

CITY OF COLLEGE STATION STEWARDSHIP ENHANCEMENT PLAN

Introduction

Recent accounting scandals in the corporate world have focused attention on fraud both in the public and private sector. The concern about fraudulent activity in the public sector is justified based on the results presented by the Association of Certified Fraud Examiners in its "2004 Report to the Nation on Occupational Fraud and Abuse." According to this survey, although most of the fraud occurred in privately held or publicly traded companies, government agencies and not-for-profit organizations represented 15.8% of the organizations that were victimized and 10.5% of the reported occupational fraud cases. These percentages are not large; however, because government employees and officials are stewards of the public's assets, the prevention, deterrence, and detection of fraud and the enhancement of stewardship is of high importance.

In response to the increasing concern about fraud, the American Institute of Certified Public Accountants' (AICPA) fraud task force of the Auditing Standards Board commissioned a group of organizations and individuals with expertise in the area of fraud prevention, deterrence, and detection to develop guidance to help organizations improve their antifraud programs and controls. In November 2002, the AICPA and six other professional organizations jointly published a document titled, "Management Antifraud Programs and Controls: Guidance to Help Prevent, Deter, and Detect Fraud." This document identifies measures entities can implement to prevent, deter, and detect fraud and discusses these measures in the context of three fundamental elements which, broadly stated, are as follows:

1. Create and maintain a *culture* of honesty and high ethics;
2. *Evaluate* the risks of fraud and implement the processes, procedures and controls needed to mitigate the risks and reduce the opportunities for fraud; and
3. Develop an appropriate *oversight* process.

In response to the AICPA's document, the City's external auditors recommended in their Management Letter dated January 16, 2004 that the City "develop a heightened 'fraud awareness' and an appropriate fraud risk-management program, with oversight from the City Council." The purpose of this document is to comply with that recommendation and to communicate steps that the City has already taken to prevent, deter, and detect fraud. In addition, this document includes recommendations to further enhance the City's efforts to prevent, deter, and detect fraud.

Creating a Culture of Honesty and High Ethics

According to the AICPA, the first step in preventing, deterring, and detecting fraud is to "... create a culture of honesty and high ethics rooted in a strong set of organizational core values." It is also important to create a culture where existing good employees don't have a reason to "turn bad" because research has shown that there is a direct correlation between an organization's culture and the level of embezzlement within an organization.

The City of College Station has taken a significant first step as evidenced by the following:

Setting the Tone at the Top

It is important that the City's top management "set the tone at the top" by demonstrating to employees through their words and actions that dishonest or unethical behavior will not be tolerated, even if the result of the action benefits the entity. Management must demand and engage in ethical business behavior, and employees must be encouraged and rewarded for valuing ethical behavior.

One method of demonstrating this desired city culture is through a strong value system founded on integrity. The City's Employee Handbook, which was recently revised and approved by the City Council on September 9, 2004, includes a Code of Ethics that City employees are expected to follow. Also, the City's Management Team recently formulated a set of values for the organization. As suggested in the AICPA document, City management has given these values visibility by posting them on the City's intranet for referral when needed and by publishing them in the City's Employee Newsletter. City management has taken the additional step of incorporating these core values into the Destination Excellence program which kicked off in July, 2004 and in the mandatory new hire orientation program. One of the goals of Destination Excellence is to blend these values and the Code of Ethics into what each employee does on a day-to-day basis. Supervisors and managers are encouraged to reinforce adherence to the Code of Ethics and the City's values through an employee's performance evaluation.

Recommendation:

1. Follow through on incorporating the City's values and Code of Ethics into each employee's performance evaluation.
2. Keep the ethics dialogue "alive" by periodically discussing the City's values and Code of Ethics at staff meetings and by incorporating discussions of ethics and integrity into training when appropriate.

Creating a Positive Workplace Environment

Research indicates that organizations with negative work environments experience low employee morale and, consequently, increased risks of fraud. According to the AICPA's document, factors within an organization that contribute to low employee morale are as follows:

- Lack of recognition for job performance
- Top management that does not seem to care about or reward appropriate behavior
- Perceived inequities in the organization
- Autocratic rather than participative management
- Less-than-competitive compensation
- Low organizational loyalty or feelings of ownership
- Unreasonable budget expectations or other financial targets
- Fear of delivering "bad news" to supervisors and/or management

- Poor training and promotion opportunities
- Lack of clear organizational responsibilities
- Poor communication within the organization

The City has implemented several programs and initiatives to create a positive work environment:

- Recognition of job performance through the SOAR Award and pay for performance. In addition, several City Departments hold regular employee recognition events.
- Use of the Employee Recognition Banquet to honor all employees and to announce the City's Employee of the Year. The City also holds a City-wide Summerfest for employees and their families.
- Establishment of the Employee Involvement Committee in order to improve communication with employees.
- Training opportunities such as Supervisory Academy, Service Excellence, Destination Excellence, Employee Orientation, Management Academy, and the Leadership Institute.
- Adoption of a pay plan with the stated goal of paying employees at the 60th percentile for performance that meets standards.
- Adoption and updating of the City's Employee Handbook and involving employees in this process.
- Adoption of an Employee Code of Ethics (Section 9.01) as part of the City's Employee Handbook.

Recommendation: Continue to minimize or eliminate factors that contribute to low employee morale.

Hiring and Promoting Appropriate Employees

Fraud in an organization can be prevented by hiring and promoting the best qualified employees. Selecting individuals with integrity and high ethical standards can be accomplished through applicant screening because effective applicant screening policies minimize the chance of hiring or promoting individuals with low levels of honesty, especially for positions of trust. The City encourages numerous proactive hiring and promotion procedures such as the following to ensure that the best qualified employees are hired and promoted:

- Background investigations are conducted on individuals being considered for employment.
- Reference checks of a potential employee's education, employment history, and personal references are conducted.
- Employees receive frequent training about the City's values and Code of Ethics, particularly through the Destination Excellence program, and in new hire orientation.

Recommendations:

- Encourage Departments to use a self selection process when hiring by asking the following questions of applicants:
 1. The City does background checks on all finalists. Do you have any concerns about that?
 2. The City does criminal checks on all finalists. Do you have any concerns about that?
 3. We contact all past employers. What do you think they will say? Will your past employee tell us about any negative job-related issues?
 4. Can you explain where you were during these gaps in your resumes?
- Incorporate adherence to the City's Code of Conduct and Code of Ethics into each employee's performance evaluation.

Training

Having a code of conduct and a set of organizational values is worthless unless employees are aware of what they are and what they mean. Therefore, the City offers the following opportunities for training on its values and code of conduct:

- The City requires that each new employee attend a one-day new employee orientation during which each employee receives a copy of the City's Employee Handbook and topics such as general policies and procedures, the Code of Ethics, the pay plan, and benefits are reviewed.
- The City offers Service Excellence on a quarterly basis. New employees are required to attend, and it is also open to existing employees to attend as well. Part of the Service Excellence program is devoted to discussing the City's values and ethics.
- The City recently offered ethics training to all employees in order to heighten employees' awareness.

Recommendations:

- Incorporate discussions of ethics and fraud prevention in the Supervisory Academy, Management Academy, and Leadership Institute programs. For example, when presenting training on how to conduct an interview, include a discussion on how hiring the appropriate employee relates to fraud (see above).
- In the Management Academy and Leadership Institute, continue to include discussions on how management can "set the tone at the top."
- For those individuals in sensitive positions (e.g., procurement or financial reporting), incorporate required ethics training as a part of his/her performance evaluation.

Confirmation

It is important that management clearly articulate that all employees will be held accountable to act within the City's Code of Ethics. An especially effective method of reinforcing this Code of Ethics is requiring all employees within senior management and the finance function, as well as other employees in areas that might be exposed to unethical behavior, to annually sign a code of conduct statement. This confirmation may include statements that the employee understands the City's expectations, has complied with the City's Code of Ethics, and is not aware of any violations of the Code of Ethics other than those that the employee lists in his/her response.

Recommendation:

- Consider having **all** City employees annually sign a code of conduct statement stating that he/she understands the City's expectations, has complied with the City's Code of Ethics, and is not aware of any violations of the Code of Ethics other than those that the employee lists in his/her response. At a minimum, consider having senior management as well as employees in the Finance and Strategic Planning Department sign a code of conduct statement.
- Management should include a "Report on Responsibility for Financial Reporting" in the City's Comprehensive Annual Financial Report. This report should be signed by the City Manager, Assistant City Manager, and Director of Finance and Strategic Planning. The report should state management's (1) responsibility for the accuracy, integrity, consistency, and reliability of the financial statements, (2) continuous monitoring of the City's system of internal controls for compliance in order to prevent misappropriation of assets and fraudulent financial reporting, and (3) commitment to fostering a strong ethical climate and communicating those standards to employees through personnel rules, administrative regulations, and City law.

Discipline

Criminal justice research indicates that successful deterrence of crime is dependent on three factors: the certainty, swiftness and severity of punishment. Of these three factors, certainty of punishment is the most important. Therefore, the manner in which an organization responds to alleged or suspected incidents of fraud can have an effect on the number of future occurrences. Sending a strong deterrent message is essential to combating fraud. The City takes the following actions in response to an alleged incident of fraud:

- Reported incidents of fraud are promptly and thoroughly investigated in a manner as confidential as possible. In most cases depending on circumstances, the Police Department shall be notified and subsequently conduct an investigation.
- Per Section 9.17 of the City's Employee Handbook, "Any employee who steals, intentionally destroys, defaces, or misuses City property shall be subject to termination of employment. This prohibition also extends to the property of employees and others on City premises." Employees are also subject to discipline, including terminations, if he/she violates the City's Code of Ethics.

- Relevant internal controls are evaluated as to their effectiveness and modified if necessary.
- Communication and training occur to reinforce the City's values, code of conduct, and expectations.

Recommendation:

- When instances of employee fraud are uncovered and substantiated and result in disciplinary action, initiate communication with employees about the incident (without naming names) to reinforce the City's commitment to an environment of high ethical standards and integrity.
- Ensure that discipline for employees who have committed fraudulent acts is fair and balanced.

Evaluating Antifraud Processes and Controls

Fraud typically occurs when there are three factors present:

1. Motivation--financial pressure on an employee.
2. Opportunity--the employee is in a position to steal or embezzle.
3. Rationalization--the personal justification used by an employee to convince themselves to commit the fraudulent act.

Organizations have little control over motivation or rationalization other than hiring employees with high levels of honesty. However, an organization can have an impact on the opportunities to commit fraud by (1) identifying and measuring fraud risks, (2) taking steps to mitigate identified risks, and (3) implementing and monitoring appropriate preventive and detective internal controls and other deterrent measures.

Identifying and Measuring Fraud Risks

It is important that management identify the fraud risks that exist within the organization and pay particular attention to those areas that could result in a material misstatement of the financial statements or material loss to the organization as a result of asset misappropriation (e.g., theft of cash, supplies, or equipment.) In fact, according to Section XI, Paragraph B of the City's Fiscal and Budgetary Policy Statements, each Department Director is responsible for ensuring that good internal controls are followed throughout his/her Department. Risk assessment within each City Department should include the identification of areas or processes where fraud is more likely to occur. For example, areas or processes that involve cash handling or inventories are areas that deserve attention.

Recommendation:

- Senior management in each City Department should identify processes within their respective areas that are particularly vulnerable to fraudulent activity. Particular attention should be given to developing effective internal control procedures for new programs.

Mitigating Fraud Risks

Fraud risks can be reduced or eliminated by changing how an entity does business. Reviewing and analyzing the methods in which payments due to the City are made could lower the risk of misappropriation of funds. Reducing or eliminating inventories where possible is another way to mitigate fraud risk.

Recommendation:

Operations that senior management identify as vulnerable to fraudulent activity should be reviewed in detail. Consideration should be given to changes that could be made to these operations that would reduce the risk of fraud. It is also recommended that these operations be reviewed in a comprehensive manner on a recurring basis.

Implementing and Monitoring Appropriate Internal Controls

After the risks have been identified within an organization, it is important to identify the processes, controls, and other procedures necessary to reduce or eliminate those risks. Appropriate and effective controls need to be in place not only for the processing of transactions but also for the information technology systems that support the processing of transactions and for the City's financial reporting process. Furthermore, the City's Fiscal and Budgetary Policy Statements require that each Department Director implement all Fiscal Services' or independent auditor's internal control recommendations and to develop and periodically update written internal control procedures.

Recommendation:

- Subsequent to identifying processes within their respective areas that are particularly vulnerable to fraud, senior management within the City's departments should engage the help of the Accounting staff to develop appropriate internal controls to detect, deter, and prevent fraud. These internal controls should take the form of written procedures and should be periodically reviewed and updated. For example, in addition to the City's general policy regarding procurement cards, each Department should have written procedures that address the appropriate use of procurement cards and approval of procurement card transactions. Similar Departmental written procedures should exist for cash handling and other procurement methods.

Developing an Appropriate Oversight Process

Having an appropriate oversight function in place is essential to preventing and deterring fraud. That oversight function should be performed both internally and externally.

Audit Committee

An audit committee or a board of directors (the City Council in a municipal government setting) should actively ensure that the City's management is proactively evaluating fraud risks, implementing anti-fraud measures, and setting the "tone at the top" in order to protect the City's financial assets. Although a governing body can provide oversight, an audit committee can enhance that oversight responsibility by:

1. Providing a direct link between the auditor and the Council.
2. Helping to facilitate communication between management and the auditors (both internal and external).
3. Enhancing the financial statement auditor's real and perceived independence.

With regard to audit committees, the Government Finance Officer's Association's (GFOA) Committee on Accounting, Auditing, and Financial Reporting makes the following recommendations:

- Every government should establish an audit committee or its equivalent. Reliable audits are essential to the credibility of financial reporting by state and local governments. The audit committee is a practical tool that a government can use to enhance the independence of the external auditor and, hence, the reliability of the financial statement audit.
- The primary responsibility of the audit committee should be to oversee the independent audit of the government's financial statements, from the selection of the independent auditor to the resolution of audit findings.
- The audit committee should present annually to the governing board and management a written report of how it has discharged its duties and met its responsibilities. It is further recommended that this report be made public.

With regard to fraud, the audit committee should encourage management to provide mechanisms for employees to report their concerns about unethical behavior, actual or suspected fraud, or violations of the City's code of conduct or ethics policy. The audit committee should receive periodic reports describing the nature, status, and eventual disposition of any fraud or unethical conduct and should provide the Council with a summary of any fraudulent activity along with follow-up action and disposition.

The City currently does not have an audit committee.

Recommendation: It is recommended that Council adopt a resolution approving the formation of an audit committee. Because research indicates that the median loss in organizations without established fraud reporting procedures is twice as high as the median loss in organizations with anonymous reporting mechanisms, it is further recommended that this audit committee establish confidential reporting mechanisms (e.g., a fraud hotline) for employees and third-party sources such as customers and vendors.

Management

There are two types of fraud: misappropriation of assets and fraudulent financial reporting. Management is responsible for preventing, detecting and deterring fraud through implementing and monitoring effective internal controls. Management is also responsible for "setting the tone at the top" and for the reliability of the City's financial statements. However, management could initiate, participate in or direct the commission and concealment of a fraudulent act through what is known as management override.

Therefore, it is important that management take proactive measures to prevent, detect, and deter fraud and show their commitment to doing so.

The misappropriation of assets also includes the misuse of communications and network services. Examples of this misuse include excessive amounts of time online tying up resources. Accessing streaming media utilizes bandwidth, and downloading certain large files takes up server space and can make the City party to copyright violations. Employees accessing inappropriate material on the internet, and other non-work related material reduces productivity, could expose the network to viruses, and could expose the City to liability.

Implementing and Monitoring Appropriate Management Controls

The Employee Handbook has clear policies concerning the use of network and computer resources, cell phones, telephones, and facsimile use. The use of these resources for business as well as limited and reasonable personal use is clearly stated. Consent to monitoring is also clearly stated. However, while cell phone use is monitored and reviewed there does not exist any mechanism for auditing or reviewing telephone use, particularly long distance use for evidence of misuse or abuse.

Recommendations:

- Management should include a "Report on Responsibility for Financial Reporting" in the City's Comprehensive Annual Financial Report. This report should be signed by the City Manager, Assistant City Manager, and Director of Finance and Strategic Planning. The report should state management's (1) responsibility for the accuracy, integrity, consistency, and reliability of the financial statements, (2) continuous monitoring of the City's system of internal controls for compliance in order to prevent misappropriation of assets and fraudulent financial reporting, and (3) commitment to fostering a strong ethical climate and communicating those standards to employees through personnel rules, administrative regulations, and City law.
- Establish an Audit Committee to oversee the activities of senior management with regard to financial reporting and monitoring of the City's system of internal control.
- Continue to monitor the use of City resources and investigate mechanisms that would permit the City to easily audit telephone use, particularly long distance use, for misuse. Ideally this function would be automated and generate alerts when identified anomalies occur.

Internal Auditor

External auditors are responsible only for fraud that may have a material impact on the financial statements as a whole. External auditors spend a limited amount of time within an organization, and research indicates no trend indicating reduced losses as a result of an external auditor.

In contrast, an internal auditor is a full-time employee who works directly for management and whose primary responsibility is helping management fulfill its oversight duties as effectively and efficiently as possible. Typically, an internal auditor aids management in preventing, detecting and deterring fraud by monitoring the design and

proper functioning of internal control policies and procedures, evaluating fraud risks and controls, and recommending action to reduce or eliminate risks and improve controls. As a result, an internal auditor functions as another layer of control within the organization, the effectiveness of which is supported by research indicating that 32.4% of fraudulent schemes within government agencies are detected by internal auditors while only 5.9% are detected by external auditors.

In addition to preventing, detecting, and deterring fraud, an internal auditor can conduct performance audits, special investigations, and special studies under the direction of management or the audit committee and can be particularly effective as a result of his/her knowledge about the organization and direct access to the organization's audit committee.

The GFOA's Committee on Accounting, Auditing, and Financial Reporting makes the following recommendations:

- Every government should consider the feasibility of establishing a formal internal audit function because such a function can play an important role in helping management to maintain a comprehensive framework of internal controls. As a rule, a formal internal audit function is particularly valuable for those activities involving a high degree of risk (e.g., complex accounting systems, contracts with outside parties, a rapidly changing environment).
- All reports of internal auditors, as well as the annual internal audit work plan, should be made available to the government's audit committee or its equivalent.

Recommendation: The City should consider creating an internal audit position that reports to senior management and to the audit committee.

Independent Auditors

Section 37 of the City's Charter requires that the City Council shall designate a qualified public accountant or accountants who shall make an independent audit of accounts and other evidences of financial transactions. The independent auditors can aid in the prevention, detection, and deterrence of fraud by examining the City's internal controls and identifying fraud risks related to fraudulent financial reporting and misappropriation of assets. At the conclusion of the audit, the independent auditors present their findings and recommendations to Council. In addition, the auditors have ready access to management to discuss concerns that may arise as a result of their audit.

Recommendation: None.

References

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