



**Howard S. Weitzman**

Nassau County Comptroller  
State of New York

# *Resource Guide on Fraud*

*Facts, Lessons Learned  
& Best Practices*

*Statewide initiative to rebuild  
public trust in school districts*

**Prepared by:**

**Manny Mosquera**  
Deputy Comptroller for Audits

**Aurora Scifo**  
Senior Project Manager

# Fraud Facts, Lessons Learned and Best Practices

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# Fraud Facts, Lessons Learned and Best Practices

## I. Purpose

This resource guide was prepared to help you prevent fraud in school district administration. Like fraud in the private sector, fraud in government institutions, including public school systems, is probably impossible to eradicate completely. Nevertheless, School Board members, and school administrators and staff, must be vigilant in ensuring that adequate measures are in place to eliminate opportunities to commit fraud, in properly training and supervising staff, and in recognizing and rooting out problems as soon as they surface.

The “Lessons Learned” section of this guide describes private sector experiences applicable to the public sector. In addition, other topics covered include strategies for detecting, deterring, and preventing fraud.

## II. Fraud Facts

**Source: 2004 Report to the Nation on Occupational Fraud & Abuse**, published by the Association of Certified Fraud Examiners (ACFE), a provider of anti-fraud training and education. The 2004 Report is the ACFE’s third study on Occupational Fraud and Abuse. The first study was done in 1996, followed by a second study in 2002.

### ACFE Definition of Occupational Fraud:

“The use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.”

The 2004 Study:

- Covered 508 Occupational Fraud Cases that were reported by Certified Fraud Examiners (CFEs)

## Fraud Facts, Lessons Learned and Best Practices

- Totaling over \$761 million in losses
- Six areas of focus
  - A. Cost of Occupational Fraud
  - B. Fraud Methods & Fraud Detection
  - C. Fraud Victims
  - D. Perpetrators of Occupational Fraud
  - E. Legal Outcomes of Fraud Cases

### A. Cost of Occupational Fraud

The cost of occupational fraud is based on estimates. The true cost is nearly impossible to determine because fraud is a crime based on concealment. Many frauds are:

- Never detected, only uncovered after they have gone on for several years or detected and never reported.
- The estimates are based upon the Certified Fraud Examiners' expert knowledge & experience with fraud.

### Cost For 2004 (According to the ACFE's 2004 Report)

- Estimated at 6% of the Annual
  - Revenue for a typical organization
  - Budget for government agencies
- Translates into \$660 Billion in annual fraud losses when multiplied by the 2003 Gross Domestic Product.
- Median Loss for all Cases - \$ 100,000
  - Losses in 20% of the Cases - \$ 500,000 & Up
  - Losses in 15% of the Cases - \$1,000,000 & Up

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## B. Fraud Methods & Fraud Detection

Frauds are classified by the ACFE according to their Uniform Occupational Fraud Classification, commonly known as the Fraud Tree.

The Fraud Tree has three main branches:

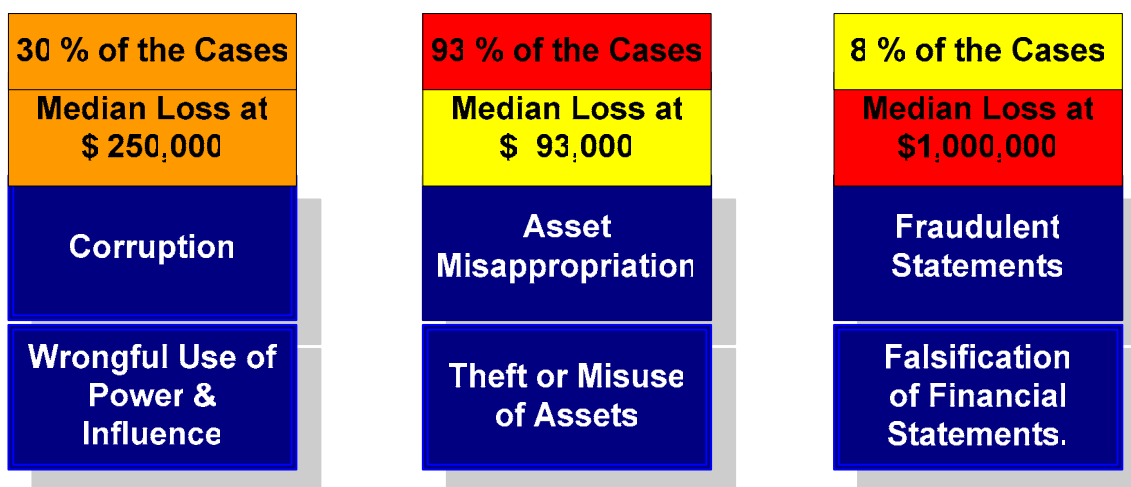
- Asset Misappropriation - Theft or misuse of assets
- Corruption - Wrongful use of influence and power to achieve a benefit contrary to their duty to their organization.
- Fraudulent Statements - Falsification of financial statements and/or other organizational documents.

**Note: The Fraud Tree Diagrams shown on the following pages were prepared using the data contained in the charts and text of the ACFE's 2004 Report.**

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## Fraud Methods – Fraud Tree- Main Branches

### Study of 508 Cases of Occupational Fraud



**MANY CASES INVOLVED MORE THAN ONE OF THE THREE MAJOR TYPES OF OCCUPATIONAL FRAUD**

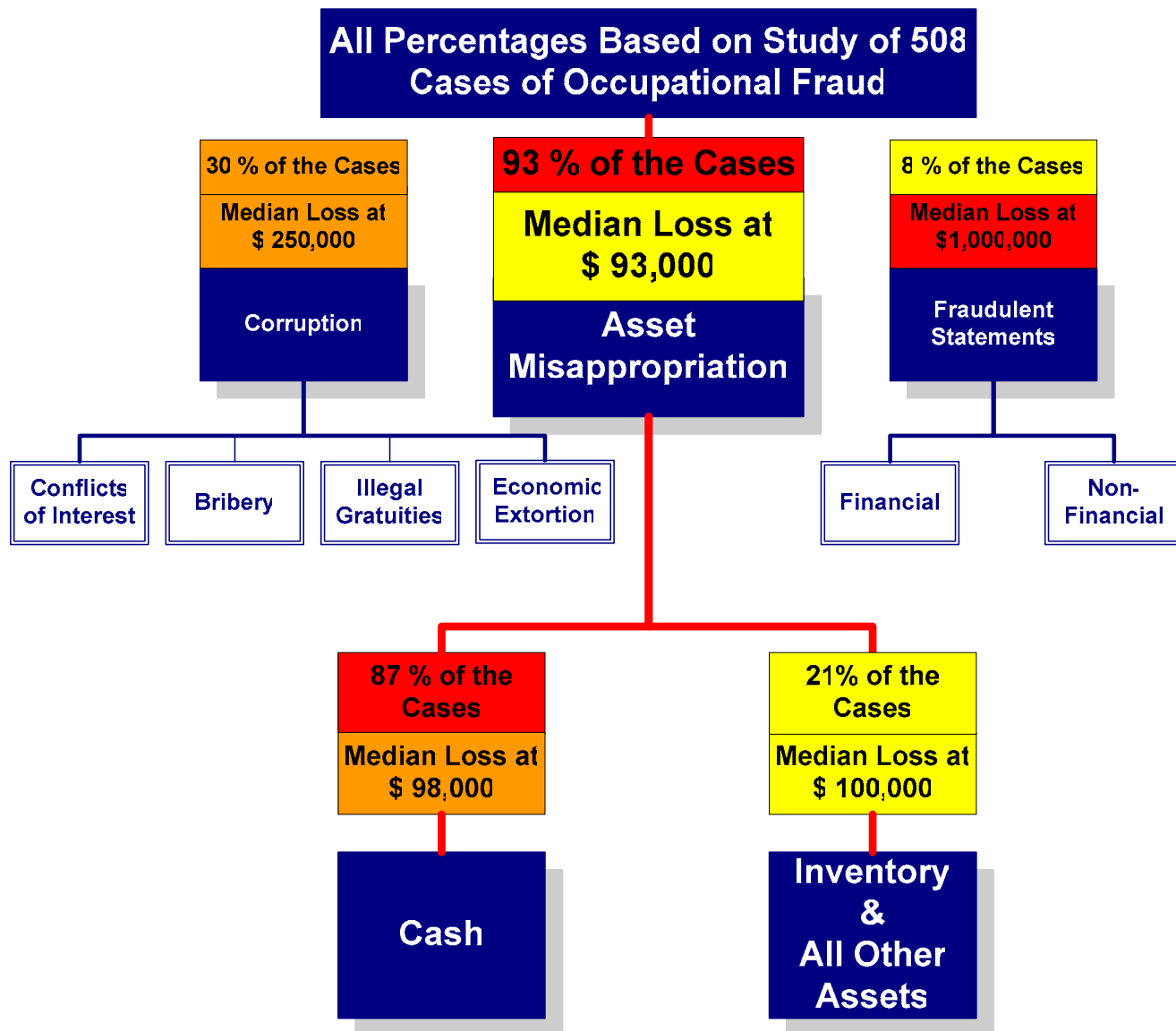
#### ASSET MISAPPROPRIATIONS

The most commonly reported of the three types of fraud, but these schemes accounted for the lowest median loss.

#### FRAUDULENT STATEMENTS

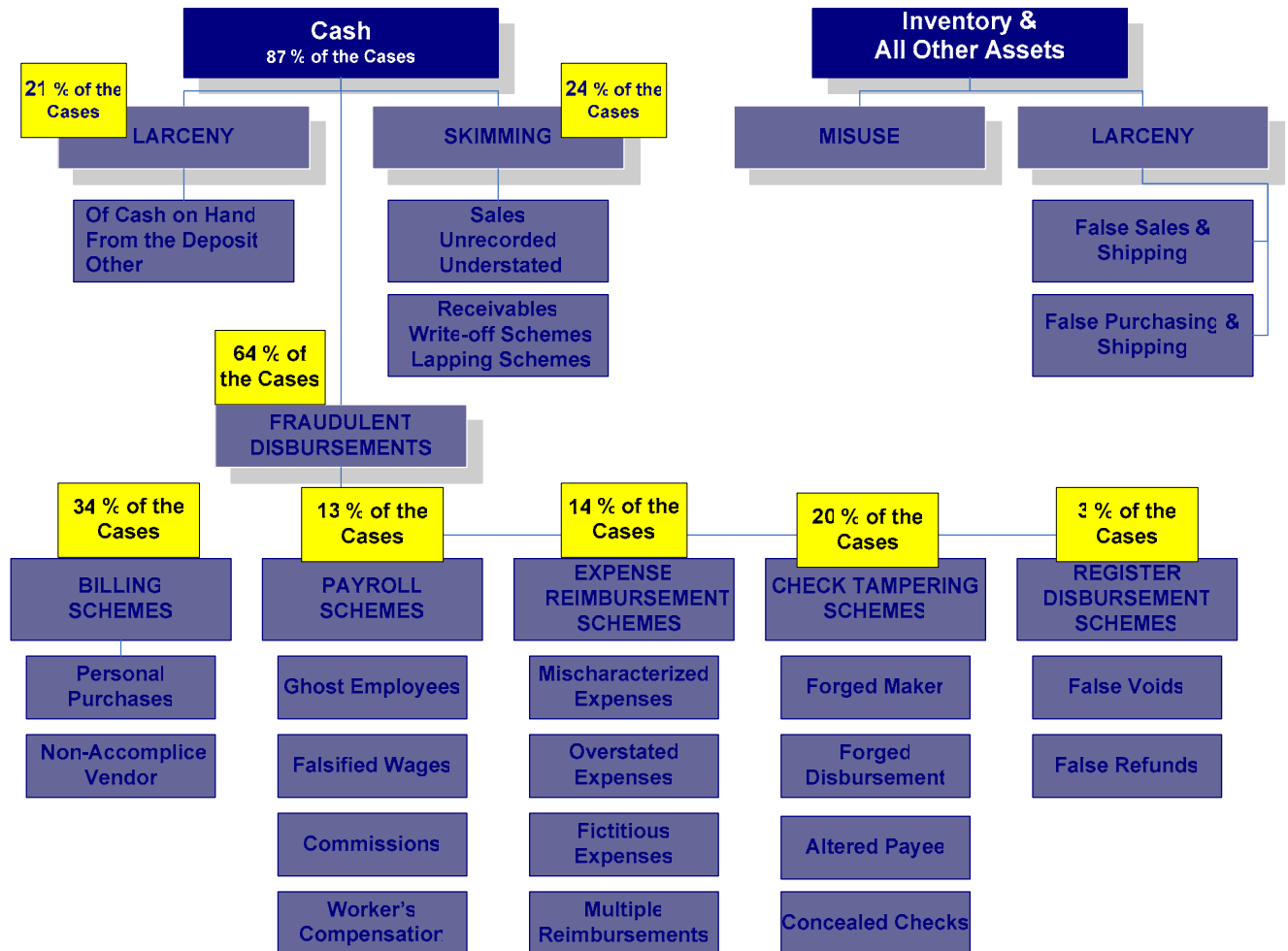
The least commonly reported of the three types of fraud, but these schemes accounted for the highest median loss.

# Fraud Facts, Lessons Learned and Best Practices



# Fraud Facts, Lessons Learned and Best Practices

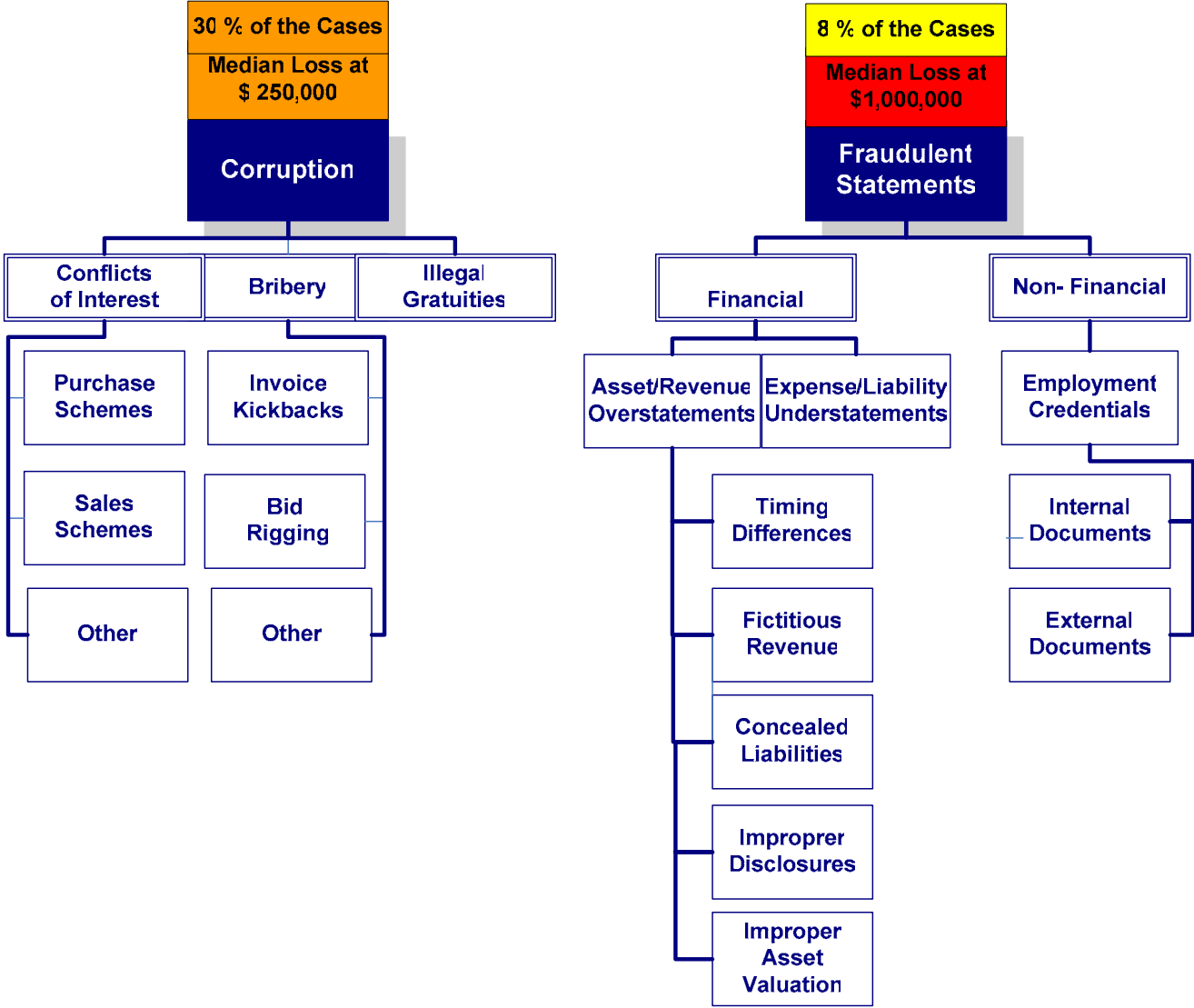
## Fraud Tree – Asset Misappropriations



**NOTE: All percentages are based on the entire pool of 508 cases**

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## Fraud Tree Corruption & Fraudulent Statements



# Fraud Facts, Lessons Learned and Best Practices

## C. Fraud Victims

- Although most of the frauds in the 2004 Study occurred in privately held or publicly traded companies, government & not-for-profit organizations were well represented.
  - Private 42% of the Cases
  - Public 30% of the Cases
  - Government 16% of the Cases
  - Not-for-Profit 12% of the Cases
  
- 46% of the frauds involved small businesses, defined as employing less than 100 people.

## D. Perpetrators of Occupational Fraud

- People who use their position of power and influence for personal enrichment through deliberate misuse or misapplication of the organization's resources.
  
- Key factors about the perpetrator that affect the frequency and size of occupational fraud are:
  - Position & Level of Authority
  - Income, Tenure, Age, Education, Gender

## Fraud Facts, Lessons Learned and Best Practices

### Perpetrator Profile in Terms of The Frequency of Fraud & Median Loss \$

Perpetrator Factors	Frequency of Occupational Fraud	Amount of Median Loss \$
As Level of Authority Increases	Decreases	Increases
As Annual Income Increases	Decreases	Increases
As Length of Employment Increases	Increases	Increases
As Age Increases	Increases	Increases
As Level of Education Increases	Decreases	Increases
Gender is Male	Even with Female	Increases
More than One Perpetrator	Decreases	Increases
Repeat Offender	Very Low	N/A

**Note: The data in the chart above was extracted from the text of the ACFE 2004 Report.**

## Fraud Facts, Lessons Learned and Best Practices

Perpetrator Factors	Perpetrator Factors	Frequency	Amt of Median Loss
Level of Authority	Employee	68%	\$ 62,000
	Manager	34%	\$ 140,000
	Owner/Exec	12%	\$ 900,000
Annual Income	Under 50,000	51%	\$ 47,000
	\$50M-\$100M	29%	\$ 135,000
	\$100M-\$150M	11%	\$ 429,000
	Over \$150M	9%	\$ 200,000 - \$ 2MM
Length of Employment	0-2 Years	27%	\$ 26,000 - \$ 50,000
	3-5 Years	27%	\$ 98,000
	6+ Years	46%	\$ 120,000 - \$ 171,000
Age	Under 30	17%	\$ 18,000 - \$ 25,000
	30 – 40	34%	\$ 75,000 - \$ 80,000
	Over 40	49%	\$ 173,000- \$ 527,000
Level of Education	High School or Less	50%	\$ 50,000
	Bachelor Degree	41%	\$ 150,000
	Postgraduate	9%	\$ 325,000
Gender	Male	53%	\$ 160,000
	Female	47%	\$ 60,000

**Note: The data in the chart above was extracted from the text of the ACFE 2004 Report.**

## **Fraud Facts, Lessons Learned and Best Practices**

### **E. Legal Outcomes of Fraud Cases**

#### ➤ **Employment Outcomes**

- In the majority of cases, the perpetrator of the fraud was fired, quit or disappeared.
- Sometimes the perpetrator entered into a restitution agreement.
- Much less frequently, the perpetrator was put on probation, suspended or not punished.

#### ➤ **Criminal Prosecution**

- The majority of cases were referred for criminal prosecution.
- Common reasons for declining to take legal action include fear of bad publicity & private settlements.
- When referred, the majority of fraud perpetrators pleaded guilty or were convicted at trial; less than 2% were acquitted.

#### ➤ **Civil Action was less common than criminal referral & prosecution**

- Typically only brought in very large cases.
- Expensive & time consuming.

# Fraud Facts, Lessons Learned and Best Practices

## III. Common Fraud Myths and Learned Truths

The “common fraud myths” and “learned truths” recited below relate to experiences in the private sector. However, they are also applicable to government operations, including the operations of public school districts.

### Myth 1:

- What we hear about in the news concerns giant fraud schemes at major private sector companies. It can't happen at our company (or in our school district), because
  - “We're too small,” “We're in a different business,” “We're different”
  - “Our employees have worked here a long time”
  
- Truth:
  - Fraud can occur in any company, in any industry, governmental entity, or public school system, regardless of size, and location.
  - Employees frequently commit fraud, a member of the management team or both.
  - All it takes for fraud to invade a company, governmental entity, or public school system is:
    - ⇒ A little travel expense abuse, inventory that walks away
    - ⇒ A purchasing department that has a "special" arrangement with a vendor or a bogus vendor.
  
- Relevant Fraud Fact:
  - According to the ACFE's 2004 Report, the average organization loses 6 percent of revenue, or \$9 per day per employee, to fraud and abuse.
  - When applied to the country's Gross Domestic Product, the 6% translates to approximately \$660 Billion in total losses!

## Fraud Facts, Lessons Learned and Best Practices

### Myth 2:

- The giant fraud schemes were so big that they should have been uncovered sooner and have been easy to detect.
  
- Truth:
  - Fraud starts small and just gets bigger and bigger, until something becomes noticeably different or unusual.
  - Fraudulent transactions are not easy to detect. They are not nicely recorded and categorized in financial statement captions entitled,
    - “Revenue from fraud schemes”
    - “Inappropriate expenditures”
    - “Write off for stolen goods”
  - The impact of fraud frequently appears in several places in the financial statements and is not easy to detect.
  
- Relevant Fraud Fact:
  - According to the ACFE's 2004 Study, 40% of the frauds were detected through tips. Internal audits and internal controls were responsible for the detection of fraud in 18.6% & 15.4% of the frauds, respectively.

### Myth 3:

- We really only need to make sure a potential new hire can produce references. And depending on how impressed we are with the person, we may not even check the references. It's usually just a waste of time because no one ever says anything negative anyway.

## Fraud Facts, Lessons Learned and Best Practices

- Truth:
  - Dishonest employees look just like everyone else.
    - ⇒ They often impress us, dress professionally and speak well.
    - ⇒ They are frequently the people we least suspect.
  - Reference checking does not always just provide positive feedback.
  - It's more than reference checking, it's an assessment of a key component of the company's ongoing culture, the character of its employees.
    - ⇒ Criminal Check

### IV. Key Lessons Learned from the Private Sector.

- The most cost-effective way to deal with occupational fraud is to prevent it.
- Existing corporate governance and oversight models were not adequate to prevent, deter or detect fraud.
- Some common statements concerning a failure to change the governance and oversight environment:
  - “If we do what we have always done, we will get what we have always gotten”
  - “The definition of insanity is to keep doing the same thing and expect a different result”
- Occupational fraud schemes typically involve inappropriate revenue recognition, costs and expenses and are often cloaked behind large complex transactions that are not readily apparent to the entity's auditors.

## Fraud Facts, Lessons Learned and Best Practices

- With Enron, for example:
  - ◆ Senior management knowingly:
    - ⇒ Overstated revenue by recording round-trip trades as sales.
    - ⇒ Hid billions of dollars of debt in off-balance sheet partnerships, which overstated equity.
    - ⇒ Gave the investment community a false impression of the company's financial condition.
  - ◆ Dispelled the old-fashioned idea that auditors, directors & stock analysts will put the interests of shareholders above their own thirst for fees.
  - ◆ Highlighted the existence of serious individual character flaws that enabled the managers who knew something was badly wrong to look the other way and not say anything publicly, until the subpoenas began to arrive.

### The lessons are ongoing

The lessons appear to be ongoing as accounting practices at many well-known established companies continue to raise eyebrows. Some examples are:

- TYCO

Tyco denies that it bolsters earnings growth by taking excessive write-downs for merger costs and using them later.
- GENERAL ELECTRIC

GE says it doesn't smooth quarterly profits by carefully matching one-time gains and losses and by boosting income from its pension plan.
- AMR

The parent company of American Airlines, like many airlines, owes billions of dollars in long-term lease agreements that do not show up as debt on the balance sheet but for which it is liable.

## **Fraud Facts, Lessons Learned and Best Practices**

### ➤ XEROX

Xerox is contesting a Securities and Exchange Commission warning not to book revenue from leased copiers as if they had been sold.

### ➤ KMART

Now bankrupt, the discount chain says it is investigating the possibility that improper accounting methods distorted its balance sheet

## V. The Context of Sarbanes-Oxley

### Background

- The Sarbanes-Oxley Act was signed into law by President Bush on July 30, 2002.
- The Act applies to publicly held companies and their audit firms.
- The Act represents a major shift in how corporations are required to govern themselves.
- The Act's provisions impose requirements aimed at decreasing corporate fraud by:
  - Strengthening board & audit committee oversight
  - Increasing auditor vigilance & independence
  - Strengthening Internal Controls & Risk Management
  - Creating accounting fraud penalties with significant deterrent effect

### Five Keys to Value Added Sarbanes-Oxley Implementation

1. Appreciate the goal behind Sarbanes-Oxley
2. Understand the fraud concept
3. Aggressively address unethical attitudes and the potential for rationalizing fraud
4. Consciously go beyond simple compliance
5. Investigate & implement enterprise risk management (ERM)

## Fraud Facts, Lessons Learned and Best Practices

### Key 1 - Appreciate the goal behind Sarbanes-Oxley

- The overall goal is preventing fraud.
- “Buy-In” to Fraud Prevention is crucial to building the right organizational mindset.
- The right organization mindset is helpful in persevering through the more onerous and tedious implementation tasks.

### Key 2 - Understand the fraud concept (the fraud triangle)

- Pressure/Incentive - the reason to commit accounting fraud.
- Opportunity - the opportunity to commit accounting fraud (ex: internal control weakness).
- Attitude/Rationalization - the justification for committing the accounting fraud.

### Key 3 - Aggressively address unethical attitudes and the potential for rationalizing fraud

- This is the most difficult fraud ingredient to address because attitude and rationalization involve:
  - An unobservable mind-set.
  - Questionable “Gray Zone” behaviors, which are not completely acceptable, but not clearly inappropriate.
  - The ability of senior management and employees to explain away questionable “Gray Zone” behaviors.
- The pathway from the Gray Zone to outright fraud is guided by Attitude and Rationalization.

## Fraud Facts, Lessons Learned and Best Practices

- Examine and understand the mindset of:
  - Private Sector Fraud – which does not put employees and shareholders first.
  - Government (including public school district) & Not-For-Profit Fraud - which does not put taxpayers, donors and beneficiaries (students) first.

### Key 4 - Consciously go beyond simple compliance

- Be Aware of the tendency and danger of focusing on compliance for compliance's sake.
- Go beyond “Check the Box” implementation approach.
- Explore governance best practices to enhance the oversight process.
- Leverage internal control work to actually improve controls.

### Key 5 - Investigate & implement enterprise risk management (ERM)

- ERM is a process that goes beyond internal controls to provide a system to address organizational risks in a comprehensive fashion as opposed to dealing with individual risk types.
- Overall Goal of ERM – to provide reasonable assurance of achieving organizational objectives in the spirit of preventing disasters and maximizing entity value.
  - In Four Areas: Strategy, Operations, Reporting & Compliance.

# Fraud Facts, Lessons Learned and Best Practices

## Sarbanes Oxley - Applicability to Government

Two questions posed in an interview with the US Comptroller General – David M. Walker, Head of the Government Accountability Office (GAO).  
(Source: July/August 2004 Issue of ACFE, the article entitled “Truth, Transparency, and Accountability with no Political Agenda”, by Dick Carozza.

Question # 1 - “To what extent should the provisions of the Sarbanes-Oxley Act (SOX) be applied equally to Governmental Entities & their leaders?”

Mr. Walker’s answer included the following statements:

- “I believe that government officials need to get the message from the recent problems in, and reforms related to, the private sector.”
- “I also believe that we need to use the related lessons learned to help modernize and transform the government’s accountability.”
- “Leaders of government organizations need to evaluate the extent to which these provisions have been implemented in their entities or could be implemented to improve accountability and management in government while reducing risk in a cost-beneficial manner.”

Question #2 - “Have some of the SOX provisions that could be relevant to the public sector already been enacted through other legislation or rulemaking?”

Mr. Walker’s answer included the following statements:

- “Some state and local governments and federal government corporations and agencies have adopted audit committees, or “financial management advisory committees” in their approach to governance.”

## Fraud Facts, Lessons Learned and Best Practices

- “In the federal government, such committees are intended to protect the public interest by promoting and facilitating effective accountability and financial management by providing independent, objective and experienced advice and counsel, including oversight of audit and internal control issues.”
- “In fact, the GAO has an audit advisory committee on a voluntary basis since 1995.”

### VI. Best Practices to Detect, Deter & Prevent Fraud

#### Definitions:

Detection - Identify fraud.

Deterrence - Persuade individuals not to commit fraud.

Prevention - Reduce opportunities to commit fraud.

#### Three Fundamental Elements to Detect, Prevent & Deter Fraud

1. Create an Ethical and Honest Culture.
2. Develop, Implement, Evaluate Antifraud Processes & Controls.
3. Develop an Oversight Process.

#### 1. Create an Ethical and Honest Culture

##### ➤ Establish the “Tone at the Top”

- Words and actions are consistent and show that unethical behavior will not be tolerated.
- Implement a strong value system, code of conduct.

##### ➤ Creating a positive work environment

- Recognize and acknowledge compliance.
- Establish a means to report violations.

## **Fraud Facts, Lessons Learned and Best Practices**

### ➤ Hiring and promoting appropriate employees

- Perform background investigations.
- Obtain and check education, employment and personal references.
- Provide code of conduct training.
- Performance evaluations - Include compliance with the code of conduct.

### ➤ Provide Ethics Training - When hired & periodic refreshers

- Obtain written confirmation that each employee has read, understood and agreed to comply with the code of conduct
- Obtain the written employee confirmation upon employment and as part of an annual recertification process.

### ➤ Discipline

- Develop the action plan to be followed for non-compliance and/or if fraud is suspected.
  - Investigate all complaints, allegations, suspicious activity, etc.
  - Establish and enforce clear consequences.
  - Communicate consequences through training.
  - Continually assess discipline's effectiveness and make changes where/when necessary or prudent.

2. Develop, Implement, and Evaluate Antifraud Processes and Controls  
Fraud occurs in the presence of a perceived opportunity to commit and conceal the act. Local governments, and school districts, can be proactive in reducing fraud opportunities by:

## Fraud Facts, Lessons Learned and Best Practices

- Identifying & evaluating fraud risks and vulnerabilities.
- Mitigating identified fraud risks.
- Implementing and monitoring effective internal controls such as:
  - Performing a risk assessment.
  - Creating an effective internal control environment.
  - Designing & implementing internal control processes & procedures.
  - Communicating & sharing information.
  - Monitoring activities.
- Think “fraud risk factors”
  - Distinguish an internal control weakness from a fraud risk factor.
  - An internal control weakness may be a fraud risk factor to the extent it helps to create an opportunity to commit fraud (3<sup>rd</sup> point of the Fraud Triangle).

### 3. Develop an Oversight Process- Oversight can be performed by many

- Management’s role
  - Design the internal control over financial reporting.
  - Design & implement programs & controls to prevent, deter & detect fraud.
  - Set the proper tone at the top.
  - Create a culture of honesty & high ethical standards.
  - Certify in its annual report that the organization has established effective internal control over financial reporting.

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- Internal Auditor's role.
  - Work in conjunction with management and the outside auditors to achieve compliance with § 404 of Education Law.
    - Primarily responsible for auditing claims.
    - Role can be expanded to include examining the adequacy & effectiveness of the district's internal controls, and making recommendations where control improvements are needed.
    - Should be independent of the operation he/she is auditing.
    - Organizationally independent (reporting directly to the audit committee or the board).
    - Should reports findings to the audit committee or the board.
  
- Role of outside public accounting firm
  - Attest to management's assertion regarding both internal control over financial reporting & the operating effectiveness of such controls.
  - Evaluate antifraud programs & controls.
  
- Establish overall oversight by an Audit Committee

Oversees the accounting & financial reporting processes and audits of the financial statements of a school district. Audit committees are tools that can help local governments and school boards increase accountability and deter fraud.

Adopt an Audit Committee Charter, which authorizes access to information, including all forms of documentation, of the school district, and provides investigative powers appropriate to fulfilling its responsibility.

## Fraud Facts, Lessons Learned and Best Practices

- Audit Committee Guidelines
  - Meet regularly (preferably monthly, at least quarterly).
  - Make regular inquiries to ensure that the public accountant remains independent.
  - Report its activities and findings to the governing board.
  
- Qualifications of Audit Committee Members
  - All audit committee members should be financially literate.
  - An understanding, through education or experience, of generally accepted accounting principles (GAAP) & audits of financial statements prepared under those principles.
  - Experience in internal governance & procedures of audit committees.
    - Obtained either as an audit committee member or an external auditor responsible for reporting on the execution and results of annual audits.
  
- NYS Comptroller and State Education Department (SED)
  - Both offices provide fiscal oversight in the form of audit services, training and technical assistance.