



REBECCA OTTO
STATE AUDITOR

STATE OF MINNESOTA OFFICE OF THE STATE AUDITOR

SUITE 500
525 PARK STREET
SAINT PAUL, MN 55103-2139

(651) 296-2551 (Voice)
(651) 296-4755 (Fax)
state.auditor@osa.state.mn.us (E-mail)
1-800-627-3529 (Relay Service)

September 14, 2017

The Honorable Eldon Baanrud
Chair, Clover Town Board
53645 Oak Leaf Trail
Leonard, Minnesota 56652

Dear Chair Baanrud:

The Town of Clover (Town) notified the Office of the State Auditor (OSA), that several falsified checks were drawn on the Town's account from March 10, 2015, to May 5, 2015. The OSA conducted a review of relevant documents.

Based on this review, the OSA offers recommendations to help the Town safeguard its financial assets against losses due to unauthorized payments.

OSA Review and Findings

The amount of the eight falsified checks reported by the Town totaled \$8,025. The OSA reviewed the images of these eight checks and several other Town checks drawn on the Town's bank account from March 10, 2015, to May 5, 2015. The eight reported checks did not appear consistent with the Town's check stock and contained check numbers significantly different from check numbers on the Town's authorized checks. Although Minnesota law requires multiple signatures on town checks,¹ seven of the reported checks contained only one signature, and the name signed was not consistent with any official or representative of the Town. One of the reported checks was not signed at all. According to the Town, these checks were not written or approved by the Town.

Nevertheless, the Town's bank honored the checks and the bank did not refund the money. Information provided by the bank indicates that it requires account holders to report unauthorized signatures, alterations or forgeries within 30 days from when the bank statement is sent or made

¹Minn. Stat. § 367.18 ("Accounts audited and allowed . . . shall be paid by the town treasurer, on the order of the town board, signed by the chair and countersigned by the clerk. . . .")

available, and prohibits the assertion of claims against the bank on any item in a statement after 60 days.² The Town apparently did not provide notice or assert a claim within these time limits. The Town reported the matter to the Clearwater County Sheriff's Office, which is investigating the matter.

Recommendations

Internal controls to protect assets are important for all local governments. In addition to being required by statute as noted above, multiple signatures are part of a town's internal controls. When more than one person is required to sign a check, each person is verifying that the check has been appropriately approved for payment. Another important internal control occurs when account holders promptly review cancelled checks to make sure checks were appropriately signed. The OSA encourages the Town to consider the following additional internal control measures that towns can take to protect public assets:

1. **Positive Pay** - Many financial institutions offer this service. The account holder supplies a list of approved payments. When checks are presented to the financial institution for payment, the financial institution compares them to the list, and pays only the checks on the list.³
2. **Timely Reviews and Reconciliations** - A town should review its monthly bank statement promptly upon receipt.⁴ The town should compare the items in the monthly bank statement with the claims authorized for payment by the town board. It should report exceptions and unusual activity to the town's financial institution as soon as possible. Ideally, someone other than individuals who sign town checks should perform the review. In towns with few staff members, it may be possible to involve a board member in this process.
3. **Regular Review of the Town's Designated Depository** - A town should review its agreement with the financial institution designated as the town's depository on an annual or regular basis. This review should include the assistance of a representative of the financial institution as needed. This review should include a review of the required timeline for reporting unauthorized payments. A town should make the financial institution aware that town checks require multiple signatures and, whenever it is feasible, choose a financial institution that will include the multiple signature requirement in the depository agreement.

²See "Important Account Information for our Customers," First State Bank of Clearbrook, p. 12. *See also* Minn. Stat. § 336.4-406 (If a bank makes a bank statement available to a customer, the customer must exercise reasonable promptness in examining the statement to determine whether any payment was not authorized, and if the customer should reasonably have discovered the unauthorized payment based on the statement, then the customer must promptly notify the bank.); *and Stowell v. Cloquet Co-Op Credit Union*, 557 N.W.2d 567, 572-74 (Minn. 1997) (Twenty-day time period for notice to financial institution is reasonable.).

³Additional information on this and other fraud prevention tools can be found in the Government Finance Officers Association (GFOA) Best Practice publication, "Bank Account Fraud Prevention," available online at: <http://www.gfoa.org/bank-account-fraud-prevention>.

⁴If available, electronic access to account information may be helpful in facilitating timely monitoring of financial accounts.

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4. **Insurance Coverage** - A town can discuss check fraud risks with its insurance carrier to determine what coverage is available to the town. Although this measure will not prevent a falsified check scheme, it may aid in the recovery of losses.

Conclusion

Enclosed please find the OSA's Statement of Position on this topic, "The Importance of Internal Controls." If you have any questions, please feel free to contact me.

Sincerely,

/s/ Mark F. Kerr

Mark F. Kerr
Special Investigations Director
Office of the State Auditor
(651) 296-4717

Enclosure

cc:

The Honorable Jeremy Baanrud, Town Board Supervisor
The Honorable Josh Reed, Town Board Supervisor
Mr. Joel Wraa, Town Clerk
Mr. Benny Erickson, Town Treasurer
The Honorable David Hanson, Clearwater County Attorney



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Statement of Position

The Importance of Internal Controls

Internal controls are designed to protect a local government from loss or misuse of its assets. Sound internal controls help ensure that transactions are properly authorized and that the information contained in financial reports is reliable.

This Statement of Position will provide practical answers to some of the questions most frequently asked by public officials and employees about internal controls.

What is the purpose of internal controls?

An internal control is a process by which an entity attempts to prevent or minimize the likelihood of accounting-related errors, irregularities, and illegal acts. Internal controls help safeguard funds, provide efficient and effective management of assets, and permit accurate financial accounting. Internal controls cannot eliminate all errors and irregularities, but they can alert management to potential problems.

How much will this cost?

The cost of internal controls should not exceed the expected benefit. When adopting policies and procedures on internal controls, it is important to maintain a balance between what is needed to ensure public confidence and to maintain the integrity of the financial systems with the cost of providing the control in terms of money, time, and efficiency. Many simple and cost-effective internal control procedures are available.

Does someone need to review every transaction?

No. It is not practical or cost effective to attempt to independently review every transaction. Instead, management should be alert to “red flags” that could indicate potential problems. Looking into “red flags” will not only detect irregularities, it will prevent them from occurring in the first place because an environment of accountability will have been established.

Reviewed: February 2014
Revised: February 2014

2007-1010

This Statement of Position is not legal advice and is subject to revision.

What are some “red flags”?

When an alert is raised, follow-up is critical. Too often we see “red flags” continue unabated long after they were first detected and reported. Here are some examples that would merit further review:

- Any unusual discrepancy between actual performance and anticipated results (for example, a major budget overrun in “supplies” or an unexplained decline in user fees);
- Receipts not matching deposits;
- Disbursements to unknown and/or unapproved vendors;
- Presigned blank checks or one signature on checks;
- Gaps in receipt or check numbers;
- Late reports; or
- Disregard for internal control policies and procedures.

What types of control policies and procedures should be implemented?

The control policies should be adequate to ensure that:

- All transactions are properly authorized;
- Incompatible duties are segregated;
- Accounting records and documentation are properly designed and maintained;
- Access to both assets and records is controlled; and
- Accounting data are periodically compared with the underlying items they represent.

Extra care needs to be taken where cash transactions are involved. Cash transactions are prevalent, for example, in liquor stores, parks and recreation programs, athletic departments and petty cash funds.

What does it mean to segregate incompatible duties?

Simply put, no employee should be in a position to commit an irregularity and then conceal it. An example taken from everyday life is a movie theater where one person sells tickets and another person collects the tickets. This helps prevent the person selling the tickets from: (1) collecting the price of the ticket, but allowing entry without a ticket (allowing the ticket seller to pocket the ticket payment without being detected); or (2) allowing entrance without the purchase of a ticket.

Duties can be segregated by department or by individual. Examples of incompatible duties that should be performed by separate individuals are:

- Receipting collections, posting collections to registers, and making bank deposits;
- Signing checks and reconciling the bank accounts;
- Receipting collections and posting collections to the accounts receivable records; and

- Approving receivable write-offs/write-downs and posting adjustments to the accounts receivable records, adjusting accounting codes, and reviewing the monthly detailed report of receipts and disbursements for accuracy.

What if we are too small to be able to segregate duties?

If it is not practical to segregate duties, management should be aware of the lack of segregation and implement oversight procedures to ensure that employees are following other internal control policies and procedures. In addition, management may want to implement other controls. For example, a mandatory vacation policy or periodic rotation of duties among employees would allow management to observe if there is any noticeable change (for example, a marked increase in cash receipts) while another person is performing the duties. These alternative controls also help lessen potential disruptions caused by employee turnover.

Do some statutes require internal control procedures?

Yes. For example, the statutory requirement that more than one person must sign a check is designed to ensure a deliberate decision about who to pay, how much to pay, and when to pay bills. Pre-signing checks and signature stamps defeat those controls. Statutory requirements should be incorporated in the internal control policies and procedures.

What sort of accounting documentation is needed?

Accounting records need to be complete. Key documents (for example, invoices, receipts, checks) should be sequentially numbered. Voided documents should be retained. Record retention schedules should be followed. Employee timesheets should be reviewed and countersigned by a supervisor or other third-party.

How do we “compare accounting data with the items represented”?

Bank statements should be routinely reconciled with the cash balances recorded in the general ledger. Check amounts should be compared with the claims approved, as recorded in the minutes. Any differences should be reconciled and documented. An annual inventory of fixed assets will ensure that the location of all recorded items is known. Similar checks can be made of other accounts (for example, petty cash counts). Explanations of discrepancies should be corroborated by supporting documentation and evidence.

Do we have to write down our procedures?

Proper documentation of control procedures is essential. Written policies and procedures outline the specific authority and responsibility of individual employees, providing for accountability. Written policies serve as a reference and training tool for new employees and ensure that procedures remain in place despite employee turnover. To be effective, an accounting policies and procedures manual must be complete, up-to-date, and readily available to all employees who need it.

Who is responsible for internal controls?

The governing body (county boards, city councils, town boards and school boards) and management are responsible for establishing and maintaining internal controls. The governing body sets the tone, communicates the importance of internal controls, reviews and approves internal control policies and procedures, and provides funding to implement the controls. The governing body must ensure that internal controls remain a top management priority.

Management is responsible for evaluating the effectiveness of internal controls on an on-going basis. Even the best-designed internal controls cannot be effective without the active involvement of management. Management can develop a favorable control environment by setting a positive tone, communicating to all employees the importance of internal controls, and taking appropriate action against staff who are not complying with approved internal control policies and procedures. Management should also encourage staff to communicate situations not addressed by the policies and procedures, so the new policies and procedures may be adopted as necessary. Finally, management should try to make employees feel comfortable when reporting potential wrongdoing or violations of policies and procedures.