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# THE RED FLAGS OF FRAUD

*Preventing fraud at the municipal  
level requires understanding triggers  
and detection mechanisms*

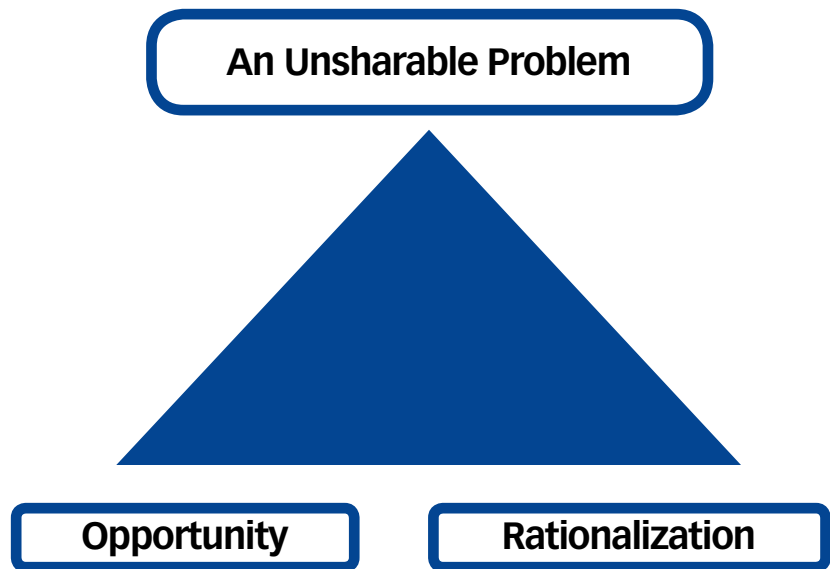
**H**ave you ever wondered why municipal employees commit fraud? What conditions make a municipality vulnerable to fraud? The “Fraud Triangle” is a set of conditions that make an individual more likely to commit fraud. The red flags of fraud are conditions that make a municipality more susceptible to fraud. The red flags of fraud consist of: 1) the characteristics of management; 2) environmental conditions; and 3) operating conditions. This article discusses the “Fraud Triangle” and red flags of fraud in addition to ways to prevent fraud.

### The Fraud Triangle

Edwin Sutherland coined the term “white collar crime” to describe the financial frauds committed by corporate executives with a pen and paper. Donald Cressey decided to pursue the reasons why white collar criminals commit fraud. He found that employees are most likely to commit fraud when three conditions converge: 1) the employee has an unsharable problem; 2) the employee sees an opportunity; and 3) the employee rationalizes his behavior. The unsharable problem can be a financial need caused by a gambling or drug addiction. Unsharable problems can also be as simple as trying to “keep up with the Jones’.” An opportunity arises when the employer fails to safeguard its assets. The employee rationalizes the behavior by believing the fraud is justified. The Fraud Triangle, depicted in Figure 1, can help employers be more aware of the factors that can lead to fraud.

### The Red Flags of Fraud

The red flags of fraud, depicted in Figure 2, are conditions that make a municipality more susceptible to fraud. They include: 1) the characteristics of management; 2) environmental conditions; and 3) operating conditions.



**FIGURE 1** The Fraud Triangle is a set of conditions that make an individual more likely to commit fraud

### The Characteristics of Management

Managerial characteristics that increase the likelihood of fraud are: 1) poor tone at the top; 2) domination by a powerful coalition; and 3) aggressive attitudes towards financial reporting.

**Poor tone at the top.** This phrase is used to characterize top management’s attitude towards internal controls, compliance with rules and regulations and accurate financial reporting. Ethical behavior is driven from the top down. Municipal officials that convey a commitment toward ethical behavior will communicate their values and motivate ethical behavior from their employees.

**Domination by powerful coalition.** Municipalities that are dominated by one or a few powerful individuals are more susceptible to fraud than municipalities where decisions are made in a participative manner. If a few powerful individuals run a municipality through fear and intimidation, or discourage open discourse and broad participation, employees will not question decisions for fear of repercussions. Employees dominated by a powerful coalition are more likely to be coerced into committing

fraud activities, intimidated to acquiescing with wrongful acts and concealing the fraudulent activities of others.

**Aggressive attitudes towards financial reporting.** Municipal officials with aggressive attitudes towards financial reporting are more likely to pressure employees into engaging in fraudulent financial reporting than officials willing to report the facts. Municipal officials do not receive performance-based bonuses and stock options as their private-sector counterparts do, but their reelections and promotions may be tied to favorable financial performance, as can be their municipality’s ability to secure bank loans, obtain favorable bond ratings and ability to conceal fiscal distress. Whatever the motivations of officials wishing to overstate financial information, individuals should avoid “cooking the books” to embellish financial information.

### Environmental Conditions

Environmental conditions that increase the likelihood of fraud are: 1) a poor economy; 2) a drop in revenue; and 3) an increase in the demand for services.

**A poor economy.** Municipalities derive their resources from the

<u>Characteristics of Management</u>	<u>Environmental Conditions</u>	<u>Operating Conditions</u>
Poor tone at the top	A poor economy	Poor internal controls
Domination by a powerful coalition	A drop in revenue	Lack of separation of duties
Aggressive attitudes towards financial reporting	An increase in the demand for services	Poor financial performance
		Significant related-party transactions

**FIGURE 2** The Red Flags of Fraud are the conditions that may make your borough susceptible to fraud

local economy. When the economy takes a downturn, whether that is caused by a short-term swing in a business cycle, a long-term structural change such as when the steel mills in Pennsylvania closed, the poor economy will make the municipality more susceptible to fraud. That's because municipalities operating in a poor economy are more likely to experience fiscal distress. Municipalities experiencing fiscal distress must still meet fixed costs such as debt payments and employee salaries. Fiscal distress and scarce resources may cause employees to resort to fraudulent activities to meet their fixed costs and to conceal their fiscal distress.

**A drop in revenue.** Municipalities rely on consistent streams of revenue to develop balanced budgets. If anticipated revenues unexpectedly dry up, the municipality will need to replace this revenue or report an annual excess of expenditures over revenues. If revenues get too low the municipality may need to cut services. Municipalities that lose previously reliable streams of revenue become susceptible to fraud, as employees seek new ways to replace lost revenues. Municipalities do not strive to make a profit, but they do not want to report an excess of expenditures over revenues either.

**An increase in the demand for services.** Municipalities exist to provide public services such as road maintenance, public safety and parks and recreation. Some of

Pennsylvania's municipalities are experiencing rapid growth. These municipalities are scrambling to provide the additional services needed to accommodate the rapid growth. Other municipalities are experiencing out-migration. Some of Pennsylvania's established municipalities are watching their residents move to the suburbs. These municipalities are left with decaying infrastructures and fewer tax dollars to provide the same level of services. Municipalities coping with rapid growth and out-migration often feel pressured to do more with less. These municipalities should strengthen their internal controls as external pressures to meet unrealistic goals can cause employees to commit fraud.

**Operating Conditions**

The operating conditions, which increase the likelihood of fraud include: 1) poor internal controls; 2) lack of separation of duties; 3) poor financial performance; and 4) significant related-party transactions.

**Poor internal controls.** Internal controls are the checks and balances put into place to ensure that assets are safe-guarded, management's policies are followed and financial reports are accurate. Good internal controls include safeguarding assets (e.g., keep blank checks in a locked cabinet), conducting periodic reconciliations (e.g., reconciling the bank statement), requiring proper authorization for transactions (e.g., using a voucher system) and

separation of duties (discussed below). Organizations with weak internal controls are vulnerable to fraud because they provide opportunities for theft.

**Lack of separation of duties.** Separation of duties means that no one person should perform two or more of the following functions: 1) maintaining custody of assets; 2) record-keeping; 3) reconciliations; and 4) authorizing transactions. If an employee has custody of assets (e.g., maintains blank checks), then that employee should not enter transactions, authorize transactions or reconcile bank statements.

**Poor financial performance.** Municipalities experiencing an excess of expenditures over revenues, insufficient cash flows or deficit balances in net assets are most susceptible to fraud. Employees of struggling organizations are more likely to attempt to use fraud to hide the failing financial condition of the municipality and to use fraudulent means to meet operating needs, secure bank loans or qualify for favorable bond ratings. Municipalities with poor financial performance can strain employees, as they struggle to maintain current services, meet short-term operating needs, and plan long-term strategies to secure new capital.

**Significant related-party transactions.** Related-party transactions are transactions involving the municipality and an employee of the municipality. Related-party transactions are not

<b><u>Employee No. 1</u></b>	<b><u>Employee No. 2</u></b>	<b><u>Employee No. 3</u></b>
Open mail (with a witness)	Reconcile bank statement	Prepare operating checks for signature
List all incoming cash	Reconcile control accounts	Prepare payroll checks for signature
Prepare deposit ticket	Maintain personnel records	Maintain subsidiary ledger
Take cash to bank		
Maintain petty cash fund		
Enter transactions in general ledger		

**FIGURE 3** This depicts a sample separation of duties with only three employees

expressly prohibited by the State Ethics Commission, but they must be entered into through a public and open process. Related-party transactions should be reviewed with skepticism because they involve a municipal employee with a familial or financial stake in the transaction. Related-party transactions should be identified and scrutinized by municipal officials to ensure they result in a fair outcome for the municipality.

**Keys to Preventing Fraud**

Municipalities cannot eliminate fraud, but they reduce it by using confidential hotlines, communicating a perception of detection and ensuring an adequate separation of duties.

**Confidential fraud hotlines.**

Confidential hotlines are the most effective tool available in preventing and detecting fraud. To be effective, hotlines must be confidential and available 24-hours a day. Due to the confidential nature of fraud hotlines, municipalities cannot provide this service themselves. However, there are organizations in the business of providing this service for a fee.

**The perception of detection.**

Fear can be an effective way to prevent fraud. Municipalities should let employees know it looks for fraud and vehemently prosecutes offenders. Establishing and communicating prohibited activities is an important preventive measure, as is publicly punishing offenders. Municipalities should communicate

policies and publicly sanction offenders, if they want employees to take fraud-related policies seriously.

**Separation of duties.** As noted previously, separation of duties is a key internal control. A pure separation of duties is not always possible, but a reasonable separation can be achieved with three people. Figure 3, for example, depicts how Employee #1 can open the mail, list all incoming cash, prepare the deposit ticket and take the cash to the bank, maintain the petty cash fund and enter transactions into the general ledger. Employee #2 can reconcile the bank account on a monthly basis, reconcile the control accounts to the subsidiary ledgers and maintain the personnel records. Employee #3 can prepare the operating and payroll checks for signature and maintain the accounts receivable and payable subsidiary ledgers. An adequate separation of duties can be achieved with as little as three people.

Small municipalities can enhance the separation of duties with heightened managerial oversight and compensating controls. Heightened managerial oversight requires municipal officials to review the activities of other employees. Compensating controls requires two or more signatures to authorize transactions, sign checks, etc. Separation of duties, managerial oversight and compensating controls cannot eliminate fraud, but they can certainly reduce it.

**Conclusion**

Most municipal employees do not set out to commit fraud. They find themselves experiencing financial difficulties and the need for a quick solution. They see municipal assets they can steal to meet their needs. Municipalities can prevent fraud by being aware of the Fraud Triangle and the red flags of fraud. They can implement confidential hotlines, communicate a “perception of detection” and strive for a separation of duties. Doing so not only protects the municipality’s assets – it protects the employees from committing fraud. It is often said that good employees can “go bad” if internal controls are weak enough, but municipalities have the ability to take an active role in preventing fraud. **(B)**

**About the Author**

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