



Internal controls and fraud

- **Three conditions are generally present when fraud occurs: motive, rationalization, and opportunity.**
- **Fraud risk can be significantly decreased through an effective internal control system.**
- **Make sure you know the appropriate channel to report internal control deficiencies or evidence of fraud.**

No one likes to talk, or even think about the potential for fraud in their organization but fraud prevention should always be on our minds.

Fraud is a broad legal concept. However, simply defined, a fraud is an intentional deception made for personal gain or to damage another individual. The perpetrator's intent is usually what differentiates fraud from other errors and mistakes.

Three conditions are generally present when fraud occurs. First, the employee has a motive or incentive to commit the fraud. Second, those involved are able to rationalize or justify the fraud in their own minds. Finally, circumstances in the organization provide an opportunity for the fraud to occur and not be detected. These conditions are often depicted as the three corners of a "fraud triangle."

The highest risk of fraud exists when all three of the fraud triangle conditions are present. To lessen the risk of fraud, you must take steps to eliminate or at least minimize one or more of the three fraud triangle conditions.

Fraud risk can be significantly decreased through an effective internal control system. Creating a positive workplace and a culture of honesty, integrity, and high ethics are key control environment factors relevant to fraud prevention. Although it is impossible to totally influence the thinking and actions of employees, an ethical framework for employee conduct makes fraudulent behaviors more difficult for employees to rationalize or justify.

Fraud risk is most dramatically minimized, however, by putting strong control activities into place. Control activities include procedures such as independent reviews and approvals, reconciliations, and appropriate segregations of duties. Control activities

remove the third fraud triangle condition, which is the opportunity for fraud to occur and not be detected.

Strong control activities also offer employees a safe harbor for performance. Beyond minimizing the risk of fraud, control activities furnish an independent review of employee work, thus providing protection against (or timely detection of) unintentional employee errors and mistakes.

Agency employees should always consider whether they have sufficient control activities in place to prevent fraud, or to detect it promptly if it does occur. Minnesota Management & Budget Operating Policy and Procedure 0103-01, *Code of Conduct for Employees with Accounting, Auditing, Financial Reporting, or Tax Filing Duties*, requires each agency to set up an appropriate, retaliation-free communication channel to receive and respond to evidence of fraud.

Suggested Action Step: Make sure you know your agency's communication channel for reporting internal control deficiencies or evidence of fraud. If you are unsure, consult your supervisor.

If you have questions, please contact Jeanine Kuwik, Statewide Internal Control and Accountability Director at (651) 201-8148 or Jeanine.Kuwik@state.mn.us.