

# Best Practices

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## Foundations of Fraud: Need, Opportunity and Rationalization

### Understanding the Fraud Triangle is a First Step in Preventing Economic Crime

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*By Auditor of State Mary Taylor, CPA*

It's no secret that Ohio families are facing difficult budget decisions in this lingering recession and that local governments and school systems serving those families are dealing with fiscal challenges of their own. What may not be as well understood is the way this poor economy has increased the risk of fraud and other economic crimes committed by employees who are driven to steal from the workplace.

A study by the National White Collar Crime Center (NW3C) shows that every U.S. recession since the 1950s has generated an increase in white-collar crime. For example, after the savings and loan crisis of 1990, white-collar crime arrests jumped 53 percent. One commentator put it well: "When the going gets tough, the fraud gets going!"

Economic crime can impact public offices of every size, even those where officials believe they have sufficient controls in place. For example, my office recently investigated a former Toledo Public

Schools official who later worked for Cleveland Municipal Schools – two of the largest districts in Ohio. He has been accused of stealing more than \$800,000 from the two districts over a number of years, using elaborate purchasing schemes. In the much smaller Clyde-Green Springs Exempted Village School District in Sandusky and Seneca counties, a former superintendent stole nearly \$300,000.

It's also true that fraud in government is not confined to

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Dear Colleague,

While this recession has been with us for some time, only recently has its effect on workplace fraud become so apparent. Personal financial issues may increase the pressure for employees to steal in the workplace. Yet, even with the increased risk of fraud, some public-sector organizations tell themselves, "it can't happen here." Sadly, too many others have learned that fraud can – and does – happen here, no matter where "here" might be. And it happens in even the most careful organizations.

As public employees, entrusted to be stewards of taxpayer dollars, we must all continue to sharpen our fraud risk management tools. This issue of *Best Practices* provides information to assist you toward that goal, while our Web site [www.auditor.state.oh.us](http://www.auditor.state.oh.us) and training programs offer additional tools.

Thank you for your personal commitment to combating economic crimes in your organization. We appreciate your efforts and pledge that the Auditor of State's Office will be your active partner in the fight against fraud.

Sincerely,

Mary Taylor, CPA  
Ohio Auditor of State

## Foundations of Fraud: Need, Opportunity and Rationalization

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highly placed administrators or those directly overseeing accounts. Two examples investigated by my office: a college student working at a regional airport authority pleaded guilty to stealing more than \$68,000 in public funds and a part-time cafeteria worker for a rural school district is now under indictment for taking more than \$24,000 from cash receipts.

These are examples of public employees abusing power and taking advantage of organizations that lacked adequate controls. They serve as a warning that the size of your organization doesn't matter. An office or agency of any size can find itself a victim of fraud if it lacks proper internal controls and monitoring.

To appreciate the root causes of fraud – an important first step in preventing economic crime – it helps to understand the mindset of an employee who arrives at the decision to steal. Fraud prevention and detection training programs, including courses offered by the Auditor of State's Office, illustrate this motivation with the three points of the Fraud Triangle: **need**, **opportunity** and **rationalization**.

**Need** can be either real or perceived. An individual might feel the need for a luxury car or vacation home. There might

also be more pressing needs, like a house payment or credit card bills. With the current recession and high unemployment in Ohio, financial need could likely be an increasing motivation for crime.

**Opportunity** arises when someone is given control over funds without proper supervision. This could happen in many ways, such as requiring only a single signature on a check, allowing credit card purchases to be approved by the person who is using the card or not maintaining strict controls over which vendors are used.

**Rationalization** is another critical aspect of the decision to commit fraud. Most people do not have an innate desire to steal and individuals who do so often convince themselves that circumstances justify the crime. Rationalization may take many forms. In some cases, an individual may justify workplace theft by thinking the money can be paid back later. Often persons committing fraud think they are somehow "owed" the money they take, and therefore their crimes are justified. A thief might also rationalize by arguing that the organization is wealthy or wasteful, therefore stolen money won't be missed.

Realizing that fraud can happen at any level of government, it is important to conduct a risk assessment of your operation to find out where internal controls

may be weak. This would include looking at your policies and procedures to determine if internal controls and monitoring procedures are strong enough to deter and detect fraud in its many forms.

Once this assessment is complete, you can determine if implementing additional controls is worth it – based on your assessed risk. The Auditor of State’s Special Investigations Unit and Special Audit Section offer training on fraud prevention that can help organizations assess their risk and understand both the costs and benefits of additional controls.

Even with the best prevention methods, fraud and theft can still occur, which is why detection measures are critical as well. If you suspect fraud and want the Auditor of State’s Office to investigate, you should call the fraud hotline at 1-866-FRAUD-OH or go to [fraudohio.com](http://fraudohio.com). ■

## RISKY BUSINESS

### Three Places Where Fraud May Lurk

Fraud can strike any aspect of your organization, but it pays to be especially vigilant in three areas identified by the Ohio Auditor of State’s Office as particularly vulnerable to fraud and abuse:

**Reimbursement policies** can be abused when they are not specific. Having a complete, detailed policy can help prevent expensive charges for travel or inappropriate purchases of goods.

**Credit cards** also require a specific and detailed policy. In order to prevent abusive purchases, your policy should outline who is allowed to use cards and be certain to require receipts for all purchases. Additionally, approval for credit card purchases should be obtained in advance and one individual should never have the ability to approve a purchase they are making themselves.

**Vendor use** is another area that can pose a risk for fraud. If your vendor list is not properly maintained, there is the risk an individual might create false vendors, charge for certain equipment or supplies that are never received and keep the money for personal gain.

There is no need to reinvent the wheel when setting fraud-fighting policies for these and other areas of risk. Look at other leading practices used by organizations similar to your own, and then borrow those policies – in whole or in part – as they apply to your own organization.

## Senate Bill 7 Update

In May 2009, the Ohio Senate unanimously passed Senate Bill 7, legislation designed to help prevent fraud in public agencies. Knowing that tips are one of the most effective fraud-fighting tools, Auditor of State Mary Taylor is a strong proponent of this legislation and has long supported more rigorous controls for fraud prevention and detection in the public sector.

Under this bill’s provisions, the Auditor of State’s Office would continue to maintain the Ohio Fraud Hotline as a mechanism for individuals – public employees as well as private citizens – to make anonymous complaints regarding suspected government fraud. The bill would require public agencies to make all new employees aware of the hotline at the beginning of their employment.

Should the bill become law, public entities would also be required to make all their current employees aware of the new law’s provisions.

Senate Bill 7 would also provide whistleblower protection for anyone making a complaint of fraud to the Auditor of State’s Office. The Auditor of State’s Office would be required to check each public entity for compliance with the new law as part of the routine financial audit process.

At this time (early May 2010), Senate Bill 7 is awaiting consideration in the Ohio House. If passed as presently written, this bill would ensure continued operation of the Auditor of State’s Fraud Hotline and increase public awareness of ways to report complaints of fraud. ■

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## SPOTLIGHT:

# Bringing Fraud into Focus

## Don't Count on Your Annual Audit to Help Spot Fraud – Strong Risk Management Tools Are Needed for 20/20 Vision

*By Julia Debes - Public Affairs Staff Writer*

While no one wants it to occur, fraud will happen. And it doesn't discriminate. No organization – large or small, public or private, simple or complex – is immune. From the mailroom to the boardroom, the risk for potential damage from fraud is universal. For 2008 alone, the Association of Certified Fraud Examiners estimates that approximately \$994 billion was lost to fraud nationwide.

When it comes to preventing or detecting fraud, however, many organizations don't recognize the risks they face or don't believe that fraud warrants a specific risk management program – until it's too late. Instead, organizations may rely too heavily on financial audits to detect fraud, yet this practice demonstrates a lack of understanding of the risk of fraud and its potential impact.

"They don't know what they don't know," said Kevin Saionzkowski, chief of the Ohio Auditor of State's Special Audit Section. "They think financial audits will always find fraud."

Actually, external auditors are at a distinct disadvantage compared to fraud perpetrators. With limited powers and much to examine in a routine financial audit, auditors are not likely to catch all of the fraud that may have been committed.

Additionally, perpetrators know exactly what needs to be concealed and who is trying to find it.

According to Saionzkowski, "If you are relying solely on a financial audit to fight fraud, you aren't going to find it, you aren't going to prevent it and you are going to increase your risk."

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*"Preventing and deterring fraud is significantly less costly than confronting the financial, operational, and reputational repercussions that can result from fraud."*

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Unfortunately, many organizations do misinterpret the role of a financial audit. While an auditor will report evidence of potential fraud if it is found during a

financial audit, the auditor does not make the final determination if the misstatement was the result of error or if it was the result of fraud. According to the Statement on Auditing Standards (SAS) 99, "...auditors do not make legal determinations of whether fraud has occurred. Rather, the auditor's interest specifically relates to acts that result in a material misstatement of the financial statements."

Robert Hinkle, Chief Deputy auditor in the Auditor of State's Office, further explained that the biggest misconception is that the Auditor of State is responsible for controls. "Instead," he said, "our responsibility is to evaluate whether clients have properly designed controls to address risk and have put those controls into operation."

While auditors cannot opine on the cause of misstatements in

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financial reports, auditors will work with clients and provide recommendations on how to institute policies and procedures to prevent or detect fraud.

However, a financial audit is not a guarantee that no fraudulent activity has occurred. According to SAS 99, "...absolute assurance is not attainable and thus even a properly planned and performed audit may not detect a material misstatement resulting from fraud."

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*"If you are relying solely on a financial audit to fight fraud, you aren't going to find it, you aren't going to prevent it and you are going to increase your risk."*

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Fortunately, organizations have the ability to prevent, detect and even deter fraud – by having a plan. A fraud risk management plan is a structured framework that details the policies and procedures an organization will use to continually assess their risk of fraud, monitor exposure through prevention and detection techniques and provide a process for reporting fraud. By establishing and maintaining this system of checks and balances within the organizational structure itself, clients can detect fraud earlier or even prevent some fraud from occurring in the first place.

Additionally, each client should customize fraud risk management policies and procedures to fit their

organization. The size, complexity, competency of individuals involved in financial transactions and resources available are all important factors in determining how a client manages its risk of fraud.

"You don't want to boiler-plate it," Saionzkowski said. "Make the plan specific to your needs."

One example is segregation of job duties, or ensuring that no one individual handles any transaction from beginning to end. For instance, a very small organization may not be able to hire additional staff in order to ensure segregation of job duties. However, an auditor may suggest a different internal control to help prevent fraud from occurring in this situation. For example, an organization could require multiple signatures on checks, so that even if one person handles the transaction, multiple individuals are overseeing the process.

Even though the overall system may change slightly from organization to organization, some fraud risk management techniques are common to all. Implementation does not have to be complicated. Instead, entities can take big steps by doing simple things.

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*After a system is set in place, an organization must work to maintain its policies and procedures and take the time to evaluate their effectiveness.*

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For example, Hinkle explained, "The most common example of an internal control is one that you have with your family – reconciling with the bank at the end of the month." This seemingly simple task is just one way that organizations can help identify fraud.

There are two basic types of fraud risk management activities: prevention and detection. According to *Managing the*

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### Each entity should include the following elements in a fraud risk management plan:

- Roles and responsibilities
- Commitment
- Fraud awareness
- Affirmation process
- Conflict disclosure
- Fraud risk assessment
- Reporting procedures and whistleblower protection
- Investigation process
- Corrective action
- Quality assurance
- Continuous monitoring

Elements found in *Managing the Business Risk of Fraud: A Practical Guide*.

## Help Mary Taylor Fight Fraud

Every year, Auditor of State Mary Taylor identifies millions of public dollars – *your tax dollars* – which would have been lost to fraud, waste or misuse.

You can help fight this abuse by reporting any suspicions of fraud to the Auditor of State’s toll-free hotline or special fraud-reporting Web site.

Make Your  
**Tax Dollars Count**  
Report Government Fraud

**866-FRAUD-OH**  
(866-372-8364) toll-free



**fraudohio.com**

## Bringing Fraud into Focus

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*Business Risk of Fraud: A Practical Guide*, “Prevention encompasses policies, procedures, training and communication that stop fraud from occurring; whereas detection focuses on activities and techniques that timely recognize whether fraud has occurred or is occurring.” While detection methods are designed specifically to find fraud, they also work to ensure prevention methods are working.

It is important to note that developing these policies and procedures is not enough on its own. After a system is set in place, an organization must work to maintain its policies and procedures and take the time to evaluate their effectiveness.

Despite an organization’s best-laid plans, however, it is important to note that fraud still may happen.

“You could run the tightest ship and have the best fraud risk assessment and put all the best practices in place, and you can still have theft,” Saionzkowski said. “There is no silver bullet. No one thing or combination of things will reduce your risk of fraud to zero.”

For that reason, organizations should have a reporting process, directed by professional and legal standards. This investigative process should be consistent, tracked and able to maintain confidentiality. Having a system in place will improve an organization’s chances of recovering losses, minimizing

litigation and reducing damage to their reputation.

While some may grumble about the time and effort it takes to develop a fraud risk management plan, according to *Managing the Business Risk of Fraud: A Practical Guide*, “Preventing and deterring fraud is significantly less costly than confronting the financial, operational and reputational repercussions that can result from fraud.”

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*From the top down, it is important for organizations to set a tone that managing their risk of fraud is important to improving the way they conduct business.*

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The benefits of a fraud risk management plan are numerous, however, not a lot of organizations have one in place. Even if they do have a basic plan, the organization may not fully understand how to best manage their risk of fraud.

“In those entities that recognize fraud risk, their risk management activities do not always demonstrate an understanding of the specific risks and specific steps being taken to manage the risk,” Saionzkowski said.

Within organizations that manage public funds, having such a plan is a crucial commitment to reducing the risk of loss of taxpayer dollars.

Nevertheless, an official plan has to start with leadership.

“The very first thing that has to happen is that management has to see that it is valuable and be committed to it,” Saionzkowski said.

From the top down, it is important for organizations to set a tone that managing their risk of fraud is important to improving

the way they conduct business, and, according to Chief Deputy Auditor Hinkle, “...to properly care for the assets entrusted to them.”

More simply put, an organization’s leadership has “to be the champions,” Saionzkowski explained. “Otherwise, the rest of the organization is not going to care, and the entire risk management plan will fail.” ■

## Best Practices

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Check out a *Best Practices* web exclusive, featuring six organizations that have taken an active role in improving their financial audits.

From fraud to a failure to remit taxes, each has a lesson to teach about how hard work pays off at audit time.

Check it out at: [www.auditor.state.oh.us](http://www.auditor.state.oh.us)

## *Managing the Business Risk of Fraud: A Practical Guide* is a joint project sponsored by the Institute of Internal Auditors, American Institute of Certified Public Accountants and Association of Certified Fraud Examiners.

The publication suggests that entities follow five principles to manage their risk of fraud:

1. As part of an organization’s governance structure, a fraud risk management program should be in place, including a written policy (or policies) to convey the expectations of the board of directors and senior management regarding managing fraud risk.
2. Fraud risk exposure should be assessed periodically by the organization to identify specific potential schemes and events that the organization needs to mitigate.
3. Prevention techniques to avoid potential key fraud risk events should be established, where feasible, to mitigate possible impacts on the organization.
4. Detection techniques should be established to uncover fraud events when preventive measures fail or unmitigated risks are realized.
5. A reporting process should be in place to solicit input on potential fraud, and a coordinated approach to investigation and corrective action should be used to help ensure potential fraud is addressed appropriately and timely.

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Ohio Auditor of State  
**Mary Taylor, CPA**

88 East Broad Street, 5th Floor  
Columbus, OH 43215  
800-282-0370

[www.auditor.state.oh.us](http://www.auditor.state.oh.us)

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