

Office of the Inspector General Commonwealth of Massachusetts

Gregory W. Sullivan
Inspector General

Guide to Developing and Implementing Fraud Prevention Programs

Second Edition

American Recovery and Reinvestment Act
Of 2009 (ARRA) Supplement

October 2009

This page intentionally left blank.



The Commonwealth of Massachusetts

Office of the Inspector General

GREGORY W. SULLIVAN
INSPECTOR GENERAL

October 2009

JOHN W. MCCORMACK
STATE OFFICE BUILDING
ONE ASHBURTON PLACE
ROOM 1311
BOSTON, MA 02108
TEL: (617) 727-9140
FAX: (617) 723-2334

Dear Public Officials:

The Office of Inspector General has updated this guide to help you understand the importance of developing comprehensive fraud prevention policies and programs for your jurisdiction.

The first edition of this guide was issued in April 2005. My office believes it is important to update the guide at this time because of the fraud risk accompanying the significant spending associated with the American Recovery and Reinvestment Act (ARRA) of 2009. Rapid program expansion without an increase in control, oversight, or reporting creates an opportunity for fraud, waste, and abuse. My office encourages ARRA funding recipients and all other public and private entities to consider the fraud risks they may be subject to and adopt a policy to help mitigate the risk.

The information contained in this guide is intended for informational purposes only. It is ultimately up to each jurisdiction to establish specific programs tailored to its needs. New to this edition is a sample fraud prevention policy from the Association of Certified Fraud Examiners (ACFE) that your jurisdiction may be able to adapt and modify for your needs.

This guide seeks to:

- provide recommendations for developing policies for fraud prevention programs;
- provide a list of resources for public officials to assist them in developing fraud policies and fraud prevention programs.

The Office of the Inspector General is charged with preventing and detecting fraud, waste, and abuse in state, county, and local government. When possible, we emphasize prevention. I hope this guide assists you in preventing fraud and protecting the integrity of ARRA spending.

Please do not hesitate to contact my staff with any questions you may have.

Sincerely,

A handwritten signature in dark ink that reads "Gregory W. Sullivan".

Gregory W. Sullivan
Inspector General

This page intentionally left blank.

Table of Contents

Section One: Introduction to Fraud	1
Section Two: Recommendations for Developing a Fraud Prevention Policy	7
Section Three: Recommendations for Developing a Fraud Prevention Program	9
Section Four: List of Resources	11
Appendix A: Uniform Occupational Fraud Classification System	A-1
Appendix B: Sample Fraud Prevention Policy from ACFE	B-1
Appendix C: Sample Non-Collusion Form	C-1

Massachusetts Office of the Inspector General

Address:

Room 1311
John McCormack State Office Building
One Ashburton Place
Boston, MA 02108

Contact Information:

(617) 727 - 9140
(617) 523 - 1205 (MCPPO Program)
(800) 322 - 1323 (Confidential 24-hour Hotline)
(617) 723 - 2334 (FAX)
www.mass.gov/ig

This page intentionally left blank.

SECTION ONE

Introduction to Fraud

The Office of the Inspector General is charged with preventing and detecting fraud, waste, and abuse in state and local government. When possible, we emphasize prevention. To further this goal, this advisory has been created to assist public officials in the development of fraud policies and fraud prevention programs in their own jurisdictions. This advisory should be used by state agencies and local jurisdictions to create their own fraud prevention policies and programs. Developing fraud prevention policies and/or programs makes it clear that fraud by public employees will not be tolerated. Fraud policies also make it clear to public managers and taxpayers alike that your jurisdiction takes potential fraud seriously and has mechanisms in place to handle cases of potential fraud.

This guide is intended to:

- provide recommendations for developing fraud policies and fraud prevention programs;
- provide a list of resources for public officials to assist them with fraud prevention policy and/or program development.

What is fraud?

The Association of Certified Fraud Examiners (ACFE) defines occupational fraud¹ as, “The use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.” The principal types of fraud include:

- breach of fiduciary duty;
- bribery;
- concealment of material facts;
- theft of money or physical property;
- theft of secrets or intellectual property, and
- other statutory offenses.

¹ See Figure 1 for a comparison of occupational fraud by scheme type.

Occupational fraud affects nearly every organization. In its *2008 Report to the Nation on Occupational Fraud and Abuse*, the ACFE examined 508 occupational fraud cases for the cost of occupational fraud and abuse, the methods for committing these crimes, detection of occupational fraud, the victims, the perpetrators, and the legal outcome of fraud cases.

The 2008 Report

In discussing cases of fraud, the ACFE uses the Uniform Occupational Fraud Classification System, commonly known as the Fraud Tree. The Fraud Tree divides fraud into three major categories:

- corruption – conflicts of interest, bribery, illegal gratuities, and economic extortion;
- asset misappropriation – cash and non-cash, and
- fraudulent statements – financial and non-financial.

Asset misappropriations represent the largest percentage of fraud cases at nearly 89 percent. The ACFE estimates that approximately seven percent of the U.S. Gross Domestic Profit (GDP) or approximately \$994 Billion is lost to fraud annually. Median identified loss per fraud case is \$175,000 while 25 percent involve \$1 Million or more.

Figure 1: Occupational Fraud by Category

<i>Scheme Type</i>	<i>2004</i>	
	<i>% Cases</i>	<i>Median Cost</i>
Asset Misappropriations	88.7	\$150,000
Cash Larceny	10.3	80,000
Skimming	16.6	80,000
Fraudulent Disbursements	64.2	125,000
Billing Schemes	23.4	100,000
Payroll Schemes	9.3	49,000
Expense Reimbursements	13.2	25,000
Check Tampering	14.7	138,000
Cash Register Disbursements	2.8	25,000
Non-Cash Misappropriations	16.3	100,000
Corruption Schemes	27.4	375,000
Fraudulent Statements	10.3	2,000,000

The sum of percentages in this table exceeds 100% because a number of cases involved multiple schemes that fell into more than one category.

Source: The Association of Certified Fraud Examiners *2008 Report to the Nation on Occupational Fraud and Abuse*.

The ACFE report states the typical organization loses seven percent of annual revenues to fraud. Based on the nearly \$9 Billion in ARRA funding the commonwealth will receive, this translates to a potential loss of \$630 Million to Massachusetts during the three years of ARRA funding.

The fraud report notes that small entities (with less than 100 employees) are particularly vulnerable to fraud. The median loss for small entities in 2008 was \$200,000. Many local jurisdictions in Massachusetts may have the same vulnerabilities as small businesses, where nearly two-thirds of fraud occurs. For this reason, municipalities should act to immediately adopt anti-fraud measures.

Interestingly, the ACFE found fewer fraud cases occurred in government agencies than in the private sector. Public entities in Massachusetts still need to be vigilant against fraud. Although most employees are honest, fraud still exists. Due diligence and the use of preventative procedures such as ethics training, anti-fraud policies, internal controls, audits and codes of conduct will help to safeguard public assets, public employees, and the taxpayers alike.

Who commits fraud?

Most people who commit fraud are first time offenders. In addition, fraud is most often committed by employees who hold executive positions or positions of responsibility, have been with an organization for a long time, and who are respected and trusted employees. According to fraud theory, there are three factors that contribute to an individual's committing fraud; need, rationalization, and opportunity. Limiting an individual's opportunity to commit fraud is where anti-fraud programs, internal controls, training and other fraud prevention measures are vital to a jurisdiction's efforts to prevent fraud.

How to detect fraud?

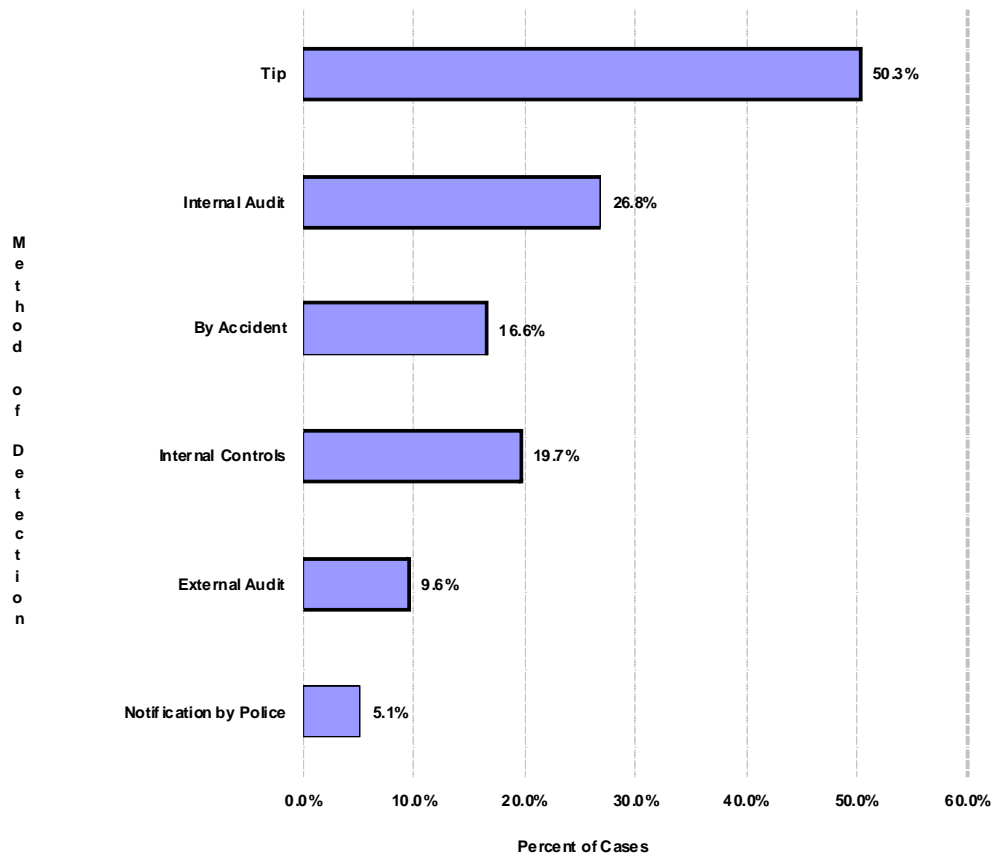
Cases of fraud within government agencies are most often detected through a tip and/or internal audit. **However, many incidents of fraud within an organization can be detected by your own measures.**² Your jurisdiction can be proactive in preventing fraud. For reasons of security, employees hired for sensitive positions and positions that may be vulnerable to fraud should undergo background checks. Still, background checks alone will not be effective in preventing fraud in an organization. Instead, an organization should consider one or more of the following fraud prevention strategies:

- strong internal controls;
- ongoing antifraud education programs;
- regular fraud audits, and
- implementation of fraud policies.

² See Figure 3 for a chart of the most common methods of fraud detection in government agencies.

Common Methods of Fraud Detection:

Figure 3: Detection of Frauds in Government Agencies



The sum of percentages in the chart exceeds 100% because in some cases respondents identified more than one detection method.

Source: The Association of Certified Fraud Examiners 2008 Report to the Nation on Occupational Fraud and Abuse.

SECTION TWO

Recommendations for Developing a Fraud Prevention Policy

The Office of the Inspector General recommends that every public jurisdiction in Massachusetts develop a fraud prevention program that includes a fraud prevention policy. “Prevention is the cheapest way to deal with fraud because few companies recover losses once they’ve become victims,” according to the ACFE. A fraud prevention policy may be addressed as part of an organization’s code of ethics, statement of business principles, or some other summary of guiding principles. Alternately, some organizations may develop a fraud prevention policy separate from these documents. The following suggestions are intended to assist in development of a fraud prevention policy:

General

- Fraud policies should be written;
- should clearly state that fraud is a crime and will be prosecuted,
- should discuss rules concerning outside employment in relation to conflicts of interest, appearance of impropriety issues, etc.,
- should discuss policies regarding use of public assets such as vehicles,
- should discuss policies regarding travel, timekeeping, reimbursements, etc., and,
- should be one component of a larger fraud prevention initiative.

Education

- Fraud policies should be given to new employees. New employees should sign a statement confirming that they received the fraud prevention policy document and that they read and understood the policies. Signed statements give organizations stronger grounds for discharging dishonest employees by protection against wrongful termination suits by showing that an employee had agreed not to take part in the fraudulent behavior.
- Fraud policies should be reviewed by all employees on an annual basis as part of your jurisdiction’s ongoing antifraud education program.

Legal

- Fraud policies should list all applicable laws and regulations that affect your jurisdiction, explain what constitutes a conflict of interest, and clarify what an employee should do if offered a gift from a supplier, vendor, or other organization.
- Your jurisdiction should also spell out what actions constitute improper and illegal behavior, including conflicts of interest, illegal gratuities, fraudulent statements, and embezzlement.

Behavior

- Fraud policies should clarify how employees are expected to conduct themselves during business hours, including the prohibition of alcohol and drug use.
- They should also detail your jurisdiction's policy on issues such as political campaigns.
- Finally, fraud policies should detail the ethical standards your employees and vendors are expected to adhere to.

Other

- Vendors should be asked to comply with your Fraud Prevention Policy as a requirement for doing business with you.
- Vendors should be required to complete a non-collusion form as part of their bid responses. (See appendix C)
- Periodically conduct fraud risk assessments by discussing controls with staff as well as external auditors. Ask your staff, those closest to the work, how they could bypass controls if they chose to. This is a way to identify the vulnerabilities within your jurisdiction and gives you the opportunity to self-correct.

SECTION THREE

Recommendations for Developing a Fraud Prevention Program

In addition to the creation of a written fraud prevention policy, all public entities should assess the potential for fraud within the organization. Successful completion of a fraud risk assessment will identify the entities vulnerability to fraud in each of the three major types of fraud (fraudulent statements, corruption, and asset misappropriation). An external Certified Public Accountant firm, Certified Fraud Examiner consultant, or other anti-fraud practitioner should conduct your fraud risk assessment. Once an organization's vulnerabilities are identified, managers can implement a fraud prevention program designed to decrease the risk of fraud. A comprehensive fraud prevention program should include:

1. Control Environment:

- Rules and procedures for work performance and employee behavior.
- Management setting the "tone at the top" ensuring that rules are used and enforced. The rules must apply to everyone.

2. Risk Assessment:

- An ongoing process the organization uses to identify and correct where it may be vulnerable to fraud, waste and abuse.

3. Appropriate Oversight:

- An audit committee to evaluate and oversee senior management and assist the governmental body with oversight of the financial reporting process and internal controls;
- Anti-fraud processes and control mechanisms that management understands, implements and monitors;
- An internal audit/assessment team, since internal employees may have knowledge about the jurisdiction that may enable them to identify indicators that suggest fraud has been committed;
- Independent auditors who can assist management and the audit committee by providing an assessment of your jurisdiction's process of identifying, assessing, and responding to the risks of fraud, and

- Certified Fraud Examiners, or professionals with similar certifications, who can provide extensive knowledge and experience about fraud which may not be available within a jurisdiction, and objective insight to your entity's management and audit committee.

4. Internal Audit Controls and Monitoring:

- Consists of an audit committee that works with accountants, internal staff, auditors, and/or other consultants to ensure that proper financial procedures are in place, which include, routine audits, and sound accounting practices and unscheduled audits.

5. Division of Responsibility:

- Individual financial transactions and contract management should be handled by multiple employees in your jurisdiction. This provides a "segregation of duties" that adds checks and balances to the process.

6. Hot Lines and other forms of Communication:

- Mechanisms through which employees can report possible misdeeds and suspicious activity.

7. Fraud Prevention Education Program:

- Antifraud education programs should be conducted at least once a year to review your jurisdiction's fraud statement. New hires, as well as current employees, should be involved in this ongoing education program.

8. Performance Measurement:

- To review whether goals and objectives are being met. Performance deviations could help identify vulnerabilities.

9. Reporting:

- Report suspicions of inappropriate or fraudulent behavior to the Office of the Inspector General, Office of the State Auditor, or Office of the Attorney General.

SECTION FOUR

List of Resources for Developing an Effective Fraud Policy and Fraud Prevention Program

- Recovery Accountability and Transparency Board
www.Recovery.gov
- Council of Inspectors General on Integrity and Efficiency
A comprehensive directory of the federal Inspectors General.
www.IGNet.gov
- Committee of Sponsoring Organizations (COSO) of the Treadway Commission
Private sector organization sponsored by five major professional associations to improve the quality of financial reporting. Web site contains articles, publications, and conference information.
www.coso.org
Internal Control – Integrated Framework
www.coso.org/publications/executive_summary_integrated_framework.htm
- American Institute of Certified Public Accountants
Provides resources and training for all Certified Public Accountants and distributes information about fraud through online newsletters, journals, and other useful links; see especially the Fraud Prevention Policy found in the Statement of Auditing Standards No. 99 (SAS99).
www.aicpa.org
- Association of Certified Fraud Examiners
Provides fraud information and articles, provides access to fraud prevention resources, books, and an online newsletter. The Association also certifies Certified Fraud Examiners.
www.acfe.com
- The Institute of Internal Auditors
Offers several online publications such as a magazine, newsletter, research reports, and an online bookstore, an online discussion group, and certifies qualified audit professionals.
www.theiia.org

- Massachusetts General Court

The Massachusetts Legislature provides access to Massachusetts General Laws, including Chapter 12A: Section 14 Complaints by public employees; investigation.

<http://www.mass.gov/legis/laws/mgl/12a-14.htm>

- Massachusetts Office of the Inspector General

Charged with preventing and detecting fraud, waste, and abuse in the expenditure of public funds; interprets the Uniform Procurement Act; accepts telephone requests for assistance with Massachusetts General Law c. 30B for municipalities; provides training through the MCPPO program; conducts performance reviews; investigates complaints and allegations of wrongdoing.

www.mass.gov/ig

A Guide for Massachusetts Public Officials: Massachusetts and Federal Laws Regarding Fraud, False Statements, and Bid Rigging in Public Contracting

<http://www.mass.gov/ig/publ/bidrig.pdf>

- Massachusetts State Auditor's Office

Provides independent and objective evaluations of the Commonwealth's financial and operational activities in accordance with generally accepted government auditing standards and works to make government more accountable and effective by reducing waste and eliminating fraud, by identifying opportunities for cost avoidance, and non-tax revenue enhancement and by assisting in improving program performance.

www.mass.gov/sao/

- Massachusetts Attorney General's Office

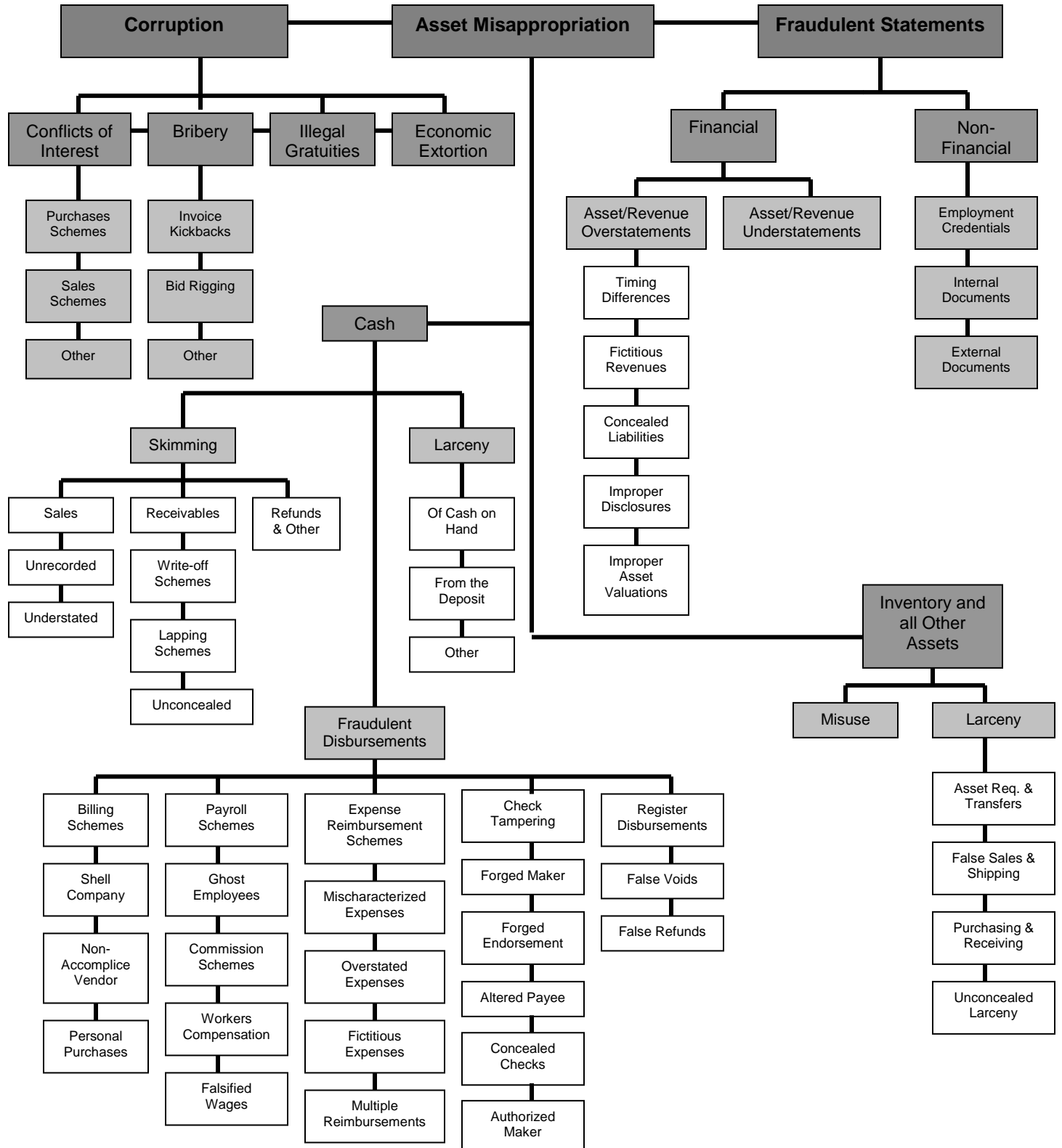
The Attorney General is the chief lawyer and law enforcement officer of the Commonwealth of Massachusetts. The Attorney General represents the Commonwealth in many matters in which the Commonwealth is a party. In addition, the Attorney General is a resource to residents who are facing challenges in the area of consumer protection, fraud, civil rights violations, health care, and insurance issues.

www.mass.gov/ago

This page intentionally left blank.

Appendix A:

Uniform Occupational Fraud Classification System



Source: The Association of Certified Fraud Examiners 2004 Report to the Nation on Occupational Fraud and Abuse

SAMPLE FRAUD POLICY

BACKGROUND

The corporate fraud policy is established to facilitate the development of controls which will aid in the detection and prevention of fraud against ABC Corporation. It is the intent of ABC Corporation to promote consistent organizational behavior by providing guidelines and assigning responsibility for the development of controls and conduct of investigations.

SCOPE OF POLICY

This policy applies to any fraud, or suspected fraud, involving employees as well as shareholders, consultants, vendors, contractors, outside agencies doing business with employees of such agencies, and/or any other parties with a business relationship with ABC Corporation (also called the Company).

Any investigative activity required will be conducted without regard to the suspected wrongdoer's length of service, position/title, or relationship to the Company.

POLICY

Management is responsible for the detection and prevention of fraud, misappropriations, and other inappropriate conduct. Fraud is defined as the intentional, false representation or concealment of a material fact for the purpose of inducing another to act upon it to his or her injury. Each member of the management team will be familiar with the types of improprieties that might occur within his or her area of responsibility, and be alert for any indication of irregularity.

Any fraud that is detected or suspected must be reported immediately to _____, who coordinates all investigations with the Legal Department and other affected areas, both internal and external.

ACTIONS CONSTITUTING FRAUD

The terms defalcation, misappropriation, and other fiscal wrongdoings refer to, but are not limited to:

- Any dishonest or fraudulent act
- Forgery or alteration of any document or account belonging to the Company
- Forgery or alteration of a check, bank draft, or any other financial document
- Misappropriation of funds, securities, supplies, or other assets
- Impropriety in the handling or reporting of money or financial transactions
- Profiteering as a result of insider knowledge of company activities

SAMPLE FRAUD POLICY

ACTIONS CONSTITUTING FRAUD

- Disclosing confidential and proprietary information to outside parties
- Disclosing to other persons securities activities engaged in or contemplated by the company
- Accepting or seeking anything of material value from contractors vendors or persons providing services/materials to the Company. Exception: Gifts less than \$50 in value.
- Destruction, removal or inappropriate use of records, furniture, fixtures, and equipment; and/or
- Any similar or related inappropriate conduct

OTHER INAPPROPRIATE CONDUCT

Suspected improprieties concerning an employee's moral, ethical, or behavioral conduct, should be resolved by departmental management and Employee Relations of Human Resources rather than _____.

If there is any question as to whether an action constitutes fraud, contact _____ for guidance.

INVESTIGATION RESPONSIBILITIES

The _____ has the primary responsibility for the investigation of all suspected fraudulent acts as defined in the policy. If the investigation substantiates that fraudulent activities have occurred, the _____ will issue reports to appropriate designated personnel and, if appropriate, to the Board of Directors through the Audit Committee.

Decisions to prosecute or refer the examination results to the appropriate law enforcement and/or regulatory agencies for independent investigation will be made in conjunction with legal counsel and senior management, as will final decisions on disposition of the case.

SAMPLE FRAUD POLICY

CONFIDENTIALITY

The _____ treats all information received *confidentially*. Any employee who suspects dishonest or fraudulent activity will notify the _____ immediately, and *should not attempt to personally conduct investigations or interviews/interrogations* related to any suspected fraudulent act (see **REPORTING PROCEDURE** section below).

Investigation results *will not be disclosed or discussed* with anyone other than those who have a legitimate need to know. This is important in order to avoid damaging the reputations of persons suspected but subsequently found innocent of wrongful conduct and to protect the Company from potential civil liability.

AUTHORIZATION FOR INVESTIGATING SUSPECTED FRAUD

Members of the Investigation Unit will have :

- Free and unrestricted access to all Company records and premises, whether owned or rented; AND
- The authority to examine, copy, and/or remove all or any portion of the contents of files, desks, cabinets, and other storage facilities on the premises without prior knowledge or consent of any individual who may use or have custody of any such items or facilities when it is within the scope of their investigation.

REPORTING PROCEDURES

Great care must be taken in the investigation of suspected improprieties or wrongdoings so as to avoid mistaken accusations or alerting suspected individuals that an investigation is under way.

An employee who discovers or suspects fraudulent activity will *contact* _____ *immediately*. The employee or other complainant may remain anonymous. All inquiries concerning the activity under investigation from the suspected individual, his or her attorney or representative, or any other inquirer should be directed to the Investigations Unit or the Legal Department. No information concerning the status of an investigation will be given out. The proper response to any inquiries is: "I am not at liberty to discuss this matter." *Under no circumstances* should any reference be made to "the allegation," "the crime," "the fraud," "the forgery," "the misappropriation," or any other specific reference.

SAMPLE FRAUD POLICY

REPORTING PROCEDURES

The reporting individual should be informed of the following:

- Do not contact the suspected individual in an effort to determine facts or demand restitution.
- Do not discuss the case, facts, suspicions, or allegations with *anyone* unless specifically asked to do so by the Legal Department or _____.

TERMINATION

If an investigation results in a recommendation to terminate an individual, the recommendation will be reviewed for approval by the designated representatives from Human Resources and the Legal Department and, if necessary, by outside counsel, before any such action is taken. The _____ does not have the authority to terminate an employee. The decision to terminate an employee is made by the employee's management. Should the _____ believe the management decision inappropriate for the facts presented, the facts will be presented to executive level management for a decision.

ADMINISTRATION

The _____ is responsible for the administration, revision, interpretation, and application of this policy. The policy will be reviewed annually and revised as needed.

APPROVAL

(CEO/Senior Vice President/Executive)

Date

SAMPLE FRAUD POLICY

Corporate Fraud Policy Decision Matrix

Action Required	Investigatio Unit	Internal Audit	Finance/ Accounting	Executive Mgmt	Line Mgmt	Risk Mgmt	Legal	Public Relations	Employee Relations
1. Controls to Prevent Fraud	S	S	S	SR	SR	S	S	S	S
2. Incident Reporting	P	S	S	S	S	S	S	S	S
3. Investigation of Fraud	P	S					S		S
4. Referrals to Law Enforcement	P						S		
5. Recovery of Monies due to Fraud	P								
6. Recommendations to Prevent Fraud	SR	SR	S	S	S	S	S	S	S
7. Internal Control Reviews		P							
8. Handle Cases of a Sensitive Nature	P	S		S		S	S		S
9. Publicity/Press Releases	S	S						P	
10. Civil Litigation	S	S					P		
11. Corrective Action/ Recommendations to Prevent Recurrences	SR	SR		S	SR	S	S		
12. Monitor Recoveries	S		P						
13. Pro-active Fraud Auditing	S	P							
14. Fraud Education/Training	P	S			S			S	
15. Risk Analysis of Areas of Vulnerability	S	S				P			
16. Case Analysis	P	S							
17. Hotline	P	S							
18. EthicsLine	S	S					P		

P (Primary Responsibility) S(Secondary Responsibility) SR (Shared Responsibility)

Appendix C:

Sample Non-Collusion Form

Jurisdictions should require a non-collusion form be signed under the pains and penalties of perjury to be completed by all contractors, subcontractors, vendors, etc., bidding on a publicly funded contract. For example, this form could state:

The Undersigned certifies under penalties of perjury that this bid has been made and submitted in good faith and without collusion or fraud with any person. As used in this certification, the word "person" shall mean any natural person, business, partnership, corporation, union, committee, club, or other organization, entity, or group of individuals.

(Signature of individual submitting bid or proposal)

(Name of Business)

(Date)