

# **BEST PRACTICES** **FOR THE PREVENTION AND DETECTION OF FRAUD**

The listed practices followed the outline in the “Key Components of a Fraud Prevention and Detection Program” document. Some practices may be detailed while others may be general to allow for flexibility in the implementation.

## **I. Culture of Honesty and Ethics**

### **1. Setting the Tone at the Top**

Best practices in this area include:

- Leaders, managers, and supervisors behave in the manner they expect their employees to behave.
- All employees are treated equally, regardless of their positions.
- Managers set achievable goals for their employees.

Each agency should develop, and clearly communicate to all employees a code of conduct, an ethics policy, a statement of business principles, and any other concise summary of guiding principles. The code of conduct may include topics such as ethics, confidentiality, conflicts of interest, intellectual property, sexual harassment, and fraud. Some agencies may elect to develop a fraud policy separate from the ethics policy. Examples of topics in a fraud policy may include:

- Requirement to comply with all laws and regulations
- Guidance regarding payments to contractors
- Relationships with vendors
- Maintenance of accurate books and records

The above guiding principles should be included in an employee handbook, policy manual, or some other formal document or location, for example, the entity’s intranet, for easy accessibility. Guidelines should be approved by the board and should be reviewed periodically.

- Due to the potential for conflicts of interest, the code of conduct should apply to anyone who has significant influence over relationships and dealings with suppliers, customers, creditors, insurers, auditors, etc. It should articulate what constitutes fraudulent behavior, how accountability for the code is established, and the sanctions imposed for noncompliance. The code should address:
  - Conflicts of interest
  - Confidentiality of information
  - Fair dealing

- Protection and proper use of agency assets
  - Related party transactions
  - Illegal acts
  - Compliance with laws, rules, and regulations
  - The monitoring of the code by management.
- To be effective, communication regarding the agency’s antifraud policies and procedures must reach all levels of employees. All personnel must receive a clear message that the agency is serious about its commitment to prevent and detect fraud. In addition, each employee must fully understand all relevant aspects of the agency’s antifraud program and their role and responsibilities to follow and enforce the antifraud policies. Every employee needs to know what behavior is expected and acceptable and what is unacceptable.
  - Implement “soft” controls, such as a process to promote ethical behavior. Soft controls deter wrongdoing and facilitate communication on difficult issues to promote appropriate workplace behavior. Soft controls appear to be the best defense against fraud involving senior management. Such a process typically requires a fulltime equivalent position as an ethics or compliance officer.

Actual agencies’ best practices include:

- a. *Agency developed ethics policy, code of ethics and rules of thumb to help avoid ethical missteps, and employees ethics survey*
- b. *Internal audit developed a control environment survey*
- c. *Agency developed an ethics page on the HR Intranet webpage to link employees to the Ethics Commission and agency ethics policies.*
- d. *Agency instituted a suggestion box for employees to anonymously report any wrongdoing.*
- e. *Agency developed an employees’ policy and procedures manual with a standards and ethics section that explains the procedures for reporting misconduct, fraud, or embezzlement involving employees or board members.*
- f. *Agency included a fraud policy in the operating policies and procedures manual. The policy establishes procedures for reporting and responding to allegations of fraud, waste, and abuse in connection with the agency’s programs, functions, and activities. Suspected fraud, waste, or abuse is reported to Internal Audit immediately.*
- g. *Agency operates under a clear code of ethics. The fraud prevention and reporting, waste, and mismanagement are referenced in different operating manuals.*

- h. Agency developed agency conflict of interest and accountability statements for employees and purchasers.*
- i. Agency Executive Administrator sets a strong ethical behavior standard and encourages openness in dealings. In addition, the Administrator encourages others to cooperate with Internal Audit.*
- j. Agency adopted Principles of Public Service as an operating rule and posts the principles in prominent places*
- k. Agency provides quarterly ethics training to staff.*
- l. Agency's ethics officer provides training to the board annually.*
- m. The Board frequently reviews of the ethics rules of major funds.*
- n. An annual financial disclosure for major funds is required and must be signed by fund administrators for compliance with ethics rules.*

## **2. Creating a Positive Workplace Environment**

Best practices in this area include:

- Allow employees to provide input in the development and updating of the code of conduct to foster loyalty and feelings of ownership.
- Develop recognition and reward system or compensation program inline with agency goals including positive feedback, recognition for job performances, and rewarding appropriate behaviors.
- Provide equal employment and promotional opportunities
- Encourage and set team-oriented, collaborative decision-making policies.
- Set reasonable budget expectations and other financial targets
- Develop professionally administered training programs and set agency priority for employee career development.
- Develop clear channels or methods of communication within the agency.
- Develop a whistle blower policy, or a system for employees to obtain advice internally before making decisions that appear to have significant legal or ethical implications. Implement a process to encourage employees to communicate or report, on a confidential or anonymous basis, without fear of retribution, concerns related to wrongdoing or violations. For example, use a telephone “hotline” directed to and monitored by an individual responsible for investigating and reporting incidents of fraud or illegal acts.

Actual agencies' best practices include:

- a. *Agency has a quarterly employee recognition program.*
- b. *Agency reviews position duties and salaries to ensure that they are in line with classification schedule and other positions.*
- c. *Agency Executive Administrator encourages supervisors to reward employees in various ways, such as granting additional administrative leave.*
- d. *Agency publicly posts its Principles of Public Service.*
- e. *Agency has a Quality Workforce Committee with fifteen elected agency staff with a Committee Charter. The Committee's purpose is to focus on and improve the physical and social workplace environment.*
- f. *Agency conducts a Biennial Organizational Excellence Survey to solicit employee feedback about supervisor/management ethics, fairness, and openness to employee concerns.*
- g. *Agency adopted principles for public services that are developed by agency staff.*

### **3. Hiring and Promoting Appropriate Employees**

Best practices in this area include:

- Conduct criminal background investigation on individuals being considered for employment or promotion to a position of trust. Some agencies may consider follow up investigation on a periodic basis, particularly for employees in positions of trust.
- Thoroughly check a candidate's education, employment history, and personal references.
- Incorporate into the regular performance reviews an evaluation of how each individual has contributed to creating an appropriate workplace environment in line with the agency's values and code of conduct.
- Incorporate ethics/compliance and fraud prevention goals into the performance measures against which managers are evaluated and which are used to determine performance-related compensation.
- Implement a continuous objective evaluation process of compliance with agency's values and code of conduct with violations being addressed immediately

Actual agencies' best practices include:

- a. Agency performs background checks on potential employees*
- b. Agency has employment policies that encourage hiring the most qualified person and panel interviews to ensure unbiased selection.*
- c. Agency performs reference checks prior to hiring.*
- d. Agency performs supervision and evaluation of employees to help ensure competency and ethical behavior.*
- e. Agency requires quarterly ethics reports for all staff providing financial advice to the Board.*

#### **4. Training Employees**

Best practices in this area include:

- New employees trained at the time of hiring about the entity's values and its code of conduct. This training should cover (1) employees' duty to communicate certain matters; (2) a list of the types of matters, including actual or suspected fraud, bribes, to be communicated along with specific examples; and (3) information on how to communicate those matters.
- All employees should receive refresher training periodically. Some agencies may consider providing ongoing training to employees who serve as purchasing agents or have financial reporting responsibilities. Agencies may consider providing training specific to an employee's level within the organization and assigned responsibilities, such as senior manager level personnel and non-supervisory employees.
- All third party or long-term contractors should be made aware of the agency's fraud policy and code of conduct.

Actual agencies' best practices include:

- a. Management requires periodic ethics training for all staff.*
- b. An ethics overview is provided at new employee orientation.*
- c. Fraud Awareness/Prevention Training is provided to construction inspectors and engineers.*
- d. Training on fraud awareness has recently been added in the new employee orientation program.*

- e. *A video on fraud awareness is being developed which will be mandatory for all employees to watch periodically. An eight-hour training class on ethics is conducted several times each year.*
- f. *Professional development for audit staff is ongoing.*
- g. *Agency offers quarterly ethics training to staff.*
- h. *Agency offers annual training for board officials.*
- i. *New employees are trained on ethics and other policies and rules.*
- j. *Agency tracks training information including dates, attendees, and signatures confirming attendees' participation.*

## **5. Notification and Confirmation of Compliance**

Best practices in this area include:

- Clearly articulate in the guidelines that all employees will be held accountable to act within the entity's code of conduct.
- All employees should be required to sign a code of conduct statement annually, at a minimum. Such confirmation may include statements that the individual understands the entity's expectations, has complied with the code of conduct, and is not aware of any violations of the code of conduct other than those the individual lists in his or her response.

Actual agencies' best practices include:

- a. *New employees receive a hard copy of code of ethics and sign a statement that they received, read, and understood it.*
- b. *New employees sign an affidavit acknowledging that the employee has read and intends to comply with the following: Texas Government Code Standards of Conduct for State Officers and Employees; rules relating to blood and marriage relations, multiple employments, conflicts of interests, and responsibility and accountability for state property.*
- c. *Agency utilizes a new hire packet that includes Agency Principles of Public Service.*
- d. *Agency has a monthly newsletter, distributed by its office of General Counsel, which include ethical issues.*

- e. Agency's major funds require acknowledgement of review and adherence to ethics policies.*
- f. Internal auditors are required to follow IIA Code of Ethics.*

## **6. Discipline**

Best practices in this area include:

- Develop standardized processes and procedures related to:
  - Rights of employees suspected of fraud
  - Disciplinary interviews
  - Circumstances of services termination
  - Dealing with complaints
  - Dealing with theft and threats
  - Rights and responsibilities of third parties related to agency's fraud policy
  - Use of competent investigators
  - Protection of information sources
  - Charging investigative costs
  - Person responsible for making claims under insurance policies
  - Notifying the various legal authorities
- Perform thorough investigation of incidents of alleged or suspected fraud, abuse, or other criminal activities.
- Take appropriate and consistent actions against violators.
- Assess and improve relevant controls.
- Communicate and train employees to reinforce the agency's values, code of conduct, and expectations. For example, if wrongdoing occurs and an employee is disciplined, communicate that fact, on a no-name basis, in an employee newsletter or other regular communication to employees. Communication should also include a strong statement from management that dishonest actions will not be tolerated and that violators may be terminated and referred to the appropriate authorities.
- If feasible, employ antifraud professionals, such as certified fraud examiners, who are responsible for resolving allegations of fraud within the agency and who assist in the detection and deterrence of fraud.
- Request assistance from the Special Investigation Unit of the State Auditor's Office to conduct investigation of incident of alleged or suspected fraud.
- Assign a responsible person to maintain appropriate documentation of incidents and define appropriate guidelines for access and security of these documents.
- Pursue all reasonable means of recovering any identified losses.

Actual agencies' best practices include:

- a. Allegations of fraud are not ignored but are thoroughly researched and investigated, including obtaining information provided via the State Auditor's hot line.*
- b. When appropriate, referrals are made to law enforcement agencies.*
- c. Agency has a policy that states employees will be disciplined for wrong doing including the possibility of termination and/or prosecution*
- d. Agency developed an operating procedure on employee disciplinary actions which prohibits fraudulent behavior.*

## **II. Antifraud Processes and Controls**

### **1. Identifying and Measuring Fraud Risks**

Best practices in this area include:

- A fraud risk-assessment process should consider the vulnerability of the agency to fraudulent activity (fraudulent financial reporting, misappropriation of assets, and corruption) and if any of those exposures could result in a material misstatement of the financial statements or material loss to the agency. The assessment should consider the various ways that fraud and misconduct can occur by and against the agency. Fraud risk assessment should also consider vulnerability to management override and potential schemes to circumvent existing control activities which may require additional compensating control activities. To be effective, management should perform fraud risk assessments on a comprehensive and recurring basis. The essential elements of an effective fraud risk assessment include:
  - A systematic (rather than haphazard) assessment process
  - Consideration of potential fraud schemes and scenarios
  - Assessment of risk at agency-wide, business unit and significant account levels
  - Evaluation of the likelihood and significance of each risk to the agency
  - Assessment of exposure arising from each of the categories of fraud risk
  - Testing of the effectiveness of the risk assessment process by internal audit
  - Documented oversight by the audit committee, including consideration of the risk of override of controls by management
- The nature and extent of management's risk assessment activities should be commensurate with the size of the agency and complexity of its operations.

- Management should recognize that fraud can occur in organizations of any size or type, and that almost any employee may be capable of committing fraud given the right set of circumstances.
- Management should develop a heightened “fraud awareness” and an appropriate fraud risk-management program, with oversight from the board of directors or audit committee.

Actual agencies’ best practices include:

- Internal audit prepares a risk assessment as part of its annual audit plan.*
- Internal audits and risk assessments are used to identify potential weaknesses in the agency's day-to-day procedures.*
- Internal Audit is informed of all investigations and allegations of suspected wrongdoing. Special projects are often performed involving Internal Audit, Legal, and other departments to look into possibilities of inappropriate activities or conflicts of interest. The internal auditors perform an annual risk assessment that takes into account all confirmed or suspected problems. The annual audit plan is developed to insure that these risks are covered.*
- Agency developed a business continuity plan*
- Internal Audit performed an annual internal audit planning and risk assessment*
- Internal Audit coordinates with State and Federal auditors*

## **2. Mitigating Fraud Risks**

Best practices in this area include:

- Consider making changes to agency activities and processes that could help reduce or eliminate certain fraud risks. For example, the risk of misappropriation of funds may be reduced by implementing a central lockbox at a bank to receive payments instead of receiving money at the agency’s various locations.
- Management may have Internal Audit play an active role in the development, monitoring, and ongoing assessment of the entity’s fraud risk-management program.
- Some agencies may perform a periodic self-assessment using questionnaires or other techniques to identify and measure risks.
- Closely monitor the agency’s procurement process.

- The risk of financial statement fraud may be reduced by implementing shared services centers to provide accounting services to multiple segments or geographic locations of an agency’s operations. A shared services center may be less vulnerable to influence by local operations managers and may be able to implement more extensive fraud detection measures cost effectively.
- Monitor compliance with the code of conduct and related training. Monitoring may include requiring at least annual confirmation of compliance and auditing of such confirmations to test completeness and accuracy.
- Develop regular measurements of the extent to which the entity’s ethics/compliance and fraud prevention goals are being achieved. Such measurement typically includes surveys of a statistically meaningful sample of employees.
- Establish a process to detect, investigate, and resolve potentially significant fraud. Such a process should typically include proactive fraud detection tests that are specifically designed to detect the significant potential frauds identified in the agency’s fraud risk assessment. Other measures can include audit “hooks” embedded in the entity’s transaction processing systems that can flag suspicious transactions for investigation and/or approval prior to completion of processing. Another measure is the use of leading edge fraud detection methods which include computerized e-mail monitoring (where legally permitted) to identify use of certain phrases that might indicate planned or ongoing wrongdoing.

Actual agencies’ best practices include:

- a. *Any identified risk by internal audit or the risk assessment process is further evaluated and procedures are developed and put in place to mitigate the risk.*
- b. *Each program that contracts with external parties or collects a fee provides monitoring controls over the contractors or fee payers. In some cases, the agency contracts with third parties to increase the assurance regarding fee payers and contractors. These efforts serve to prevent and detect fraud.*
- c. *Agency has three units with distinct responsibilities related to fraud prevention investigation and prosecution: a Special Investigations unit, Compliance, Evaluation and Audit section, and the Internal Audit unit.*
- d. *Agency developed best practices for fraud prevention in all areas including procurement, contracting, and contract management*  
*Examples include:*
  - *Enhanced investigative tools*

- *Assigned investigators to potential fraud cases*
- *Established a 1-800 number for employees to call and report possible fraud*
- *Sent notices to employees in their monthly paycheck to notify them of the 1-800 and encouraging them to call and report fraud*
- *Reduced SORM claims*
- *Implemented a risk based system and targeted audit resources to identify contractors who may be committing fraud*
- *Created a new Public Integrity Division*
- *Made technological changes to allow for improved data analysis and matching*

- e. *The internal audits are designed to include steps that would be likely to uncover fraud if it were occurring.*
- f. *Agency developed operational and accounting controls, procedures, and policies.*
- g. *Developed major fund investment policies and procedures manual and soft dollar controls.*
- h. *Agency developed control self-assessment protocols for use by state facility managers and staff to help identify weaknesses at the local level.*

### **3. Implementing and Monitoring Appropriate Internal Controls**

Best practices in this area include:

- Use the fraud risk assessment to identify the processes, controls, and other procedures that are needed to mitigate the identified risks. The agency must consider:
  - Whether the controls implemented are adequate to address all of the individual agency's specific business activities
  - Whether these controls are properly designed for the purposes of detecting, deterring and mitigating the particular fraud risks to which the agency is exposed
  - Whether these controls are being applied properly to sufficiently address the agency's unique business operations and fraud risks.
- The necessary control activities should be documented to ensure each significant fraud exposure identified during the risk assessment process has

been adequately mitigated. The audit committee should evidence its oversight and approval of the adequacy of the design and operating effectiveness of the control activities in minutes of its meetings. Internal audit or a third party working on behalf of the audit committee should evaluate the effectiveness of the design of control activities through a walk-through.

- Effective internal controls include a well-developed control environment, an effective and secure information system, and appropriate control and monitoring activities.
- Implement and maintain appropriate controls, whether automated or manual, over computer-generated information because of the importance of information technology in supporting operations and the processing of transactions. Consideration may include:
  - Technologically enabled fraud such as manipulating system time clocks that affect a cut-off on the books and records
  - IT security controls, with increased emphasis on prevention and detection of unauthorized access and physical intrusion
  - The impact of system access on segregation of duties
  - The adequacy of fraud detection and monitoring tools such as of fraud-related computer-assisted auditing techniques
  - Inappropriate modifications to computer programs by IT personnel, such as falsification of financial reports
  - The system override of control features, such as using information systems to circumvent control activities
  - The ability to investigate computer misuse, such as computer forensics/incident response capabilities and maintaining system logs for an adequate period to perform investigations

General computer controls related to security should be tested to ensure they are operating effectively and they should be documented.

- Create a strong value system and a culture of ethical financial reporting to overcome fraudulent financial reporting that involves management override of internal controls.
- Implement appropriate oversight measures by the board of directors or audit committee.
- Implement appropriate ongoing monitoring imbedded in the course of operations and built into the normal, recurring operating activities of the agency. It should include regular management and supervisory activities and other actions personnel take in performing their duties. It is essential that the agency's plan, approach, and scope of monitoring activities be documented and reviewed from time to time. Management's monitoring systems should be evaluated in terms of the following:
  - Management's responsibility for enforcement and monitoring of the antifraud program and policies

- Management prompt and sufficient response to significant deficiencies and material internal control weaknesses
- Management's responsiveness to internal and external auditor recommendations regarding ways to strengthen antifraud controls
- The knowledge and experience of individuals, and whether they receive periodic and adequate training with regard to fraud.

Actual agencies best practices include:

*a. Agency implemented the following controls:*

- *Cash controls – all mail is opened in a central mail room and remittances are immediately entered to a cash system and processed for deposit – two employees must be present at all times.*
- *Reconciliations*
- *Segregation of duties*
- *Consulting with Internal Audit when major processes are changed*
- *Employees review and sign telephone logs.*
- *Approval levels for expenditure and refund transactions*
- *Original deposit documentation provided and verified prior to a refund.*

*b. A balance and check system is in place, such that no one employee processes and releases a single payment by him or herself.*

*c. Agency staff is aware of the need for constant examination and improvement of internal controls. All internal audits performed examine the adequacy and effectiveness of the internal controls in the area under audit.*

*d. Agency requires major funds ethics reports of staff and board*

*e. Internal Audit develops an internal audit plan*

*f. Management ensures the implementation of audit recommendations*

*g. Agency developed major fund investment procedures manual*

### **III. Appropriate Oversight Process**

#### **1. Audit Committee or Board of Directors**

Best practices in this area include:

- Have key oversight roles with respect to the code of conduct. Evidence of their oversight role should be documented in the board of directors and audit committee charters and meeting minutes.
- Evaluate management's activities relating to the following:
  - The process for identifying and documenting fraud risk
  - The types of fraud considered by management (fraudulent financial reporting, misappropriation of assets, unauthorized or improper receipts and expenditures, and fraud by senior management)
  - The level at which risk is considered (company-wide, business unit and significant account)
  - The level of likelihood of fraud (probable, reasonably possible and remote)
  - The level of significance of fraud (inconsequential, more than inconsequential or material)

Agencies will need to reach their own conclusions with respect to the cost of controlling a risk compared to the benefits of mitigating or eliminating that risk. However, an agency should have a documented process that assesses, identifies, and evaluates fraud risk.

- Have an active oversight to help reinforce management's commitment to creating a culture with "zero tolerance" for fraud.
- Ensure that senior management implements appropriate fraud deterrence and prevention measures to better protect stakeholders.
- Obtain from the internal auditors and independent auditors their views on management's involvement in the financial reporting process and, in particular, the ability of management to override information processed by the entity's financial reporting system (for example, the ability for management or others to initiate or record nonstandard journal entries).
- Assess the strength of the agency entity's internal control and the potential for fraudulent financial reporting using information received in communications from the independent auditors.
- Encourage management to provide a mechanism for employees to report concerns.
- Request periodic reports of any fraud or unethical conduct to ensure that the board has been notified about all matters that should have been reported and that appropriate communications have taken place. Adequate documentation of the process should exist. In addition, internal audit or an independent party should conduct a walk-through of the hotline/whistleblower process to assist the audit committee in understanding the process.
- Establish an open line of communication with members of management one or two levels below senior management to assist in identifying fraud at the

highest levels of the agency or investigating any fraudulent activity that might occur.

- Develop audit committee charter that empowers the committee to investigate any alleged or suspected wrongdoing brought to its attention and to retain legal, accounting, and other professional advisers as needed to advise the committee and assist in its investigation.
- Ensure all audit committee members are financially literate, and have at least one financial expert with an understanding of generally accepted accounting principles and audits of financial statements. The financial expert should also have an experience in internal governance and procedures of audit committees, obtained either as an audit committee member, a senior agency manager responsible for answering to the audit committee, or an external auditor responsible for reporting on the execution and results of annual audits.

Actual agencies' best practices include:

- a. Board review of major fund ethics reports*
- b. Internal Auditor provides reports to agency head*

## **2. Management**

Best practices in this area include:

- Provide a periodic report, certificate, or similar acknowledgment of the responsibility for the fraud policy administration and the establishment and maintenance of an effective system of internal controls.
- Create “ownership” of fraud risks by identifying a member of senior management as having responsibility for managing all fraud risks within the entity and by explicitly communicating to divisions and units managers that they are responsible for managing fraud risks within their part of the agency
- Implement an ongoing process for regular identification of the significant fraud risks to which the agency is exposed.
- Management implement measures, where possible, to eliminate or reduce through process re-engineering each of the significant fraud risks identified in its risk assessment. Basic controls include segregation of duties relating to authorization, custody of assets and recording or reporting of transactions. In some cases, it may be more cost-effective to re-engineer business processes to reduce fraud risks rather than layer on additional controls over existing processes. For example, some fraud risks relating to receipt of funds can be eliminated or greatly reduced by centralizing that function or outsourcing it to a bank's lockbox processing facility, where stronger controls can be more affordable.

- Management implement measures at the process level designed to prevent, deter, and detect each of the significant fraud risks identified in its risk assessment.

Actual agencies' best practices include:

- a. *Agency involves financial staff when implementing a new system that has any relation to revenues, expenses, or assets.*
- b. *Agency involves Internal Audit when processes change or a problem arises.*
- c. *Agency conducts a bi annual review of USAS access.*
- d. *Agency periodically changes or rotates financial staff's duties.*
- e. *Agency has written procedures for all major duties.*
- f. *Agency utilizes Internal Auditor*
- g. *Board has supervision over major funds.*
- h. *Agency has instituted signature authority and approval limitations.*
- i. *Agency Oversight Committee reviews local facility managers' control self-assessments on quarterly basis.*

### 3. Others

Best practices in this area include:

- Internal auditors should assist in the deterrence of fraud by identifying indicators of fraud and fraud risks, examining and evaluating the adequacy and the effectiveness of the system of internal controls, and recommending action to mitigate risks and improve controls.
- Internal auditors, in carrying out this responsibility, should determine if the agency has an environment that fosters control consciousness, realistic goals and objectives, written policies that describe prohibited activities and the action required whenever violations are discovered. They should also determine if agency has:
  - Established and maintains appropriate authorization policies for transactions
  - Developed policies, practices, procedures, reports, and other mechanisms to monitor activities and safeguard assets
  - Developed communication channels that provide adequate and reliable information

In addition, if recommendations are needed to be made for the establishment or enhancement of controls to help deter fraud.

- Internal auditors should conduct proactive auditing to search for corruption, misappropriation of assets, and financial statement fraud.
- Internal auditors should employ analytical and other procedures to isolate anomalies and perform detailed reviews of high-risk accounts and transactions to identify potential fraud.
- Internal Auditors should assess the operating effectiveness of the hotline or whistle blower program, if any. Considerations include:
  - Are employees aware of the hotline
  - Is reporting of alleged incidents encouraged
  - Are people actually reporting possible instances of misconduct
  - Is follow-up appropriate and timely
  - Do employees use the hotline to get advice for difficult decisionsThe process should be tested through an examination of the various communications and a sample of alleged incidents.
- Internal Auditors should ensure that executive management is aware each year of what risks are not being covered by the audit plan to alert management to the risks being assumed
- Internal auditors should have an independent reporting line directly to the audit committee, to enable them to express any concerns about management's commitment to appropriate internal controls or to report suspicions or allegations of fraud involving management.
- Independent or external auditors should provide the audit committee with an assessment of the agency's process for identifying, assessing, and responding to the risks of fraud.
- Independent auditors should have an open and candid dialogue with the board of directors (or audit committee) regarding management's risk assessment process, the system of internal control, the agency susceptibility to fraudulent financial reporting, and the agency's exposure to misappropriation of assets.
- If employed, certified fraud examiners should provide the audit committee and board of directors with objective input into management's evaluation of the risk of fraud, the development of appropriate antifraud controls, evaluation of the fraud risk assessment and the fraud prevention measures implemented by management.
- Certified fraud examiners should conduct examinations to resolve allegations or suspicions of fraud, report either to an appropriate level of management or to the audit committee or board of directors.

Actual agencies' best practices include:

*a. Internal audits and several program specific audits are performed annually.*

- b. Audits of functions that may be subject to fraud are performed periodically to determine any improprieties and to ascertain that internal controls are in place to ensure compliance. In addition to internal audit functions, the State Auditor's Office periodically conducts audits of department functions.*
- c. Reviews are performed by Internal Audit, State Auditor, Comptroller, LBB, Federal auditors who review federal programs, Governor's Office, and the Sunset Commission.*

## **Sources**

- Management Anti-fraud Programs and Controls commissioned by the Fraud Task Force of the American Institute of Certified Public Accountants, AICPA's Auditing Standards Board.
- Key Elements of Anti-fraud Programs and Controls by Price Waterhouse Coopers
- Fraud Prevention Checkup by the Association of Certified Fraud Examiners
- SAO's Internal Audit Best Practice List
- State agencies responses, TEA, ERS, TPRB, GLO, TxDOT, TWC, TFSC, and TWDB
- State agencies information from other sources: TCEQ, TRS, and TWC