Office of the Inspector General

Commonwealth of Massachusetts

Gregory W. Sullivan
Inspector General

Guide to Developing and Implementing Fraud Prevention Programs

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Dear Public Officials:

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

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.

This guide seeks to:

- provide recommendations for developing fraud policies and 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. We hope this guide assists you in preventing fraud before it occurs.

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

Sincerely,

Gregory W. Sullivan
Inspector General

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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

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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 is not meant to be a fraud policy. Rather, this advisory should be used by state agencies and local jurisdictions to create their own fraud prevention policies and programs. Developing a fraud policy 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.

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 policy and/or program development.

What is fraud?

The Association of Certified Fraud Examiners defines occupational fraud[1] 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

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

- other statutory offenses.

Occupational fraud affects nearly every organization. In its *2004 Report to the Nation on Occupational Fraud and Abuse,* the Association of Certified Fraud Examiners 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 2004 Report

In discussing cases of fraud, the Association of Certified Fraud Examiners uses the Uniform Occupational Fraud Classification System, commonly known as the Fraud Tree. The Fraud Tree divides fraud into three major categories:[2]

- 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 93 percent.

[2] See Figure 2 for a chart of occupational fraud by method.

Figure 1: Comparison of All Occupational Fraud Categories by 2004 and 2002 Data

Scheme Type	2004		2002	
	% Cases	Median Cost	% Cases	Median Cost
Asset Misappropriations	**92.7**	**$93,000**	**85.7**	**$80,000**
Cash Misappropriations	86.6	$98,000	77.8	$80,000
Cash Larceny	20.7	$80,000	6.9	$25,000
Skimming	24.4	$85,000	24.7	$70,000
Fraudulent Disbursements	64.2	$125,000	55.4	$100,000
Billing Schemes	33.5	$140,000	25.2	$160,000
Payroll Schemes	12.6	$90,000	9.8	$140,000
Expense Reimbursements	14.2	$92,000	12.2	$60,000
Check Tampering	20.1	$155,000	16.7	$140,000
Register Disbursements	2.8	$18,000	1.7	$18,000
Non-Cash Misappropriations	20.5	$100,000	9.0	$200,000
Corruption Schemes	**30.1**	**$250,000**	**12.8**	**$530,000**
Fraudulent Statements	**7.9**	**$1,000,000**	**5.1**	**$4,250,000**

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 *2004 Report to the Nation on Occupational Fraud and Abuse.*

Figure 2: Methods of Fraud - All Occupational Frauds
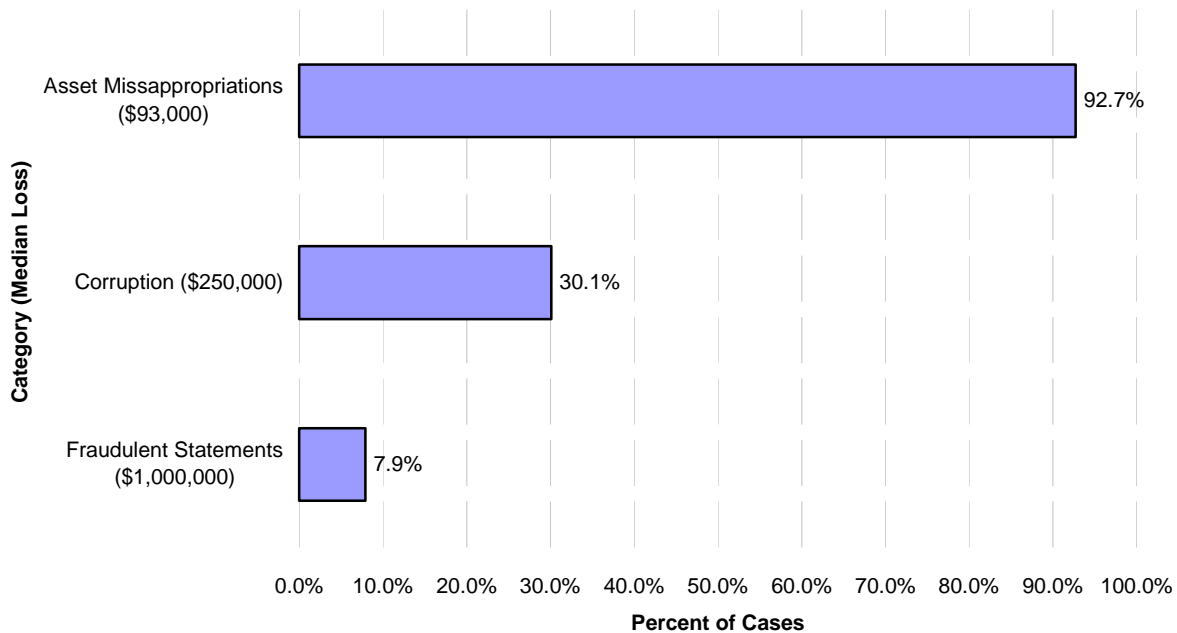
The sum of percentages in this chart exceeds 100% because a number of cases involved multiple schemes that fell into more than one category.
Source: The Association of Certified Fraud Examiners *2004 Report to the Nation on Occupational Fraud and Abuse.*

In fact, the Association of Certified Fraud Examiners fraud report states the typical organization loses 6 percent of annual revenues to fraud. According to United States Census data for 2001 to 2002, Massachusetts state and local government revenues totaled $41.9 billion. This translates to a potential loss of $2.5 billion among Massachusetts' municipalities and state agencies. [3]

The fraud report notes that small entities are particularly vulnerable to fraud. The study found that close to 46 percent of fraud cases occurred in small entities (organizations with less than 100 employees). The median loss for small entities in 2004 was $98,000. Additionally, entities with 100 to 999 employees suffer over 21 percent of fraud cases, with a median loss of $78,500. Most local jurisdictions in Massachusetts have fewer

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[3] Source: *U.S. Census Bureau, Governments Division.*

than 1000 employees and therefore may have the same vulnerabilities as small businesses where nearly two-thirds of fraud occurs.

Interestingly, the Association of Certified Fraud Examiners 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 will help to safeguard public assets, public employees, and the taxpayers alike.

Who commits fraud?

Most people who commit fraud are first time offenders. The Association of Certified Fraud Examiners found that only 12 percent of those people had a previous conviction for a fraud-related offense. In addition, fraud is most often committed by employees who hold executive positions, have been with an organization for a long time, and who are respected and trusted employees.

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.[4]** 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

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

- implementation of fraud policies.

Figure 3: Detection of Frauds in Government Agencies
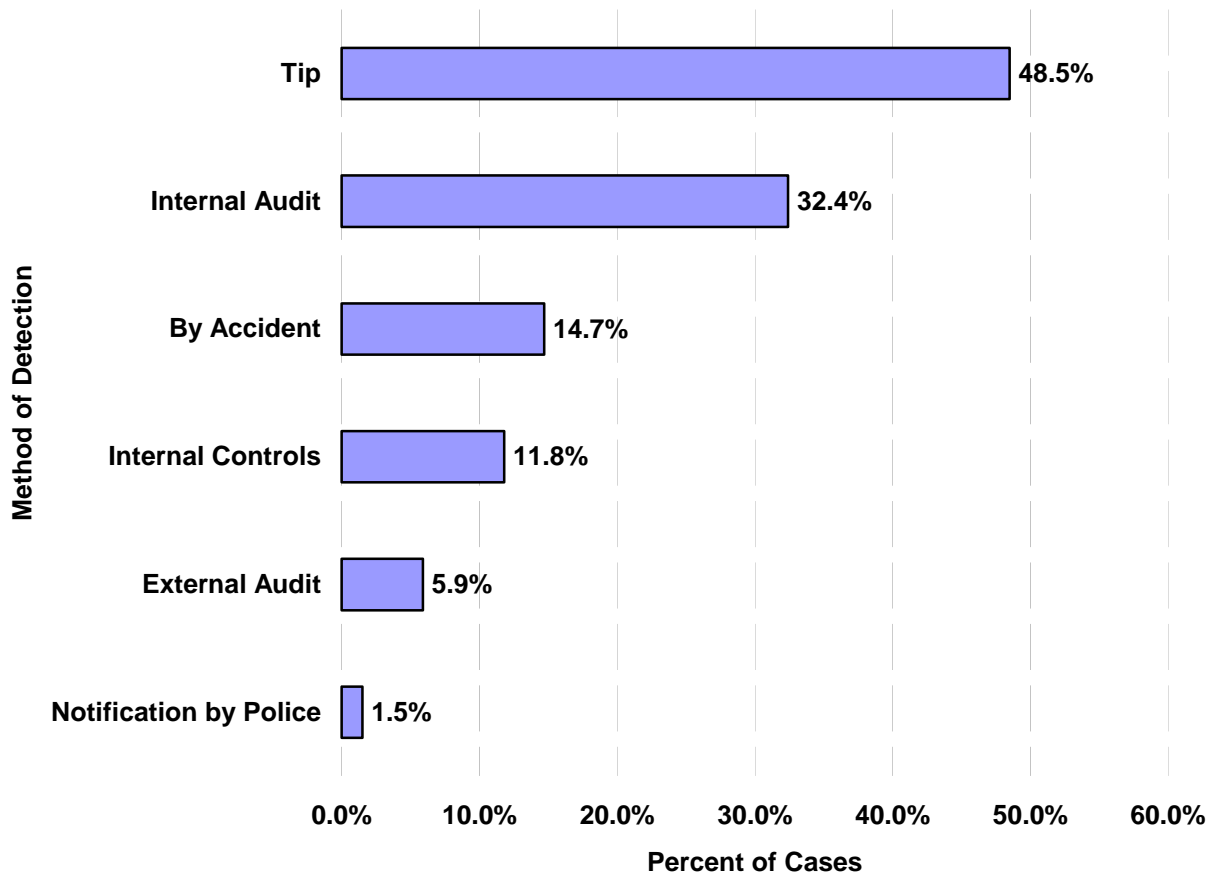
The sum of percentages in the chart exceeds 100% because in some cases respondents identified more than one detection method.
Source: The Association of Certified Fraud Examiners 2004 Report to the Nation on Occupational Fraud and Abuse.

SECTION TWO
Recommendations for Developing a Fraud Policy

The Office of the Inspector General recommends that every public jurisdiction in Massachusetts develop a fraud policy. "Prevention is the cheapest way to deal with fraud because few companies recover losses once they've become victims," according to the Association of Certified Fraud Examiners report. A fraud 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 policy separate from these documents. The following suggestions are intended to assist in development of a fraud policy:

General

- fraud policies should be written;

- 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, and

- should discuss policies regarding travel, timekeeping, reimbursements, etc.

Education

- Fraud policies should be given to new employees. New employees should sign a statement confirming that they received the fraud 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 jurisdictions 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 political contributors are expected to adhere to.

SECTION THREE
Recommendations for Developing a Fraud Prevention Program

In addition to the creation of a written fraud 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 or Certified Fraud Examiner consultant 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. **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 implements and monitors;

   - an internal audit 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 who can provide extensive knowledge and experience about fraud that may not be available within a jurisdiction, and objective insight to your entity's management and audit committee.

2. **Internal Audit Controls**: consists of an audit committee that works with accountants to ensure that proper financial procedures are in place, which include, routine audits and sound accounting practices and unscheduled audits.

3. **Division of Responsibility**: individual financial transactions and contract management should be handled by multiple employees in your jurisdiction.

4. **Hot Line**: a mechanism through which employees can anonymously report possible misdeeds and suspicious activity.

5. **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.

6. **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

- CFA Institute (formerly the Association for Investment Management and Research)

  Provides resources to financial analysts through an online journal, magazines, books, and other links.
  www.cfainstitute.org

  How to Select a Financial Advisor

  http://www.cfainstitute.org/investorservices/choosingafinancialadvisor.html

- 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.

  www.aicpa.org

- Association of Certified Fraud Examiners

  Provides fraud information and articles, provides access to fraud prevention resources, books, and an online newsletter and certifies Certified Fraud Examiners.

  www.cfenet.com

- Financial Executives International

  Contains accounting information through various manuals, books, and newsletters that are available online or by subscription.

  www.fei.org

- Information Systems Audit and Control Association

  Web site provides valuable links, journal articles on technological topics of interest and professionals can become a Certified Information Security Manager or a Certified Information Systems Auditor.

  www.isaca.org

- 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

- Institute of Management Accountants

  Provides links to full text articles, an online journal, a monthly magazine, and a newsletter for business professionals, identifies trends in finance and identify technological trends and tools, and certifies professionals in management accounting and financial management.

  www.imanet.org

- Massachusetts General Law

  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/

- National Association of Corporate Directors

  Promotes professional standards for corporate governance and provides educational information through handbooks, guides, manuals, surveys, and reports.

  www.nacdonline.org

- Society for Human Resource Management

  Provides useful human resource information through links to web sites and an online library of articles, papers, surveys, and directories.

  www.shrm.org

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Appendix A:

Uniform Occupational Fraud Classification System

Corruption
- **Conflicts of Interest**
  - Purchases Schemes
  - Sales Schemes
  - Other
- **Bribery**
  - Invoice Kickbacks
  - Bid Rigging
  - Other
- **Illegal Gratuities**
- **Economic Extortion**

Asset Misappropriation

Cash
- **Skimming**
  - Sales
    - Unrecorded
    - Understated
  - Receivables
    - Write-off Schemes
    - Lapping Schemes
    - Unconcealed
  - Refunds & Other
- **Larceny**
  - Of Cash on Hand
  - From the Deposit
  - Other

Fraudulent Disbursements
- **Billing Schemes**
  - Shell Company
  - Non-Accomplice Vendor
  - Personal Purchases
- **Payroll Schemes**
  - Ghost Employees
  - Commission Schemes
  - Workers Compensation
  - Falsified Wages
- **Expense Reimbursement Schemes**
  - Mischaracterized Expenses
  - Overstated Expenses
  - Fictitious Expenses
  - Multiple Reimbursements
- **Check Tampering**
  - Forged Maker
  - Forged Endorsement
  - Altered Payee
  - Concealed Checks
  - Authorized Maker
- **Register Disbursements**
  - False Voids
  - False Refunds

Fraudulent Statements
- **Financial**
  - **Asset/Revenue Overstatements**
    - Timing Differences
    - Fictitious Revenues
    - Concealed Liabilities
    - Improper Disclosures
    - Improper Asset Valuations
  - **Asset/Revenue Understatements**
- **Non-Financial**
  - Employment Credentials
  - Internal Documents
  - External Documents

Inventory and all Other Assets
- **Misuse**
- **Larceny**
  - Asset Req. & Transfers
  - False Sales & Shipping
  - Purchasing & Receiving
  - Unconcealed Larceny

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