First Friday Fraud Facts

November 5, 2010

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Welcome to First Friday Fraud Facts (F^4). This issue will address the effects collusion can have on an organization's internal control system, the average loss and duration of fraud schemes and the effects a strong internal control program can have on prevention and detection.

Single Party Fraud vs. Collusion

Approximately two-thirds of fraud instances are perpetrated by a single individual. These cases result in an average loss of approximately $115,000 to the victim organization. While collusion is less common than single party fraud schemes, collusion results in over four times the loss to the victim organization.

Fraud committed by a single party can be very difficult to detect, but collusion can be even more difficult to deal with. Collusion often allows employees to circumvent otherwise good internal controls that could detect or limit the impact of fraud. Because collusion requires that two or more people are working together to "cheat the system," it is very difficult to prevent or detect.

One of the most common controls to mitigate the occurrence of collusion is to institute mandatory job rotations. In addition, many organizations require employees, contractors, and vendors to provide a disclosure of any relationships that could result in the perception of a potential conflict of interest. When this control is instituted, it should be annually reviewed and updated.

Benefits of Internal Controls

As previous issues of F^4 have indicated, not all controls are created equal. Different controls serve different purposes. While some controls have a greater effect in reducing the loss sustained by a fraud scheme, others help limit the length of time a fraud scheme is perpetrated.

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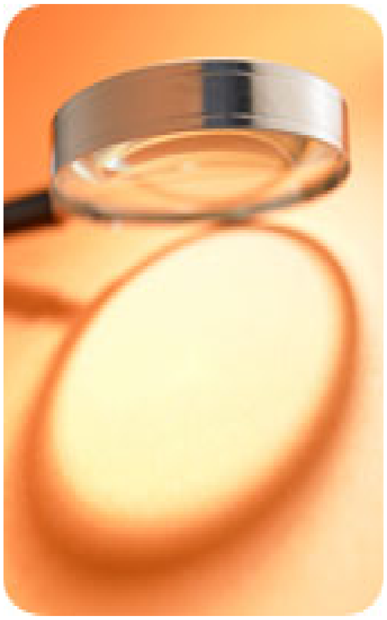


On average companies that had implemented internal controls to protect against fraud decreased their median loss by over 40%. The control with the most notable effect was the presence of a hotline. Over 48% of companies included in a recent Association of Certified Fraud Examiners study had a hotline in place. The decrease in loss attributable to the presence of a hotline was over 59%.

Decrease in Overall Loss Attributable to Presence of Anti-Fraud Control

Anti-Fraud Control	% Reduction
Hotline	59.20%
Employee Support Programs	59.00%
Surprise Audits	51.50%
Fraud Training for Employees	50.00%
Fraud Training for Managers/Execs	50.00%
Job Rotation/Mandatory Vacation	46.80%
Code of Conduct	46.60%

A strong internal control program can also lead to a reduction in the average duration of the fraud scheme. Companies that implemented internal controls to protect and detect fraud experienced, on average, a duration of fraud that was over 33 percent shorter. The control that was attributed with the most significant reduction was the implementation of management review. This single control lead to a 50 percent reduction in the average duration of a fraud scheme.

Decrease in Overall Duration Attributable to Presence of Anti-Fraud Control

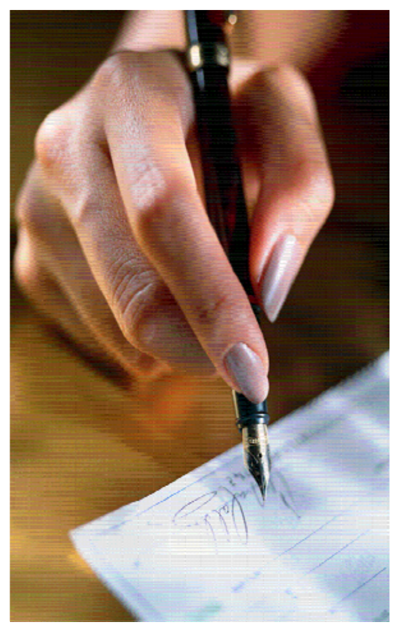
Anti-Fraud Control	% Reduction
Management Review	50.00%
Internal Audit	41.70%
External Audit	37.50%
Code of Conduct	37.50%
Surprise Audits	36.80%
Hotline	35.00%

FRAUD CASE OVERVIEW

This case involves collusion between several high level school district officials. Several individuals were involved in this case, at least 29 received personal benefit as a result of the scheme, and three primary school district officials were indicted in the collusion. These officials included the Superintendent, Assistant Superintendent, and the Account Clerk.

The collusion took place over an approximately eight-year period and resulted in a loss of $11.2 million that was identified by auditors. The largest portion of the stolen funds was $5.9 million that was used to pay the personal credit card bills for the Superintendent, Assistant Superintendent, Account Clerk, and at least 10 of their family members and friends.

Several break downs in the internal controls contributed to the fraud. The Superintendent and Assistant Superintendent had sufficient system access to enable them to override controls and process payments outside the normal flow of transactions. They were essentially able to maintain a fake set of books, in which they recorded seemingly legitimate payments to official vendors. The two employees that could have identified the fraud scheme failed to do their jobs to ensure only appropriate and authorized payments were made. The School Board did not regularly review budget status reports that could have indicated improper/excessive spending. The Board had not established policies or procedures regarding cash receipts and payment, travel, credit cards, or bank account reconciliations. A conflict of interest by the independent auditor resulted in overlooking important information that could have identified the problems.



The fraud was discovered when a tip was reported regarding the district purchasing numerous home improvement items that seemed to be for residential, not school district, use. The initial finding only involved the Assistant Superintendent. The individual and the School Board agreed to restitution of $250,000, which accounted for the loss and fees incurred by the school district at the time. In addition, the Assistant Superintendent was allowed to resign and surrender her administrator's license without any criminal charges or public announcement. A little over a year later additional allegations surfaced and the full scope of the fraud began to be known.

Eventually, the Superintendent pleaded guilty to grand larceny and was sentenced to four to twelve years in prison in addition to restitution of $2.2 million. The Assistant Superintendent was sentenced to three to nine years in prison and restitution of $4 million. The Account Clerk was sentenced to two to six years in prison.