

# **When Integrity Fails: Identifying and Addressing Internal Fraud in Local Government Operations**

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MEET THE TEAM



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## **Presentation Outline**

Understanding internal fraud

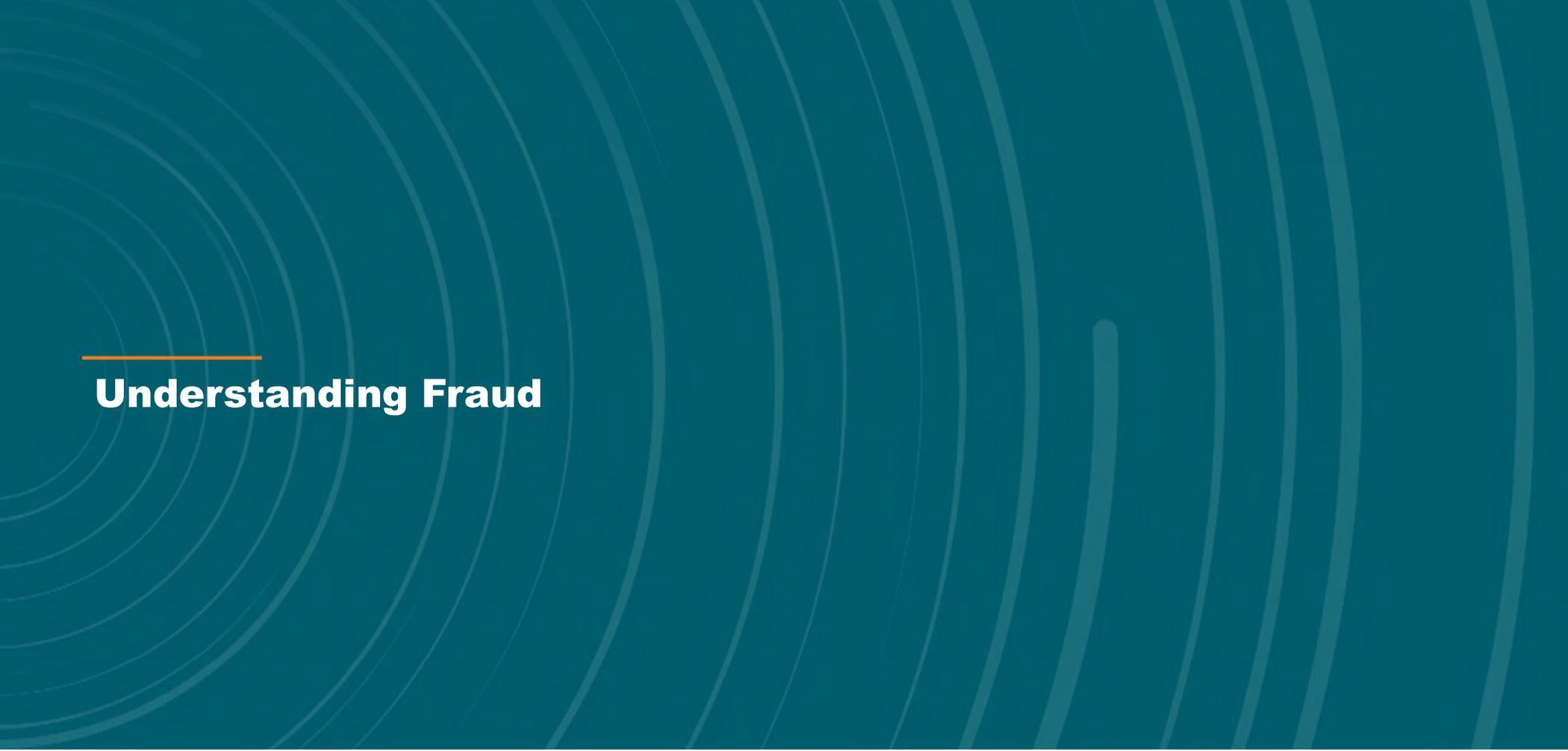
Recognizing red flags

Roles and responsibilities

Prevention strategies

Responding to suspected fraud

Recovery and rebuilding trust

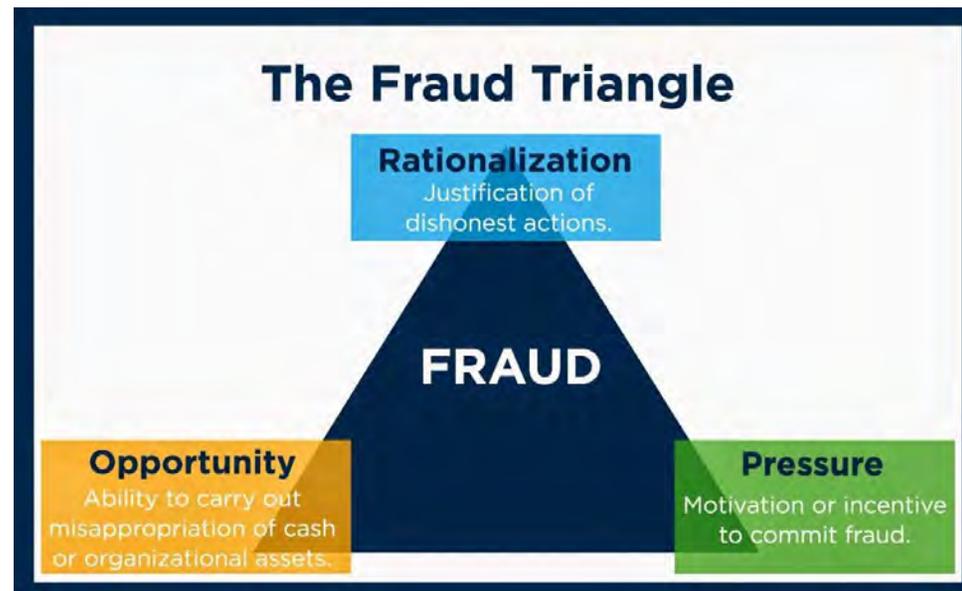


# Understanding Fraud

# What is fraud?

## Definition

Fraud is any intentional act or omission designed to deceive others and resulting in the victim suffering a loss and/or perpetrator achieving a gain.



# TYPES, CAUSES, AND CONSEQUENCES



## Most Common Types of Local Government Fraud

- **Billing:** false invoices
- **Cash receipts:** customer payments
- **Asset:** selling municipal assets
- **Disbursement:** withdrawing funds
- **Procurement:** personal use of vendor accounts

## Common Causes

- **Personal pressure/incentive:** personal financial pressure
- **Organizational opportunity:** Weak internal controls, lack of oversight
- **Personal rationalization:** justification for behavior

## Consequences of Fraud

Financial loss, reputational damage, and erosion of public trust severely impact local governments after fraud occurs.

## Mitigation Importance

Recognizing causes and impacts helps local governments implement strategies to prevent and respond to internal fraud.



## **Common Types of Fraud**

# COMMON FRAUD SCHEMES

- Asset Misappropriation
  - Cash Theft
    - Skimming
    - Credits to Accounts Receivable
  - Inventory Use
    - Selling Personally
  - Fraudulent Disbursements
    - Billing
    - Payroll
    - Expense Reimbursement
    - Check Tampering
    - Credit Cards
- Corruption
  - Conflicts of Interest
    - Relatives
  - Bribery and Incentives



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## **Behavioral Red Flags**



# PERSONAL – INCENTIVE

*“The reason I did this is because I needed money for my prescriptions. I had money, it wasn’t that I necessarily needed it...”*



# PERSONAL RATIONALIZATION

I deserved that promotion.

I am worth a lot more than they're paying me.

I have more responsibility/work harder than anyone else.

I'll pay it back as soon as I get ahead.

They don't appreciate what I do here.

*"I knew the first time I turned in that invoice that it was wrong, but I hated \_\_\_\_\_ so much for what he had been doing to me."*



# PERSONAL BEHAVIORAL TRAITS

I'll get you the details later, I've got too much on my plate right now.

I have my own way of doing things.

It's easier if I do it myself.

I just remodeled my house and am having a hard time paying the bills.

I have too much to do, I can't take that much time off at once.

It wasn't budgeted, but we need it now. We don't have the time to go through a process.

I can't get my work done during business hours, I'll come in at night/weekend.



These policies and procedures are just bureaucratic red tape that slow me down.

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## **Organizational Red Flags**



# OPERATIONAL RISK

We don't have enough staff to separate roles.

We'll investigate it if/when we have concrete evidence.

We already do annual audits – if there was fraud, they'd catch it.

We use credit cards because it's fast and easy.

Requiring extra sign-offs just slows things down.

We'll look into it if/when we have concrete evidence.

People can just go to HR if they see something wrong.



# OPERATIONAL MINDSET

This may work for others, but we're different and how we do it works for us.

We can revisit this when we don't have so much on our plates.

These policies and procedures feel like bureaucratic red tape.

Jane has been with us for years. We completely trust her. She's not like that.



Why are you spending your time on this when you have more pressing work?

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## Records Red Flags



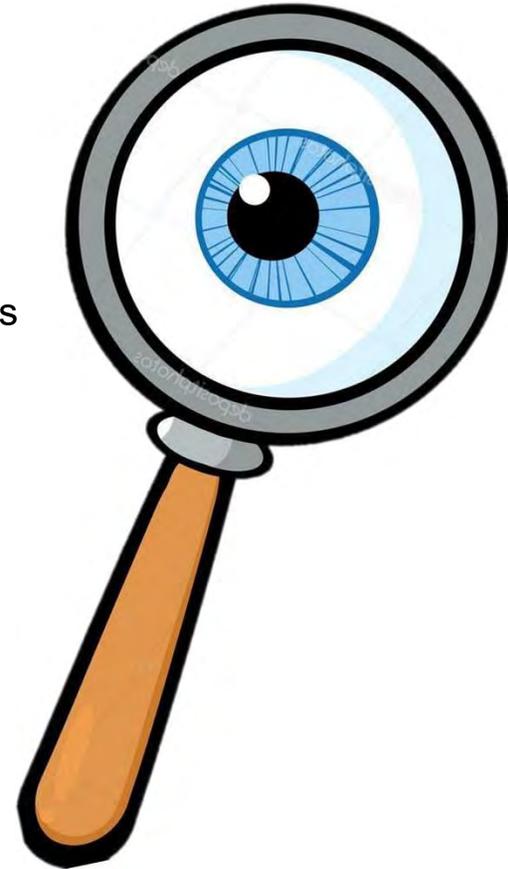
# DATA ANALYTICS

## Financial:

- Round numbers repeatedly (invoices, expense reports, vendor payments)
- Invoices/payments just below authorization threshold
- Duplicate payments
- Multiple smaller payments to same vendor to avoid authorization thresholds
- Payments posted outside normal business hours

## Vendors

- New vendor without history
- Same address for multiple vendors
- Vendor address a P.O. Box
- Vendor street address is a UPS store (looks like actual street address)
- Unprofessional invoice – spelling, math errors, grammar

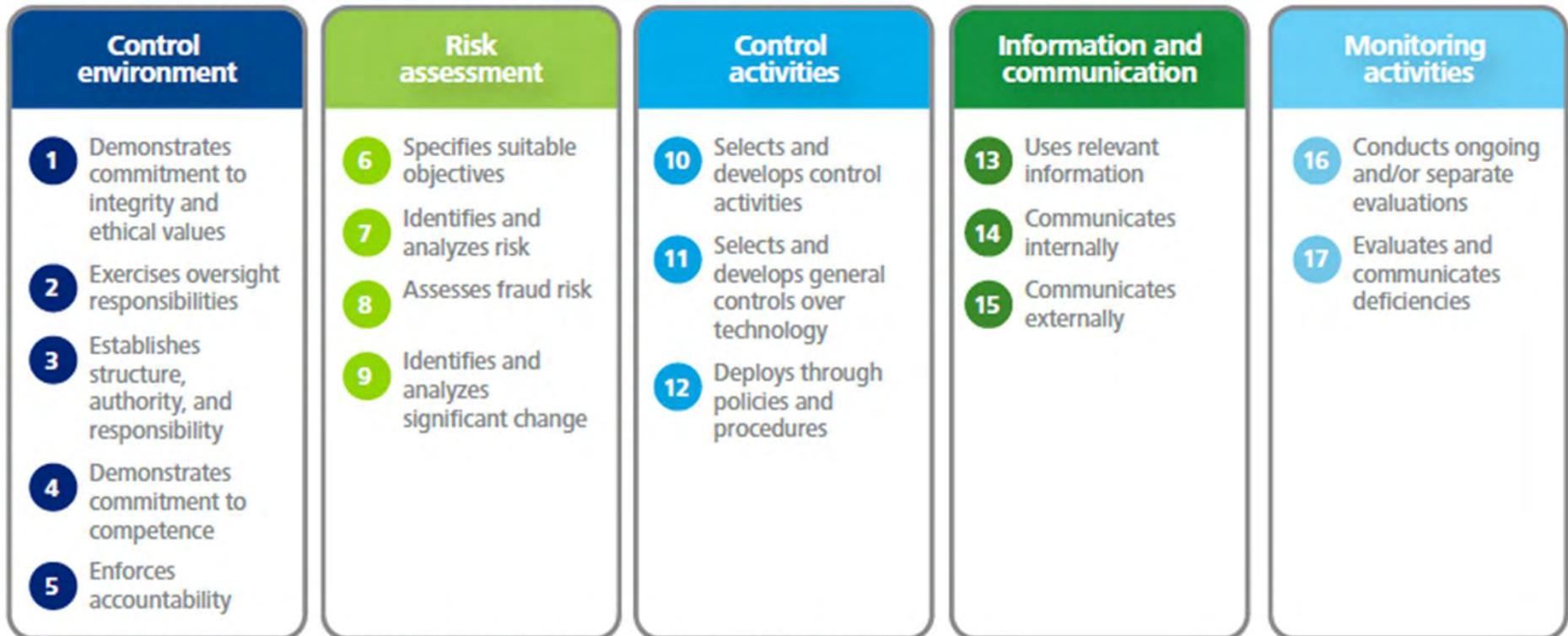




# Prevention Strategies

# Internal Controls

## COSO's 17 principles of internal control – summarized



Source: Audit Committee Brief, March 2014. Deloitte Development Corporation. All rights reserved.

# Control Environment

## Tone at the top!

- Municipal Board and Department Leaders
- Responsible for oversight
- Establish structure, policies, responsibility
- Enforce accountability



# Risk Assessment

## Risk vs. Reward/Effort

- What are our areas of concern?
- What is being done currently?
- What should we do?
- How do we fix it?
- What technology do we have?

|            |            |                        | Impact              |                                   |  |                           |
|------------|------------|------------------------|---------------------|-----------------------------------|--|---------------------------|
|            |            |                        | 0                   | 1                                 | 2  | 3                         |
|            |            |                        | Acceptable          | Tolerable                         | Unacceptable                                   | Intolerable               |
|            |            |                        | Little or No Effect | Effects are Felt but Not Critical | Serious Impact to Course of Action and Outcome | Could Result in Disasters |
| Likelihood | Improbable | Risk Unlikely to Occur |                     |                                   |  |                           |
|            | Possible   | Risk Will Likely Occur |                     |                                   |  |                           |
|            | Probable   | Risk Will Occur        |                     |                                   |  |                           |

# Control Activities & Information and Communication

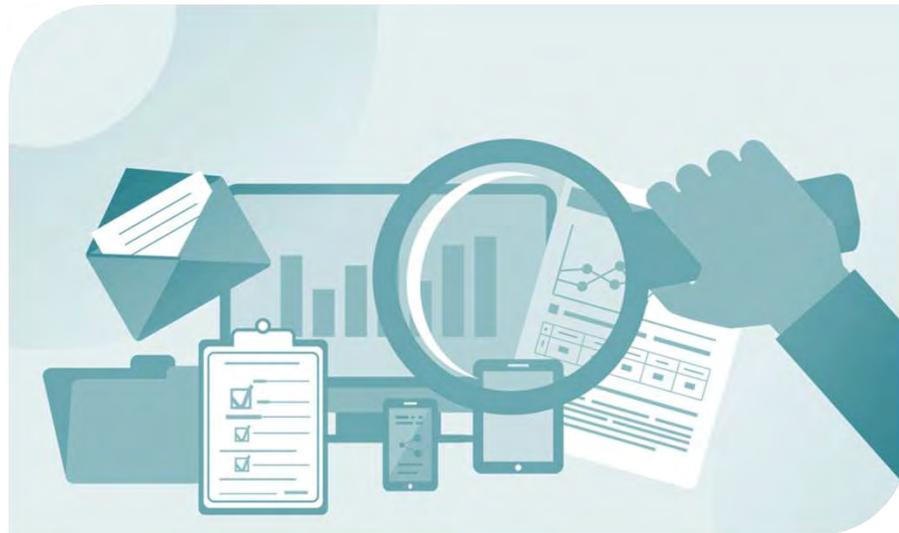
- **Control Activities**
  - Develop control objectives for issues identified in the risk assessment.
  - How does technology assist with this?
  - Develop policies.
- **Information and Communication**
  - How are we going to communicate this?
  - Who is going to communicate this?
  - Is this for internal or external purposes?
  - Is training needed?



# Monitoring Activities

## This is often not done...

- Review policies that were implemented.
- Discuss processes.
- Solicit feedback.
- Make needed changes.



# BILLING FRAUD

## FALSE INVOICES

St. Croix Chippewa Indians Housing Authority \$200K; Eau Claire County \$1.3M

- Vendor Verification: Maintain an approved vendor list.
- Three-Way Match: Require matching of purchase order, invoice, and receiving report.
- Segregation of Duties: Separate staff who approve vendors, process invoices, and issue payments.
  - If staffing limits capacity to segregate, increase board oversight: independent review, dual authorization, mandatory detailed documentation.
- Require that anyone involved in the disbursement cycle take at least one consecutive week of vacation annually.



# CASH RECEIPTS FRAUD

## STEALING CUSTOMER PAYMENTS

Marshfield – \$73K; Bellevue – \$25K

- Dual Control: Require two employees to handle cash and reconcile receipts.
- Daily Deposits: Mandate same-day deposits to reduce cash on hand.
- Independent Reconciliation: Assign reconciliation to someone not involved in collection.
- Lockbox Services: Use bank lockbox for direct customer payments.
- Surprise Cash Counts: Conduct unannounced audits of cash drawers.



# ASSET FRAUD

## SELLING MUNICIPAL PROPERTY

Milwaukee – \$350K; Brown County – \$650K



- Asset Inventory System: Maintain detailed records of all municipal assets.
- Approval for Disposal: Require written authorization from senior management or governing board.
- Public Sale Process: Use transparent auction or bid process for asset disposal.
- Physical Verification: Perform periodic asset counts and reconcile with records.
- Restrict Access: Limit who can initiate asset transfers or disposals.
- Monitor supplies: Watch for unusually large orders compared to usage/operational needs.

# DISBURSEMENT FRAUD

## WITHDRAWING FUNDS

Town of Adrian – \$294K; Town of Bergen – \$130K

- Dual Authorization: Require two signatures for all disbursements.
- Bank Positive Pay: Implement bank verification of issued checks.
- Separate Bank Reconciliation: Assign reconciliation to someone independent of disbursement.
- Transaction Limits: Set dollar thresholds requiring board approval.
- Monthly Review: Governing board reviews bank statements and disbursement reports.



# PROCUREMENT FRAUD

## USING VENDOR ACCOUNTS FOR PERSONAL PURCHASES

Example: Vernon County – \$35K



- Purchase Order System: Require POs for all purchases, no exceptions.
- Vendor Account Controls: Restrict who can place orders and monitor account activity.
- Credit Card Restrictions: Limit or eliminate credit card use; enforce strict documentation.
- Periodic Vendor Statement Review: Compare vendor statements to approved purchases.
- Conflict of Interest Disclosure: Require annual disclosure from staff involved in procurement.

# THE IMPORTANCE OF EVALUATIONS & PERFORMANCE IMPROVEMENT PLANS

Fraud rarely happens in isolation—it often follows patterns of policy violations and control circumvention.

- Unauthorized or unusual overtime and/or working off hours without approval
- Poor record-keeping;
- Refusal to delegate or share access;
- Circumventing established purchasing and authorization procedures.

Evaluations & Performance Improvement Plans as internal controls:

- Help detect early warning signs;
- Enforce compliance;
- Create a defensible record that supports investigations and legal processes.

# Segregation of Duties - Example

## Two Person Office

| Bookkeeper   | CEO or Owner/Manager  |
|--|---|
| <ul style="list-style-type: none"><li>• Record accounts receivable entries</li><li>• Mail checks/authorize electronic payments</li><li>• Write checks</li><li>• Record general ledger entries</li><li>• Reconcile bank statements</li><li>• Record credits/debits in accounting records</li><li>• Approve payroll</li><li>• Receive cash</li><li>• Disburse petty cash</li><li>• Authorize purchase orders</li><li>• Authorize check requests</li><li>• Authorize invoices for payment</li></ul> | <ul style="list-style-type: none"><li>• Approve and sign checks</li><li>• Sign employee contracts</li><li>• Complete deposit slips</li><li>• Perform interbank transfers</li><li>• Distribute payroll</li><li>• Reconcile petty cash</li><li>• Approve employee time sheets</li><li>• Process and approve vendor invoices</li><li>• Review bank reconciliations</li><li>• Prepare/approve annual budget</li><li>• Review monthly financial statements</li></ul> |

# Segregation of Duties - Example

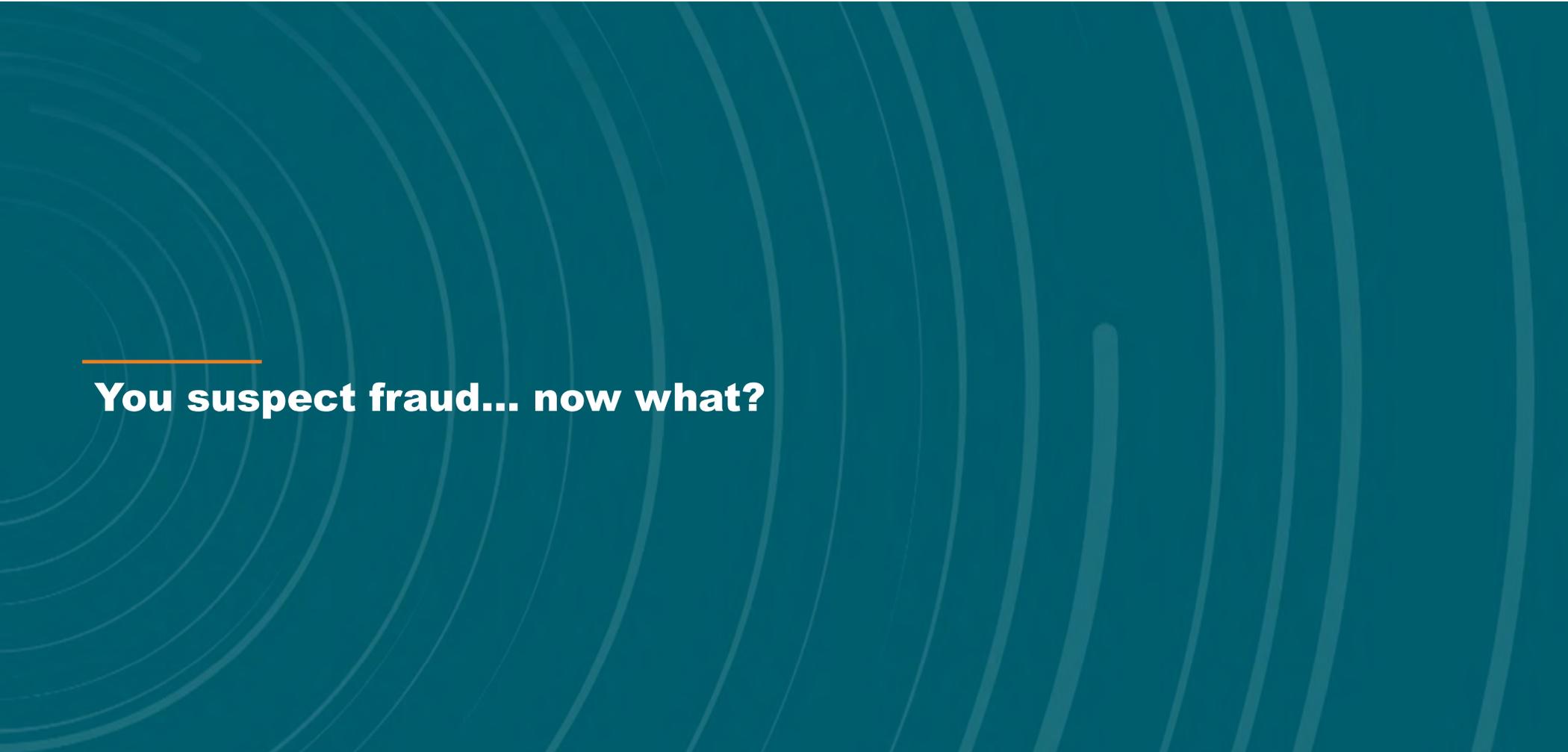
## Three Person Office

| Bookkeeper  | Office Manager  | CEO or Owner/Manager   |
|---|---|--|
| <ul style="list-style-type: none"> <li>• Record accounts receivable entries</li> <li>• Reconcile petty cash</li> <li>• Write checks</li> <li>• Record general ledger entries</li> <li>• Reconcile bank statements</li> <li>• Record credits/debits in accounting records</li> </ul> | <ul style="list-style-type: none"> <li>• Process vendor invoices</li> <li>• Receive cash</li> <li>• Mail checks/authorize electronic payments</li> <li>• Approve invoices for payment</li> <li>• Distribute payroll</li> <li>• Authorize purchase orders</li> <li>• Authorize employee timesheets</li> <li>• Approve payroll</li> <li>• Disburse petty cash</li> <li>• Prepare annual budget</li> </ul> | <ul style="list-style-type: none"> <li>• Sign checks</li> <li>• Sign employee contracts</li> <li>• Complete deposit slips</li> <li>• Perform interbank transfers</li> <li>• Review bank reconciliations and contents of bank statements</li> <li>• Approve annual budget</li> <li>• Review monthly financial statements</li> </ul> |

# Segregation of Duties - Example

## Four Person Office

| Bookkeeper  | Clerk  | Office Manager  | CEO or Owner/Manager  |
|---|--|---|---|
| <ul style="list-style-type: none"> <li>• Record accounts receivable entries</li> <li>• Reconcile petty cash</li> <li>• Write checks</li> <li>• Record general ledger entries</li> <li>• Reconcile bank statements</li> <li>• Record credits/debits in accounting records</li> </ul> | <ul style="list-style-type: none"> <li>• Distribute payroll</li> <li>• Receive cash</li> <li>• Disburse petty cash</li> <li>• Authorize purchase orders</li> <li>• Authorize check requests</li> <li>• Mail checks</li> <li>• Authorize electronic payments</li> </ul> | <ul style="list-style-type: none"> <li>• Complete deposit slips</li> <li>• Process vendor invoices</li> <li>• Approve payroll</li> <li>• Approve invoices for pay</li> <li>• Prepare annual budget</li> </ul> | <ul style="list-style-type: none"> <li>• Sign checks</li> <li>• Sign employee contracts</li> <li>• Approve employee timesheets</li> <li>• Perform interbank transfers</li> <li>• Review bank reconciliations and contents of bank statements</li> <li>• Approve annual budget</li> <li>• Review monthly financial statements</li> </ul> |



**You suspect fraud... now what?**

# INITIAL RESPONSE

- Limit the suspected individual's access.
- Avoid alerting suspect to prevent destruction of evidence or retaliation
- Preserve evidence: documents, emails, logs.

Fraudsters often violate employment norms to conceal fraudulent activity. **These behaviors are serious policy breaches and can justify immediate termination to prevent evidence tampering or removal.**

- Notify



# SECONDARY RESPONSE

- Initiate investigation
- Outside law enforcement agency in coordination with accounting professional
- Fraud Examination/Audit
  - What might examiners/auditors do?
    - Understand transaction cycles/processes (controls)
    - Observe actual processes
    - Count cash
    - Perform fraud interview questions
    - Perform additional audit procedures
    - Make internal control process recommendations





# **Recovery & Insurance**

# FINANCIAL RECOVERY

- Restitution
  - Seek repayment through civil/criminal proceedings – usually only a fraction of loss
- Role of insurance
  - Crime coverage policy
  - Submit claim to insurance
  - Insurance may seek repayment through civil/criminal proceedings



# REPUTATIONAL RECOVERY

- Transparency – Reactive AND Proactive
  - Reactive: be prepared with a press release at start in case it gets out before charges filed.
    - Pending investigation, cannot comment, will at conclusion of investigation.
  - Proactive: once charges are filed, frame the narrative about what you DID.
    - Staff noticed anomalies and reported.
    - We froze access to preserve evidence.
    - We initiated an investigation.
    - Reviewed/updated policies and procedures to prevent future occurrences.
    - We will seek restitution for the loss.
- Role of insurance
  - Crime coverage policy
  - Submit claim to insurance
  - Insurance may seek repayment through civil/criminal proceedings

MEET THE TEAM



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**Please reach out if you have any questions!**