

County of Solano  
Office of the Auditor-Controller



Fraud Prevention and Detection Guide

# Fraud Prevention and Detection Guide

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## I. Overview of Fraud

### A. Definition of Fraud

According to the Association of Certified Fraud Examiners (ACFE), “Fraud is any intentional act or omission designed to deceive others and resulting in the victim suffering a loss and/or perpetrator achieving a gain.”

### B. Occupational Fraud

The ACFE further defined occupational fraud as “The use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.”

### C. Fraud Facts

The ACFE’s 2010 Report to the Nations on Occupational Fraud and Abuse stated:

- Typical organization loses 5% of its annual revenue to fraud.
- The median loss caused by the occupational fraud cases in our study was \$160,000. Nearly one-quarter of the frauds involved losses of at least \$1 million.
- The frauds lasted a median of 18 months before detected.
- Asset misappropriation schemes were the most common form of fraud.
- Occupational frauds are much more likely to be detected by tip than by any other means.
- The industries most commonly victimized were the banking/financial services, manufacturing and government sectors.
- More than 80% of the frauds were committed by individuals in one of six departments: accounting, operations, sales, executive/upper management, customer service or purchasing.
- More than 85% of fraudsters had never been previously charged or convicted for a fraud-related offense.
- Fraud perpetrators often display warning signs that they are engaging in illicit activity.

### D. Fraud Triangle

To fight fraud one must not only realize that it occurs, but also how and why it occurs. Donald R. Cressey, a well-known criminologist, developed the Fraud Triangle. According to Cressey, the three elements of the Fraud Triangle are: Opportunity, Pressure (also known as incentive or motivation) and Rationalization (sometimes called justification or attitude). For fraud to occur, all three elements must be present.

## The Fraud Triangle



### Opportunity

Of the three elements of the Fraud Triangle, opportunity is often hard to spot, but fairly easy to control through organizational or procedural changes. Opportunity is the ability to commit fraud. Because fraudsters don't wish to be caught, they must also believe their activities will not be detected.

It is essential that organizations build processes, procedures and controls that don't needlessly put employees in a position to commit fraud and effectively and timely detect fraudulent activity if it occurs.

#### Fraud Opportunity Checklist – Ask Yourself!

- How can I get a check issued or get my hands on cash?
- What accounting documents are easiest to access and forge?
- What deviations from acceptable business practices are possible?
- How much review and supervision goes on to deter and detect fraud?
- What are the weakest links in my department's internal control?

### Pressure/Incentives

Pressure is what causes a person to commit fraud. Pressure can include almost anything including medical bills, expensive tastes, addiction problems, etc. Most of the time, pressure comes from a significant financial need/problem. Often this need/problem is non-sharable in the eyes of the fraudster. The person believes their problem will be solved in secret. However, some frauds are

committed simply out of greed alone. At other times, pressure arises from problems on the job; unrealistic performance targets may provide the motive to perpetrate fraud.



### **Rationalization**

Rationalization is a way to justify in the person's consciousness the act of fraud is not so bad. Rationalization is a crucial component in most fraud. Some common rationalizations for committing fraud are:

- The person believes committing fraud is justified to save a family member or loved one.
- The person believes they will lose everything if they do not take the money.
- The person believes no help is available from outside.
- The person labels the theft as "borrowing" and fully intends to pay the stolen money back at some point.
- The person because of job dissatisfaction believes something is owed to him/her.

There are two aspects to rationalization: One, the fraudster must conclude the gain to be realized from a fraudulent activity outweighs the possibility for detection. Two, the fraudster needs to justify the fraud.

### **E. Types of Fraud**

There are literally dozens types of fraud. The ACFE organizes these into three fraud categories within their **Uniform Classification of Fraud System**:

#### **Corruption**

Fraud arises from conflicts of interest and extends to the receipt of illegal gratuities. This type of fraud is difficult to detect and, unfortunately, not uncommon in government. Corruption often results in higher prices charged to and in lower quality delivered to governments.

Examples of corruption schemes include bribery, extortion, and conflict of interest.

**Asset Misappropriation**

This is the most common and recognizable kind of fraud and it features the greatest variety of schemes. The outright theft of cash or inventory is a form of asset misappropriation. Overpaying vendors or employees – or paying vendors and employees that don't actually exist – is another.

These frauds include schemes such as skimming cash receipts, falsifying expense reports and forging company checks.

**Fraudulent Financial Statements**

Since the compensation of government employees is generally not tied in to profits or share price, this form of fraud is less common in the public than the private sector. Still, fraudulent financial statements are employed by fraudsters in government to cover up other forms of fraud, such as asset misappropriation. Also, governments can be the victims of fraudulent financial statements they receive from the private sector in connection with contractor vetting.

Common methods of fraudulent financial statement manipulation include recording fictitious revenues, concealing liabilities or expenses and artificially inflating reported assets.

## II. Fraud and Perpetrators

### A. Recent cases in the news

The Enron and WorldCom frauds were highly publicized, but it only represents a few of the many cases involving fraud and abuse. Recent news reports confirmed that fraud can occur anywhere by anyone.

SFWeekly.com

#### **Robin O'Connor, Giants Payroll Manager, Admits to Embezzling \$2.2 Million from Team**

By Erin Sherbert

The woman who accused of diverting millions of dollars from the San Francisco Giants for personal use pleaded guilty in federal courtroom today.

Robin O'Connor, 41 the former payroll manager for the team, admitted to transferring more than \$2.2 million from the Giants into her own personal banking account between June 2010 and June 2011. She also ripped off funds by improperly reducing employee tax withholdings, as well as creating fictitious paychecks, according to US Attorney Melinda Haag.

The well-respected manager was in charge of processing payroll for the San Francisco baseball team, including all the players. She has returned some of the money and has agreed to forfeit certain assets and pay restitution.

The bizarre off-the-field incident came to the attention of the Giants in June when team officials confronted O'Connor after a home-loan representative from Bank of America called human resources. Part of her loan file included a letter allegedly signed by the head of human resources, explaining O'Connor's extra compensation. She fessed up to the theft and was fired that same day.

O'Connor, 42, was subsequently arrested on July 8, 2011 and was released on a \$500,000 bail. She will be sentenced on Mar. 5, 2012 in San Francisco. She could face up to 20 years in prison.

Other fraud cases are below:

- In July 1997, Yasuyoshi Kato, pleaded guilty to embezzling \$62 million from Day-Lee Foods, Inc., a meat processing company in California where he had been employed as Chief Financial Officer. According to prosecutors, Kato, wrote checks to himself and his wife, from company accounts over a period of about six years. Kato then took out bank loans and forged accounting entries to cover the theft.
- Lloyd Benjamin Lewis, had been employed by Wells Fargo Bank for more than 10 years when he began taking advantage of a flaw in the internal control alarm system for check clearing at bank branches. Lewis was able to take advantage of the five day grace period between a check being credited at one bank branch and a debit being made at the account's branch by routinely making fraudulent credits and debit on his accounts.
- On January 2010, Sujata Sachdeva, was indicted by a grand jury on six counts of wire fraud for allegedly embezzling as much as \$31.5 million from Koss Corporation, a publicly traded head phone manufacturer where she had been employed as Vice

President of Finance, Secretary, and Principal Accounting Officer. According to the indictment, Sachedeva authorized at least 206 wire transfers of funds from Koss bank accounts to pay for her American Express credit card bills and issued more than 500 cashier's checks from company accounts to pay for personal expenses.

## B. Red Flags of Fraud



A **red flag** is a set of circumstances that are unusual in nature or vary from the normal activity. It is a signal that something is out of the ordinary and may indicate that something may be wrong. Red flags do not indicate guilt or innocence but merely provide possible warning signs of fraud.

Recognizing red flags is an important element in the fight against fraud.

### Employee Red Flags

- Employee lifestyle changes: expensive cars, jewelry, homes, clothes
- Significant personal debt and credit problems
- Behavioral changes: these may be an indication of drugs, alcohol, gambling, defensive
- High employee turnover, especially in those areas that are more vulnerable to fraud
- Refusal to take vacation or sick leave
- Lack of segregation of duties in the vulnerable areas (cash, etc.)

### Management Red Flags

- Reluctance to provide information to auditors
- Managers engage in frequent disputes with auditors
- There is a weak internal control environment
- Accounting personnel are lax or inexperienced in their duties
- Unexpected overdrafts or declines in cash balances

### Behavioral Red Flags

- Borrowing money from co-workers
- Creditors or collectors appearing at the workplace
- Gambling beyond the ability to stand the loss
- Excessive drinking or other personal habits



- Easily annoyed at reasonable questioning
- Providing unreasonable responses to questions
- Refusing vacations or promotions for fear of detection
- Bragging about significant new purchases
- Carrying unusually large sums of money
- Rewriting records under the guise of neatness in presentation

#### Other Common Forms of Fraud

- Falsifying timesheets for a higher amount of pay
- Stealing of any kind (e.g., cash, petty cash, supplies, equipment, tools, data, records, etc.)
- Forgery
- Pocketing payments on customers' accounts, issuing receipts on self-designed receipt books
- Not depositing all cash receipts
- Creating fictitious employees and collecting the paychecks
- Failing to end personnel assignments for terminated employees and collecting the paychecks
- Paying for personal expenses with County funds
- Increasing vendor invoices through collusion

### III. Approach to Controlling Fraud

Fraud is a significant potential problem for all organizations. The AICPA's *Management Antifraud Programs and Controls: Guidance to Help Prevent and Detect Fraud* stated "that some organizations have significantly lower levels of misappropriation of assets and are less susceptible to fraudulent reporting than other organizations because they take proactive steps to prevent or detect fraud. It is only those organizations that seriously consider fraud risks and take proactive steps to create the right kind of climate to reduce its occurrence that have success in preventing fraud."

The report further stated that when employees are in a positive work environment, they will be more reluctant to commit fraud that will hurt the organization. Misconduct is reduced when employees have positive feeling about their organization.

#### A. Setting the Tone at the Top

Management needs to "set the tone at the top" for ethical behavior in an organization. "Tone at the Top" is a term used to define management's leadership and commitment towards openness, honesty, integrity, and ethical behavior. If the tone set by management upholds honesty, integrity and ethics, employees are more likely to uphold those same values.

#### B. Financial and Non-Financial Systems and Controls

Both financial and non-financial systems and controls should be implemented to detect and prevent fraud.

Among the financial controls management can implement include:

- Reconcile accounts – A person who doesn't authorize transactions or does not have custody of the assets should perform the reconciliations.
- Review all general ledger adjustments.
- Institute job rotation and mandatory vacations.
- Conduct surprise audits.

Among the non-financial controls are:

- Pre-screen potential employees.
- Communicate the consequences of committing fraud.
- Conduct anti-fraud training for managers and employees.
- Implement an anti-fraud policy.

### C. Fraud Responsibility

#### **If you suspect fraud:**

##### DO:

- Convey your suspicions to someone with appropriate experience and authority
- Deal with the matter promptly
- Cooperate fully with all investigations

##### DO NOT

- Be afraid of raising your concerns
- Accuse any individual directly
- Try and investigate the matter yourself
- Tell anyone about your suspicions other than those with the appropriate authority

#### **If you suspect Fraud, Waste or Abuse activity, report such activity to:**

Solano County Whistleblower Hotline  
1-866-384-TIPS

The Solano County Whistleblower Hotline is designed to promote reports of suspected fraud, waste, and abuse of County policy. Administered by the County Auditor-Controller's Internal Audit Division, the Hotline is available 24 hours a day, 365 days a year.

**Sources:**

Comptroller of Commonwealth, *A ToolKit for Departments to Combat Fraud, Waste and Abuse*, November 2009

Association of Government Accountants, *The AGA Fraud Prevention ToolKit*

Keller & Owens, LLC, *Preventing and Detecting Fraud in Not-For-Profit Organizations*

Christopher Marquet, Marquet International, *The Top 10 Embezzlement Cases in Modern US History*