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The Risk of Fraud

By Rebecca Otto, State Auditor

A report recently released by the Association of Certified Fraud Examiners (ACFE) has estimated that U.S. organizations lose 5% of their annual revenues to fraud. Workplace fraud schemes occur in all types of organizations, including government, corporations, small businesses, and not-for-profit organizations.

Minnesota Statute § 609.456 requires that local government employees and officials notify the Office of the State Auditor whenever evidence of theft, embezzlement, or any unlawful use of public funds or property is discovered. While occupational fraud, also known as internal fraud or employee theft, is uncommon in Minnesota government, reports to the Office of the State Auditor have increased over the last few years. When fraud does occur, it can be damaging to a city's financial condition and traumatic for the community where it occurs.

Common Fraud Myths

Frauds are generally ongoing crimes that can continue for months or even years before they are detected. Often, officials assume that safeguards are in place to detect fraud, but those assumptions don't necessarily hold true.

One common myth about fraud prevention holds that an entity's audit is the best place to uncover fraud. While internal and external audits do detect fraud, the ACFE report found that the greatest source of initial fraud detection for government came from tips -- when another person becomes suspicious of fraudulent activity and reports their suspicions. The ACFE reported that 46% of fraud incidences in government entities began as tips, while internal and external audits were the source of initial fraud detection 15% and 7% of the time, respectively.

Another common belief is that fraud only happens in large entities with large budgets. The ACFE report found that smaller organizations are in fact particularly vulnerable to fraud. Over 30% of all fraud cases in the report occurred in organizations with less than 100 employees, and smaller organizations sustained higher median losses than larger organizations.

The "Fraud Triangle" and Increased Risk of Fraud

When reviewing the risk of fraud auditors often use the "Fraud Triangle", first identified by sociologist Donald Cressey. There are three factors that make up the "points" of the Fraud Triangle:

- Incentive/Pressure. Pressure, such as a financial need, is the "motive" for committing the fraud. One common pressure is a gambling problem.

- Rationalization. The person committing the fraud frequently rationalizes the fraud. Rationalizations may include, "I'll pay the money back", "They will never miss the funds", or "They don't pay me enough."

- Opportunity. The person committing the fraud sees an internal control weakness and, believing no one will notice if funds are taken, begins the fraud with a small amount of money. If no one notices, the amount will usually grow larger.

All three points of the triangle show the increased risk of fraud in an economic downturn. In a downturn, personal financial needs are greater, which increases incentive/pressure; bad financial news is used as a rationalization; and as staff reductions eliminate internal controls that would prevent fraud, opportunity is increased. Accordingly, the Office of the State Auditor has seen an increase in 609.456 reports during the recent downturn, from 34 in 2007 to 64 in 2008, 54 in 2009, and 51 through September 15th of this year.

How Fraud Happens

The 2010 ACFE study confirmed a finding from prior studies: in fraud, the more authority a person has in the organization, the greater the loss. This makes sense because a person with more authority has greater access to resources and a greater ability to override controls in order to conceal the fraud.

The study also found a direct correlation between the length of time an employee has been employed by an organization and the size of the loss. An employee's tenure is likely related both to trust and to opportunity. The more trust an organization places in an employee, the greater the person's opportunity to commit fraud. Long-term employees may also be the most familiar with gaps in the organization's operations and controls, which may help them avoid detection more easily.

Exposing Fraud

Workplaces are benefiting from many effective means of uncovering fraud schemes. In the ACFE report, over half of the tips which exposed occupational fraud were from fellow employees. This reinforces the need for entities to maintain open channels of communication so employees are comfortable bringing forward their concerns.

Fraud can be stopped or detected early. The one area that an organization can control in the fraud triangle is opportunity. Effective tools for protecting against opportunity to commit fraud include segregating duties, adopting internal controls, and creating a strong control environment. For more information see our Statement of Position, "The Importance of Internal Controls", at:

http://www.auditor.state.mn.us/other/Statements/importanceic_0703_statement.pdf.