rests with the city or district. So what to do?

Financial Controls

There are a number of protections a system can employ to discover and prevent employee theft. One of the simplest protections is reconciliation of bank statements on a monthly basis. In order to insure that you are receiving the proper information, bank statements should be sent to management or a board treasurer directly from the bank, either through mail or electronically. They should not be sent to or opened by the same employee who writes checks and reconciles the bank statements. Reconciliation should be done by someone other than the person who writes checks. Receipts of only summary reports, or examination of these reports after review and reconciliation by employees, can allow for concealment of employee theft.

Controls should also be in place to insure proper processing of transactions. Checks should require more than one signature. Pre-signing of blank checks and the use of signature stamps or other such methods to execute checks should be avoided. Additional procedures should be employed for electronic funds transfers and debit card use. While



use of debit cards by employees may be discouraged, it is unlikely that current business practice would allow a municipality to transact business without some electronic transfers. Require documentation for each transfer at the time it is performed and require examination of all these transfers at the time of review by the board.

Generally, the most common embezzlement schemes are the forging of checks, issuing extra pay checks, abusing institutional credit card accounts for personal use or otherwise submitting false documents to obtain payments. These schemes can be complex, but by carefully examining financial transactions on a monthly basis the municipality will be better able to prevent loss.

Know Your Employees

In some cases, trusted employees with long tenure have been found to have committed significant financial crimes. It is a natural tendency in these instances to build up a level of trust with employees who have faithfully discharged their duties for many years. However, proper management would be to exercise care in managing all employees, no matter how long they have worked for the utility.

First, if possible, try not to allow a single individual access to all financial information and divide duties so as to insure that more than one person is handling portions of financial transactions of the municipality. Merely having more than one set of hands involved in the work can lessen the chance of theft. Another simple procedure would be to prevent bookkeepers or other employees from taking work home, and monitor time at work or in the office generally to insure excessive time is not being spent at the office. Schemes to obtain funds through forgery and alteration require substantial work to conceal due to the need to alter documents and manage information received by the municipality. Allowing additional time for work or to take work home ultimately allows more chances for concealment and the ability to hide certain transactions and documents. Note that checking time cards or reported hours of work may not be enough, as the employee may be at the office after hours and not be clocked in. Another simple way to minimize risk is to require bookkeeping personnel to take vacation time

off, or to shift bookkeeping duties among employees. Embezzlers require complete control over the flow of information to prevent discovery and will often times refuse or desire little vacation time. In addition, potential embezzlers dislike delegation of their duties to others due to this need for control, and will do even menial tasks in place of others, even if in a management position.

Insurance

Part of the regular duties of the management of a utility would be the examination of insurance coverage. It is the responsibility of the governing body as well as management to understand the insurance coverages. Contact your insurance agent to be sure you understand who is covered, the limits and deductibles that apply to that coverage and whether those limits are adequate.

Audits

Consult with appropriate professionals to protect municipal finances. A regular audit is an important check to employee theft, however even the best audits can be fooled by an enterprising employee. Do not treat audits as mere formalities, but instead task a board member with the closest understanding of the finances to carefully review the audit. Do not treat the auditor's advice about the need for adequate financial controls as unnecessary, impractical or applicable only to the "big cities". Risk of loss due to fraud or embezzlement is actually greater with small systems than it is with larger ones, and although amounts may be comparatively small, they may be more damaging. A \$30,000 loss to a system that only has \$30,000 is worse than a \$300,000 loss to a system with \$3,000,000.

Finally, if you suspect abuse, fraud, theft or embezzlement, move fast. Contact your attorney and accountant immediately. Contact the bank or card issuer, as your counsel may advise. Investigate the situation and take appropriate measures to stop or prevent losses. Ask questions before making accusations. Notify your insurer promptly if there is a loss.

The public's trust depends on integrity in the safeguarding of public moneys. Board members, council members, officers and managers must all do their part to insure this trust is maintained.

Complete well service for Kansas

- Distributors of Regal Chlorinators
- Sales and distribution of Redi Clean products
- Underwater video camera inspection
- Telemetry
- Extracting and setting pumps and motors
- Well remediation, restoration
- Rebuilding, restoring pumps and motors
- New pump and motor sales
- Variable frequency drive sales and service – Square D, Yaskawa
- Starting panels
- Consulting services with surge blocks with brushes and sand buckets
- Complete parts service



In a well remediation, Alexander Pump's unique truck mounted hydraulic walking beam (above) cycles the surge tank, double surge block and brush (left) up and down through the well. The action forces 'Redi Clean' chemicals into the gravel pack to dissolve iron bacteria, placing it into suspension for removal.

**Alexander Pump
& Service, Inc.**

Phone: (785) 437-6305 Fax: (785) 437-2394

E-mail: aps@kansas.net Web site: www.alexanderpump.com