

System-Wide Fraud Awareness Project

Final Report
June 14, 2006

This report is being released as a public document at the June 20, 2006 meeting of the Minnesota State Colleges and Universities Audit Committee.



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For the past few years, the audit committee deliberated the federal Sarbanes-Oxley Act and implemented some of its relevant provisions voluntarily. The committee concluded that existing Board Policy 1C.2, which had been implemented in June 2002 prior to passage of the Sarbanes-Oxley Act, already incorporated provisions consistent with the act's expectations for reporting fraudulent activities. Committee members wanted assurance, though, that colleges and universities were implementing their responsibilities under policy and sought an internal audit to assess compliance with selected provisions of Board Policy 1C.2. This project was added to the Internal Auditing plan for fiscal year 2006.

This study raises questions about the effectiveness of efforts to implement Board Policy 1C.2. It offers recommendations for increasing employees' awareness about their responsibilities for reporting evidence of fraudulent or other dishonest acts, training supervisors and managers, and creating a more effective alternative reporting channel for employees.

We conducted this audit in compliance with the *Institute of Internal Auditors: Standards for Professional Practice of Internal Auditing*. We completed an analysis of reported fraud investigations and interviewed employees, including fraud contacts and human resource directors from all MnSCU institutions. We are grateful to these employees for their assistance. In addition we reviewed documentation supporting each institution's fraud reporting infrastructure and educational techniques.

Ms. Kim McLaughlin, Northeast Regional Audit Coordinator, was responsible for much of the lead work on this project, including the design of the interview questionnaires and data analysis. Other Internal Auditing Coordinators contributed significantly to this project.

Sincerely,

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BACKGROUND

President Bush signed the Sarbanes-Oxley Act in July 2002. The act was passed in response to cases of corporate corruption involving misconduct by senior executives. Although the act applied only to publicly traded companies, many other public and private organizations, including the Minnesota State Colleges and Universities (MnSCU), voluntarily adopted some of its provisions. The Board of Trustees amended Board Policy 1A.2 to clarify and strengthen the role of the audit committee consistent with several provisions contained in the act. The act also directed publicly traded companies to establish an anonymous reporting channel for reporting evidence of fraudulent financial reporting to an audit committee. The MnSCU audit committee concluded that Board Policy 1C.2, which was adopted by the Board of Trustees in June 2002, already incorporated provisions consistent with the act's expectations for reporting fraudulent activities.

Board Policy 1C.2 stipulates that “to ensure that MnSCU resources are used appropriately, managers and supervisors are responsible for educating employees about proper conduct, creating an environment that deters dishonesty and maintaining internal controls that provide reasonable assurance of achieving management objectives, and detecting dishonest acts.” The policy operationalizes state laws that require employees to report evidence of fraudulent acts. It cites the existence of anonymous reporting channels provided by the Minnesota Office of the Legislative Auditor and MnSCU Office of Internal Auditing. Key provisions of the policy are shown in Table 1.

During fiscal year 2003, Internal Auditing representatives met with the executive teams at each college and university to create an awareness of the new policy and to inform them of their responsibilities. Decisions about how to inform employees about their responsibilities under the policy were left to the discretion of each college and university.

As part of the fiscal year 2006 audit plan, the audit committee requested the Office of Internal Auditing to examine whether colleges and universities had implemented effective practices for informing employees about their responsibilities pursuant to Board Policy 1C.2. This project was designed to assess the effectiveness of actions taken to implement those aspects of the Board Policy 1C.2.

Table 1: Relevant Provisions from Board Policy 1C.2

	Provision	Board Policy Reference
Purpose	To ensure that MnSCU resources are used appropriately, managers and supervisors are responsible for educating employees about proper conduct, creating an environment that deters dishonesty and maintaining internal controls that provide reasonable assurance of achieving management objectives, and detecting dishonest acts.	Part 1
Applicability	This policy applies to all MnSCU trustees and employees, including faculty (full-time, adjunct and part-time faculty), administrative staff, and student employees.	Part 2
Responsibilities	An employee with a reasonable basis for believing fraudulent or other dishonest acts have occurred has a responsibility to report the suspected act in a timely manner. Reports should be made to the employee's immediate supervisor or manager, unless the employee suspects the supervisor or manager has participated in the condoned act. In that case, the employee should report the matter to the next highest level of supervision or management or directly to the college, university, or Office of the Chancellor Director of Human Resources. Employees are encouraged to report matters through their designated college, university or Office of the Chancellor channels, but may report any matters directly to the MnSCU Office of Internal Auditing.	Part 4 / Subpart B
Responsibilities	If it is determined that a fraud inquiry ¹ merits a fraud investigation ² , the president or Chancellor shall report the matter to the Office of Internal Auditing.	Part 4 / Subpart D
Reporting to the Board of Trustees and the Legislative Auditor	The Executive Director of Internal Auditing shall notify the Board of Trustees of any significant violations of law or board policies, as required by policy 1D.1, or any material departures from this policy. The Executive Director of Internal Auditing is responsible for reporting evidence to the Office of the Legislative Auditor as required by Minnesota Statutes 10.47, 43A.39, and 609.456, Subdivision 2 and, if federal funds are involved, to the responsible federal authority.	Part 9

Source: Board Policy 1C.2 Fraudulent or Other Dishonest Acts

¹ Per MnSCU Board Policy 1C.2 a fraud inquiry is the initial process for examining complaints, allegations, and other possible evidence of dishonest acts. The objective of a fraud inquiry is to determine whether sufficient evidence exists to warrant a fraud investigation.

² Per MnSCU Board Policy 1C.2 a fraud investigation is the process of collecting and examining evidence to determine whether a dishonest act involving possible criminal action or significant financial loss has occurred.

AUDIT SCOPE & METHODOLOGY

This project was designed to be a narrowly focused project. It was not intended to be a risk assessment or an internal control evaluation. The project objectives approved by the audit committee were to identify:

- The infrastructure that has been established by each institution for the reporting of improprieties.
- Methods used to educate employees about state statutes, fraud indicators, reporting responsibilities and reporting channels.

The audit methodology included interviewing the fraud contact(s) and human resource director at all colleges and universities and the Office of the Chancellor. Others, as requested by institution presidents, participated in the interview meetings. Internal Auditing also compiled a list of investigations that have been reported to it by colleges and universities from fiscal year 2004 through the beginning of our audit fieldwork. Table 2 provides a summary of the reported investigations.

Table 2: Reported Investigations – July 2003 – April 2006

MnSCU Components ^(a) with Unduplicated Annual Headcount ^(c)		Number of Reported Investigations		Classification of Investigations			
				Theft of Property		Other ^(b)	
		Total	Annual Average Per Component	Total	Annual Average Per Component	Total	Annual Average Per Component
> 750	7	99	4.71	64	3.05	35	1.67
> 500 and <= 750	12	118	3.28	95	2.64	23	.64
> 250 and <= 500	12	61	1.69	46	1.28	15	.42
<= 250	7	7	.33	5	.24	2	.10
Total	38	285	2.50	210	1.84	75	.66

- (a) Hibbing Community College, Itasca Community College, Mesabi Range Community and Technical College, Rainy River Community College and Vermilion Community College make up the Northeast Higher Education District, a consortium of 5 colleges. Northwest Technical College at Bemidji is aligned with Bemidji State University. For purposes of this analysis each of these colleges as well as the Office of the Chancellor was reviewed independently and results are merged with the remaining MnSCU institutions to arrive at a total of 38 MnSCU components.
- (b) Includes but is not limited to investigations resulting from violations of MS 43A.39 – Compliance with Law and 10.47 – Telephone Service.
- (c) Unduplicated Annual Headcount obtained from MnSCU ITS Management Reporting Website – 2006 Employee Salary Summary – All Funds.

Source: Database maintained by the MnSCU Office of Internal Auditing.

CONCLUSIONS

A significant risk remains that a large number of employees are not aware of their responsibilities under MnSCU Board Policy 1C.2. Most colleges and universities conduct new employee orientation that cites responsibilities for reporting evidence of dishonest acts. Most orientation programs, however, do not include all classifications of employees (e.g. adjunct or student employees) covered by policy 1C.2. Also, most MnSCU components do not provide employees with periodic fraud messages to remind employees of their responsibilities under policy 1C.2 and to reinforce the need to uphold the public trust. In addition, we found that supervisors and managers generally have not had appropriate training to fulfill their responsibilities under policy 1C.2. Finally, the effectiveness of mechanisms and channels for reporting incidents³ needs improvement.

1. A significant risk remains that a large number of employees are not aware of their responsibilities under MnSCU Board Policy 1C.2.

Audit work performed at 38 MnSCU components found that 26 components conduct a new employee orientation program that includes a section on responsibilities for reporting evidence of dishonest acts. Four components do not conduct a formal employee orientation. The remaining components have a new employee orientation program, but it does not include a section on reporting evidence of dishonest acts.

Of the 26 MnSCU components which have a new employee orientation program that includes a section on reporting evidence of dishonest acts, only one component covers all classifications of employees to which MnSCU policy 1C.2 applies. The other 25 components do not include at least one classification of employees to which the policy applies to the employee orientation. Student, temporary, and adjunct employees are commonly not included in new employee orientation programs.

Only 18 colleges and universities provide periodic reminders on a recurring basis to employees about their responsibilities to report evidence of fraudulent or other dishonest acts. Where periodic messages are communicated, it is common that they are not received by all classifications of employees covered by MnSCU policy 1C.2. Several college and university representatives expressed a reluctance to send periodic reminders because of concerns about unduly alarming employees and adversely affecting the environment of mutual trust. We believe, however, that such messages can be presented diplomatically and strengthen, rather than deteriorate the trust environment.

The value of sending periodic reminders to employees is illustrated by comparing the rates of reported investigations experienced by colleges and universities. Almost twice as many, or 39%, of the colleges and universities that sent periodic reminders to employees

³ Incident, as defined in the Office of Internal Auditing Guideline Number 3000: Fraud Incident Handling is any indicator of potential criminal conduct, violation of code of ethics, or misuse of long distance telephone service which requires a fraud inquiry and may lead to investigations and charges of fraud. Indicators include but are not limited to reports from sources, personal observations, media reports, etc.

reported at least a moderate rate of investigations per employee⁴, compared to institutions that did not send periodic reminders, or 20%.

The Office of General Counsel has a project underway to evaluate the need for a system-wide compliance function and a recommended structure for a compliance program. Many college and university systems, including the University of Minnesota, have created an independent compliance officer position or other compliance program structures. The University of Minnesota, Office of Institutional Compliance “provides independent oversight over the University of Minnesota’s compliance programs. The Director, who reports to the President, is responsible for coordinating and monitoring these programs to assure that the University is compliant with federal, state and local laws and regulations as well as University policies.”⁵ The compliance officer sends out an annual reminder to all University employees about their obligations to comply with the code of conduct and report evidence of dishonest acts. Whether or not a separate compliance officer position is created within MnSCU, the idea of transmitting a standard periodic reminder about ethical expectations to all MnSCU employees is worth exploring.

Recommendations

- *Colleges, Universities and the Office of the Chancellor need to improve the process of informing all employees, including faculty (full-time, adjunct and part-time), administrative staff, and student employees, of their responsibilities under MnSCU Board Policy 1C.2 as part of orientation programs and periodic reminders.*
- *Consideration should be given to creating a process for sending standard periodic reminders to all MnSCU employees about their reporting responsibilities under policy 1C.2.*

2. Supervisors and managers generally have not had appropriate training to fulfill their responsibilities under MnSCU Board Policy 1C.2.

Of the 38 MnSCU components surveyed, 35 of them did not provide supervisors and managers with explicit instruction on how to handle suspected wrongdoings brought to their attention. MnSCU Board Policy 1C.2, Part 4 subpart B instructs employees with a reasonable basis for believing fraudulent or other dishonest acts have occurred to report the suspected act in a timely manner to the employee’s immediate supervisor or manager, unless the employee suspects that the supervisor or manager has participated in or condoned the act. In that case, the employee should report the matter to the next highest level of supervision or management or directly to the college, university, or Office of the Chancellor Director of Human Resources. Where explicit instruction is not provided the likelihood of compliance with Board policy diminishes.

⁴ See finding 3 for an explanation of this metric.

⁵ Information from the University of Minnesota web site, <http://www.instcomp.umn.edu/about.html>, retrieved on June 8, 2006.

The Office of the Chancellor Human Resources Division has a project underway to develop training tailored specifically for MnSCU supervisory employees. This project presents an opportunity to incorporate a module on responsibilities for implementing Policy 1C.2.

Recommendations

- *Colleges, universities, and the Office of the Chancellor should ensure that supervisors and managers are aware of their responsibilities under Policy 1C.2.*
- *The Office of the Chancellor Human Resources Division should review the appropriateness of incorporating supervisory responsibilities for implementing Policy 1C.2 in its supervisory training course or develop an alternative method of delivering this training.*

3. The effectiveness of mechanisms and channels for reporting incidents needs improvement.

MnSCU Board Policy 1C.2 requires that colleges, universities and the Office of the Chancellor designate reporting channels. Design and implementation of reporting mechanisms and channels is at the discretion of each college, university and Office of the Chancellor and thus varies significantly. At the time of our review, all colleges and universities had designated a fraud contact and defined who would be responsible for conducting fraud inquiries. 31 colleges and universities and the Office of the Chancellor relied solely on the verbal reporting of incidents by employees to designated personnel. Two components had not defined reporting channels and four components had non-verbal reporting channels. Non-verbal channels include use of a voicemail tip box, suggestion boxes, web-based instant feedback to the president, and the use of an anonymous on-line silent witness program. Based on the number of reported investigations, the non-verbal reporting channels have been implemented with varying degrees of success.

Table 2 provides a summary of investigations that were reported to the Office of Internal Auditing from fiscal year 2004 through April 2006. On average, components reported 2.50 investigations per year. However, it should be noted that 7 components included in the average did not report any investigations during the 3-year period under review. Further, there was significant reporting variability among the 31 reporting components, with the total number of reported investigations ranging from 1 to 38 per component for the 3-year period.

Of the 285 reported investigations, 210 resulted from theft of property. Most property thefts involved missing equipment that was reported to local law enforcement officials for investigation. A few cases, though, involved cash shortages that required internal

investigations prior to referral to law enforcement. Seven colleges and universities reported more than ten property thefts during this period; 13 institutions and the Office of the Chancellor filed no theft reports during the period. The other 75 reported investigations resulted from potential misuse of telephone service or other state resources and possible violations of the code of ethics. The highest number of other matters reported for investigation by components surveyed was eight. Twelve components filed no investigations into other matters.

A common metric used to assess the effectiveness of processes for reporting evidence of fraud and unethical acts is the incident rate by which fraud is reported. An incident rate is determined by dividing the number of reported incidents by the number of employees in an organization. A commonly cited statistic is that organizations with effective communication channels should expect to have an incident rate in the range of 1-3%. In November 2005, the University of Minnesota implemented a web-based confidential system for reporting evidence of wrongdoing. The University consolidated several pre-existing reporting channels into this new system. It informed employees about the new reporting channel through its routine reminder to employees about ethical conduct, but did not alter its basic message to employees. After seven months of operation, the University has received 95 reports through the new system. Approximately 60% of these reports are categorized as routine human relations issues and according to the University Compliance Officer only a handful of reported incidents were without merit. Based on its early experience, the University would have an estimated incident rate of 0.54%. The University Compliance Officer expects that rate will increase as awareness about the system expands. Using the data in Table 2, a calculated incident rate for MnSCU⁶ is 0.42% for the three year period and suggests that too many incidents remain unreported.

An alternative reporting channel that exists for MnSCU employees is to file a report with the Minnesota Office of the Legislative Auditor (OLA). The OLA has guidance on its web site for persons wishing to file a report, but does not offer a web-based reporting mechanism. Thus, reports must be filed with Legislative Auditor via phone, e-mail, or in person. The OLA Director of Investigations estimated that the office receives about 100 reports per year through its existing channels for all of state government.

The new reporting channel implemented by the University of Minnesota last year, known as UReport, is purchased from a third party vendor. The system makes it easier for employees to file reports, allows them to protect their identity, facilitates case management, and enables reporters to determine that the matter has been resolved. Many corporations, and increasingly colleges and universities, have begun to implement similar systems. While earlier versions of such systems were reviewed by personnel in the

⁶ MnSCU does not capture sufficient data to calculate a full incident rate. The numbers cited in Table 2 are for reported investigations, not reported incidents. Policy 1C.2 requires that components conduct a fraud inquiry on any evidence of possible wrongdoing and report for investigation only those matters warranted by the evidence. Thus, inconsequential matters or misperceptions may be dismissed following an inquiry and not result in a reported investigation. Accordingly, the MnSCU reported investigation statistics would somewhat understate its actual incident rate.

Office of the Chancellor and the Office of Internal Auditing two years ago, another review of available services may be warranted at this time.

Recommendation

- *The Chancellor should explore developing alternative reporting mechanisms for use by employees at MnSCU colleges, universities and the Office of the Chancellor.*