

Video: *What Fraud Looks Like: Red Flags* (4:47 video length)

<https://youtu.be/949Swm9X4Rw>

Produced by Innovative CPE

Video Synopsis:

This video discusses the difference between error and fraud, which is the intent of the perpetrator. The presenter also talks about the fraud triangle, which he describes as a three legged stool, composed of need, rationalization, and opportunity. For fraud to occur, a basically honest person must have an unmet need, the ability to rationalize his or her actions, and the opportunity to carry out the fraud. Because management controls opportunity, management participates in every fraud, by providing the opportunity for the fraud to occur.

Background and Fraud Theory:

Fraud is a knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment (Black's Law Dictionary).

Most people who commit fraud are not career criminals and are often trusted staff with no past criminal history. Usually, something in the person's life motivates or prompts him or her to commit fraud. The situation could be lifestyle related, such as lavish spending or addiction problems, or could be outside of the person's control, such as a family member's catastrophic illness or job loss. These motivations can make an honest person turn to fraud.

Basically honest people who are contemplating fraud must also be able to justify their actions. Rationalizations can include feelings of overwork and lack of appreciation, a belief that they are acting in the best interest of their family, or intent to make restitution when they get back on their feet. These rationalizations allow fraudsters to knowingly and intentionally commit a dishonest act while still functioning in the workplace.

Finally, for fraud to occur, the organization needs to give the person an opportunity, through poor segregation of duties or other weak internal controls, to commit the fraud. Ineffective or absent controls allow people to believe they will not get caught because no one will review their work or investigate anomalies.

These three factors; motivation (or need), rationalization, and opportunity, are most often present when ordinary people commit fraud. Together, they are referred to as the "fraud triangle". The goal of any good internal control system is to break the triangle by removing one of the factors. It is unlikely that an employer can significantly influence people's motivations or rationalizations. Therefore, taking away the opportunity to commit fraud by implementing and maintaining a strong internal control structure is an agency's best deterrent. (Internal Controls Bulletin Vol. 5, Issue

10 <http://mn.gov/mmb/images/October%2520ICB%25202013.docx>)

A red flag is a set of circumstances that is unusual in nature or a variance from normal activity. It is a warning to the presence of risk—something that could be amiss and in need of further inquiry or investigation. Red flags are not absolute indicators of guilt or defalcation but merely out-of-the-ordinary warning signs that fraud might be present.

Establishing an organization culture in which employees are encouraged to be alert to irregularities and red flags, and feel empowered to raise concerns is one of the most effective strategies an organization can use to reduce fraud. It is equally important that employees, particularly supervisors and senior management, receive regular fraud training—what common fraud indicators are, what to look for, how to respond, and how to follow-up. It is through appropriate response to warning signs that fraud can be detected sooner, or prevented altogether, and losses reduced and associated costs minimized. (Internal Controls Bulletin Volume 3, Issue 9 <http://mn.gov/mmb/images/September%2520ICB%25202011.docx>)

Potential Discussion Questions:

Content related:

- What do you think about the presenter's contention that "fraud and stupid often look exactly the same"? Do you agree or disagree?
- Do you think proving intent to defraud is difficult?
- Do you agree with the presenter that management participates in every fraud by providing the opportunity for the fraud to occur?
- Why do you think so many public officials from Louisiana (and Illinois) are serving time in prison?
- Do you think Minnesota has more or fewer instances of fraud than other states?

Theory related:

- Why do you think it is hard for fraudsters to stop their schemes once they start?
- Have you seen instances of poor internal controls which could provide an opportunity for theft or fraud to occur?
- How might fraud occur in your organization?
- Have you seen red flags within your workplace?
- Would you be comfortable coming forward to report potential fraud in your workplace?
- Do you know the mechanism to use for reporting suspected fraud within your state agency?

Add additional discussion questions here:

Closing Remarks:

Globally, fraud costs organizations up to five percent of their annual revenue. The government sector is the second most victimized by fraud. It is an expensive burden on taxpaying citizens. It results in losses of public funds. It increases the cost of government services. It also decreases confidence in public officials and government. It affects each of us.

Each agency needs a policy for worker conduct under the statewide code of conduct policy. Statewide policy requires agencies to have designated channels for reporting misconduct. This policy also requires employees to report suspected fraud. Do you know your agency specific reporting channel?

An employee must also report certain cases of suspected fraud to the Office of the Legislative Auditor. The law protects any employee from retaliation who reports suspected wrongdoing in good faith. You can reference statute, policy, OLA contact information, and whistle-blower protections below.

- Minnesota Statute §43A.38, Code of Ethics for Employees in the Executive Branch – <https://www.revisor.mn.gov/statutes/?id=43A.38>
- Statewide Code of Conduct Policy – <http://mn.gov/mmb-stat/documents/accounting/fin-policies/chapter-1/0103-01-code-of-conduct-policy.pdf>
- Reporting to the OLA – <http://www.auditor.leg.state.mn.us/reporting.htm>
- Whistle-blower Protections – <https://www.revisor.mn.gov/statutes/?id=181.932>