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PREVENTING FRAUD AND MISMANAGEMENT IN GOVERNMENT

Systems and Structures

JOSEPH R. PETRUCELLI
JONATHAN R. PETERS

WILEY

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Foreword

IT SEEMS LIKE GOVERNMENT CORRUPTION is in the news every day and the public's opinion of those representing us is very low. People are frustrated with politicians and their policies, but most of us just complain and go on about our business. My good friend Joe the “800-pound friendly gorilla” Petrucelli decided to do something about it. A dedicated accounting professional, Petrucelli put together this book based on his years of investigating various frauds and applied that to the problems we see in our government. Waste, fraud, and abuse of power are all things that thrive in the darkness but quickly wither in the light of day.

Government should be held accountable to the people, and the best way to do that is for the people to understand how government works. In many ways, the government is transparent in its reporting, but not transparent enough according to Petrucelli and his coauthor, Dr. Jonathan Peters. More transparency is only going to come about through understanding what all the information coming from our government representatives means. When there is understanding, there are questions, and where there are questions, transparency had better follow.

Fraud can be prevented, but it may have less to do with reminding people of their ethical responsibilities and more to do with procedures that let people know that they will be caught if they cheat. The concept of the 800-pound friendly gorilla—someone providing powerful oversight—should be applied to government as much as it is in well-run companies. Now Petrucelli and Peters are doing just that.

—Walter A. Pavlo, Jr.
President of Prisonology, LLC
Forbes.com Contributor
Coauthor of *Stolen Without a Gun*

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TO WRITE A BOOK MEANS someone believes in your ideas and vision. Sheck Cho, Pete Gaughan, Connor O'Brien, and Wiley: Thank you for making this project a reality. To Brien Jones at NACVA, thank you for your continued support.

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CSI students, faculty, and staff: Thanks for re-creating me and allowing me to share in your current and future successes. Your energy, your support, and the team spirit are second to none. To my coauthor, Jonathan Peters, your insight, your support, and all your efforts made this book a reality. Professor Pat Galletta: Thank you for taking time to proofread and for all you do for the students at CSI and allowing me to be part of that.

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To Assemblyman and friend, Robert Karabinchak, thank you for your efforts to create accountable government, for continuing to fight for transparency, and for emphasizing the importance of creating “numbers that don't lie.”

To my staff at PP&D, Lynn, Brian, Joe Z., Joe M., Priscilla, Mom, Jennifer, and anyone else I've missed, thanks for your loyalty and support. My second family.

To my Mom and Dad, thanks for all your support and making believe that “I think I can” means you can as long as you're willing to put the time and

effort in. To my in-laws, thanks for all the years of support. To my two boys, Joey and Matt, I love you and enjoy watching you grow each and every day. Thanks for your support.

To my wife, Angela, who gives me the freedom to be me and reminds me of the importance of family. Thank you for your patience.

To all of those virtuous public servants who show up every day and work to make our government institutions. Your service inspires our work and your selfless dedication is one of the few things that keep us hopeful for the future of government enterprises. We hope you all achieve 800-pound friendly gorilla status and that you use that power to make our government institutions accountable and efficient.

Joseph R. Petrucelli

To Joseph Petrucelli, my coauthor, whose guidance and inspiration was critical to the completion of this work. His boundless energy and endless ideas drew out many concepts and thoughts from me that have enriched this work. My hope is that our writing will inspire further discussion as to the potential solutions for corruption and mismanagement in our government institutions.

To the public servants and elected officials that served with me or worked for the various public agencies I have served or work with. Your endless good and bad examples pepper this work and enriched our discussion, making it all the more accurate. I cannot say it has all been good, but it all has been informative and educational for me.

To my colleagues in the field of public finance and economics. The growing need for our services in government service is becoming more critical as society and elected officials defer key public finance decisions to a later date. We need to step forward into the policy debate and provide clear and objective analysis of our financial challenges. I hope, as a profession, we can develop tools and techniques to help our society pick through the political mire and help us all find reasonable solutions for our government financial challenges that are fair, practical, and equitable.

To my Mom and Dad: You are both at the core of my being. Dad, you still inspire me from Heaven with your life examples of honesty and integrity. You were an 800-pound friendly gorilla if there ever was one. Mom, you were my first and best copy editor. I hope this work reflects well on the time you spent working with me. All errors that remain are due to my flaws, not your training.

To Caroline and Adam, my children, you both continue to inspire me and make me try to be a better person and a better father. Sorry for all the lost time when I was typing and could have done more with you. Sorry for the

missed meals when I was off working on government matters and attending town meetings. I hope that you both have long lives full of adventure and success; I have all the best dreams for you both. Maybe this book will convince you that public service is an honorable and important use of one's time.

To my wife, Nancy, the patient observer of this herculean effort and my endless sounding board for book topics and issues. You have been there through all of my years of government service and academic work. You put up with all that comes from being married to a crazy professor who actually serves as an elected official. Your integrity, wit, taste, and clarity of thought have made this work more precise, more fair, and more grounded in perspective.

Jonathan R. Peters

About the Authors

Joseph R. Petrucelli, CPA/CFF/CGMA/ABV, FCPA, CVA, MAFF, PSA, CFE (CPA in New Jersey, New York, Pennsylvania), is a well-known expert in the area of forensic accounting. He is a founding partner of PP&D Accounting Services Inc. and Fraud Forces Inc., where he provides forensic accounting, tax, and consulting services. He is called upon frequently as an expert witness on valuation, labor negotiations, and fraud. His client list includes large public agencies, major corporations, and multiple municipal unions and governments. He authored *Detecting Fraud in Organizations* (Wiley). He is a popular adjunct professor at the College of Staten Island of the City University of New York, where he teaches accounting-related courses on a regular basis and assisted in the development of a graduate-level forensic accounting course. He frequently lectures on fraud risk and ethics. He is a former New Jersey real estate commissioner and is actively involved in various nonprofit work.

Jonathan R. Peters, Ph.D. (Fair Haven, NJ), is a professor of finance in the Business School at the College of Staten Island of the City University of New York and a member of the doctoral faculty in the Ph.D. programs in economics and earth and environmental science at the CUNY Graduate School. He is also a research fellow at the University Transportation Research Center at the City College of New York. Dr. Peters has served as an expert on panels at the National Academies of Science and is a subject-matter expert in the areas of transportation finance, road pricing, and the privatization of public assets. He has recently published in *Research in Transportation Economics*, the *Journal of Public Transportation*, and the *Transportation Research Record* of the National Academies of Science. He also has served as a member of the Borough Council of the Borough of Fair Haven, New Jersey, for the past 10 years. He currently serves as president of the Borough Council.

Preface

"The tree of liberty must be refreshed from time to time with the blood of patriots and tyrants."

—Thomas Jefferson

THE 800-POUND FRIENDLY GORILLA SPIRIT is back, and joining him in writing this book is Professor Jonathan Peters. In *Detecting Fraud in Organizations*, the idea was to use the gorilla to deter, detect, and prevent fraud in all organizations but with a focus on the private sector. In this book, the same level of thinking will be applied to government and public entities. With the addition of Professor Peters, a whole other dimension will be brought to learning about the existence of mismanagement and fraud in the world of government.

The 800-pound friendly gorilla metaphor refers to creating a self-governing spirit. The gorilla lives in groups. The gorilla eats foliage, leaves, bamboo, and fruits, and it does not have to kill to eat. The gorilla will recklessly pound on its chest, hoping to scare off its enemy to avoid the fight. The gorilla cares for its young. Despite all this, the perception is often that the gorilla is strong and forceful in order to achieve its objectives. The author's reference to the 800-pound friendly gorilla is not a one-person focus but, rather, involves the spirit of all interested concerns. The 800-pound friendly gorilla that will be continually emphasized throughout this book is to remind the reader that it's not about catching fraud and mismanagement after the fact. It's all about setting the proper ethical self-governing tone in the people involved in the process, by ensuring that they understand the consequences of a bad choice before they make it. Good people do bad things, but maybe if they better

understood the responsibilities and the resulting consequences of their actions, they might think twice before doing them.

With the continuing political and social unrest in other countries and at home, people are now faced with idiosyncratic risk. These unsystematic risks occur as a result of change due to the unique circumstances associated with specific microcosms, as opposed to any overall, or macro, perspectives. How much of a role government can or should play in our society and, in particular, with respect to spending and taxation is currently open for public and political debate.

With the continued focus on smoothing social justice and equality, the past and current surge in spending appears to be the means that government has chosen to quell public unrest. Identifying the societal preferences for government services and output will assist in the understanding of how we have arrived at this point. So, how and when did this surge in spending start? No greater set of societal, legal, and government change occurred than during the 1960s, only, perhaps, excluding the 1930s and the Great Depression. All the change was brought about by societal influences. Social movements will come and go, and if there remains a continual attempt to represent all manner of political beliefs and objectives, it is likely that government debt will continue to rise and may lead us down the path to government insolvency.

In the early 1960s, governments relied on increased revenues. Economic growth was strong. Unfortunately, by the early 1970s, when deficits began to pop up in governments, borrowing and other forms of financing became the preferred method of funding government shortfalls. It is interesting to consider the differences between national and state government finances and the flexibility that a national monetary system such as the Federal Reserve may offer in terms of public finance.

In this book, the public debt, including some of the behavior that led to the current \$18 trillion U.S. national debt, will be examined. With government increasing taxes of all kinds, hiking fees such as entrance fees and road tolls, and creating new fees, while providing fewer services, one has to ask why the debt is continuing to increase.

And let's not forget the lowest cost of funds (interest rates) in history, massive financial system bailouts, and questions about inflation fighting. Yet governments and public entities, at all levels, tend to be awash in debt.

One could easily argue that in any government and/or public agency greed is a product of everyone. Starting with the public at large that wants big government when it comes to personal pocketbooks—for retirement needs such as Social Security, medical care, wars, and more—but doesn't want to pay

for any of it, there's the problem of competing greed. The formula we need to examine is whose interests are being served and whether or not the intended needs being satisfied are those of the people that the government and/or public agency intended to benefit.

The conflict-of-interest formula: self-interest of the few/(divided by) self-interest of all should = (equal) 1. We need to have one-to-one correlations, which means everyone is on the same page and rowing in the same direction.

The Government Accountability Office (GAO), formerly the General Accounting Office, provides a unique perspective on this situation. The GAO is an excellent example of an 800-pound friendly gorilla at work. It independently examines the processes and standards of government entities at all levels. Its insight into the financial practices of the federal government is quite telling and provides us with some context for the scale of the challenge we face in reforming government financial practices:

While federal financial management has improved since the federal government began preparing these statements, the GAO has been unable to render an audit opinion on the government's consolidated financial statement because of the following impediments:¹

1. Serious financial management problems leading to financial statements from the Department of Defense that cannot be audited;
2. The federal government's inability to adequately account for and reconcile intragovernmental activity and balances between federal agencies; and
3. The federal government's ineffective process for preparing the consolidated financial statements.

This is pulled directly from the GAO's website. The authors will look to fully explore and explain these types of issues in an attempt to understand potential mismanagement and fraud. Only sound systems and structures built on independent integrity and ethics can correct the problems of the past and pave the way to a fiscally brighter future for government entities.

NOTE

1. http://www.gao.gov/key_issues/federal_financial_accountability/issue_summary.

Introduction

PREVENTING FRAUD AND MISMANAGEMENT in *Government Systems and Structures* explores the dimensions of fraud and mismanagement that can and, unfortunately, do exist too often in government entities. Mismanagement is when people manage or control situations poorly. It can be associated with misconduct, corruption, malfeasance, and misuse and may or may not be fraud. Understanding mismanagement and the intent of the parties involved in it leads to skeptical thinking and close scrutiny.

Both of the authors have extensive experience with government entities—as elected and/or appointed officials and as government staffers and/or contractors. Applying their life experiences in dealing with government entities, the authors bring the reader not only an academic perspective but real-life examples and lessons learned in fraud and mismanagement. Through examples and well-explained overviews, the authors create a much-needed awareness of how mismanagement and fraud in government are precipitated, despite consistent oversight. The authors argue that only through keen awareness and sound adjustment of systems to the changing times can the journey to creating a more efficiently managed government begin. The premier issues of status quo apathy remain: that the general public accepts and, all too often, does not care about fraud in government. This attitude resounds on a daily basis, from the national to the local level. Without interest and at times ensuing outrage, mismanagement and fraud will continue in today's governments.

The words *greed* and *need* rhyme. The two words work hand in hand in developing an understanding of where mismanagement and fraud might exist in government. From the first breath we take, we learn to need. **Need** is defined as “a situation in which someone or something must do or have something.”¹ Now let's define **greed**. Greed is “a selfish desire to have more of something.”² Exploring greed and need in the context of a relevant range of the facts is a key step in correcting areas of mismanagement and fraud in government. The “**carrot and the stick**” comes to mind when thinking of the establishment

of government policies within which a combination of rewards (carrot) and punishments (stick) are used to motivate and control. Once it's understood that a particular "carrot" motivates a person, it is not hard to control that person, as that person's self-interests are being satisfied.

The authors examine areas in which conflicting interests may be hidden in government systems and structures. A conflict of interest is defined as "conflict between the private interests and the official responsibilities of a person in a position of trust."³ Examining the trust we bestow on others and the responsibilities assigned to parties we trust is where the focus needs to be placed in order to prevent fraud and mismanagement in government. Knowing where value (transferred into cash) and people can meet that value within the system and structures is key to developing an understanding of the potential for mismanagement and fraud.



PEOPLE ARE YOUR GREATEST RISK AND YOUR GREATEST ASSET

"We the People of the United States, in Order to form a more perfect Union, establish Justice, insure domestic Tranquility, provide for the common defense, promote the general Welfare, and secure the Blessings of Liberty to ourselves and our Posterity, do ordain and establish this Constitution for the United States of America."

Sound familiar? It's the preamble to the U.S. Constitution. A self-check of unexpected morally guided systems and creation of balance among people are key in getting a good grasp on where fraud and mismanagement can occur in government. This is no different in private organizations, as it all comes down to the tone set at the top of the organizational structure.

Without the proper ethical spirit being instilled at the top and funneled all the way through to the bottom, fraud and mismanagement in government will continue to exist. Notice that the term *ethical spirit* is used, as it would be impossible to create a position of oversight everywhere to make sure people adhere to the higher principles. What the authors are counting on is that the readers of this book will become informed and assume the friendly watchdog tenor of that future 800-pound gorilla by holding those in public service accountable.

These are all familiar partnerships: president-Senate, president-Congress, president-voter, husband-wife, parent-child, board of directors—chief executive

officers, manager-staff, and mob boss-soldier. What is the common theme? Besides their obvious relationship to one another, they are all just people. So the question becomes: “Whose interests are being served, their own or others’?”

In primary school, the familiar Latin motto was learned: “E pluribus unum.” It translates into “One out of many.” But are all people’s needs met equally? How does government handle these differing needs? Is it the proverbial “squeaky wheel” that “gets the oil”? Is a beneficial outcome contingent upon a “horse trade,” making an unethical act for political gain appear acceptable?

The **salad bowl** concept suggests that the integration of the many different cultures of U.S. residents combine like a **salad**, as opposed to the more traditional notion of a cultural melting pot. In Canada this concept is more commonly known as the cultural mosaic.

Crayola brand **crayons** were the first kids’ crayons ever made, invented by cousins Edwin Binney and C. Harold Smith. The brand’s first box of eight Crayola crayons made its debut in 1903. The crayons were sold for a nickel, and the colors were black, brown, blue, red, purple, orange, yellow, and green. The brand name Crayola was created by Alice Stead Binney (wife of Edwin Binney), who took the French words for chalk (*craie*) and oily (*oleaginous*) and combined them.⁴ The idea is that the more colors in your box, the more diversity and, in turn, the more opportunity for creating a more diversified drawing. Yet in government this diversity comes with a cost and often creates distractions that can lead to diversions and ultimate division.

Government tends to mix all funding sources into one bowl in order to satisfy the vast variety of self-interests. It is this **fishbowl** thinking that creates the opportunity for fraud and mismanagement to exist. We like to call it comingling and related-party subsidies.

Government leaders live their lives in a fishbowl. Most of what they do is up for public perusal, broadcast around the world. They are public servants. As such, their lives are no different from that of the fish being viewed as it swims around in its bowl, subjected to the eye of beholder. National service requires a level of openness unheard of by leaders in the private sector of for-profit organizations and even nonprofit enterprises. Social networks and media demand a new level of transparency that fosters communication and interest. Generational shifts, technological advancement, revenue shortfalls, and political changes are just a few of the key shifts occurring at all levels of government to create the necessary awareness. This new complexity demands leaders with proactive vision in order to manage effectively.

Terms like *salad bowl*, *colored crayon box*, and *fishbowl* need to be replaced with one term that reflects a united self-interest. We all know a salad bowl creates diversity in taste, a full box of colored crayons gives a picture with a rainbow-like effect, and a fishbowl full of well-balanced fish with no conflicting interests such as hunger remain peaceful and soothing to view. Yet we know that with diversity comes challenge.

We often forget that the concept of the sum of the whole being equal to its parts can be problematic. This whole is based on some type of grouping, such as proximity or similarity, so the parts can be collected in an organized manner. As we know it, this creates consistency in order to attempt to achieve the whole. But does it really? We mentioned the beauty of what happens with combining vegetables in a salad bowl to enhance the taste. We know that having many crayons to choose from in creating that drawing make it more colorful. We know that a fishbowl full of fish that are well-fed live in peaceful harmony. It's all about balance.

Yet, once conflicting self-interests are introduced, they may become the overriding force in the decision-making process. An environment where mismanagement and fraud can flourish has been created. All it takes is for one fish to want to eat more than the food that is available (resources). Soon the fish seeking more food (resources) looks at the other fish as food, and that fish turns on yet another fish. Soon the only fish that's left to eat is the one that has eaten all the resources.

In an organized structure, everyone has to eat in order to maintain balance. Putting the proper policies and procedures in place that help avoid conflicting self-interests and maintain the resources allows the public entity to remain a viable ongoing concern.

There is no greater government advancement than policies and decisions that advance all people's interests. An adherence policy that requires the core mission and defined objectives of the whole group's interests, not just the parties benefiting, must be considered. This is the formula. The whole, in order to be a sum of its parts, must be balanced, with all interests and concerns addressed. Disneyland is not the only place where this can be achieved. When all interests and concerns are considered, a self-monitoring, ethical group of people can reduce more mismanagement and fraud than the best-defined internal controls.

If you accept our challenge, you will have a significant element to monitor in your everyday lives from this point on—identifying where these conflicting

interests lie. Why is it that people, in general, seem to commonly oppose one another? The answer: Once you identify the potential greed and needs within relationships within a given process, you will be on your way to understanding why conflicting interest left unchecked will continue to enable fraud. The same level of thinking can be applied in determining where potential mismanagement and fraud can occur.

It is always easy to think that it is someone else who should intervene to identify, manage, and correct fraud, but the simple reality is that we all have a hand in government and public corruption, and we all need to lend a hand to control corruption. If not you, then who? If not now, then when? Remember the famous John F. Kennedy quote, “My fellow Americans, ask not what your country can do for you, ask what you can do for your country”? What can you do for your government? You can maintain some level of professional skepticism and, in doing so, help hold government accountable.

FOCUS OF THE BOOK

The authors review government and public entity systems and structures to understand their inner workings and where the opportunities for the kind of misstatement that leads to mismanagement and fraud lie. By continually applying the skeptical who, what, where, why, when, and how—the standard journalism formula for questioning—you will see how one can successfully expose those areas ripe with potential for fraud and mismanagement. Understanding and applying history, we will help the reader gain an understanding of the importance of developing sound structures and systems that can be put in place to mitigate fraud and mismanagement. Notice that the word *mitigate* is used. That is because, since no two people think and/or act alike, there is no 100 percent guaranteed method to stop fraud and mismanagement. One-size-fits-all “government issue” thinking does not work. All laws can do is mitigate some common forms of misbehavior. The most effective mitigation lies in maintaining a high standard of ethics.

Promoting ethical behavior in organizations through ethical leadership has been brought to the forefront in developing effective systems and structures to prevent fraud from occurring. As a result of many of these highly visible frauds, ethical behavior at the top levels of organizations is of interest. While companies such as Enron and Tyco typify corruption, there are examples of

wrongdoing in a wide variety of organizations including, but not limited to, education, athletics, the media, as well as the boardroom. Our focus will be to shed light on the particular areas in the public/government entities.

Being a moral person involves acting with integrity and objectivity that is free from bias. The moral person is perceived as being a trustworthy person. Ethical leaders should exhibit traits such as integrity, honesty, and trustworthiness.

Specifically: The displayed moral behavior of public officials' and public employees' actions in their private lives should be consistent with the moral standards they publicly portray. Look to see if they do the right thing when no one is watching. Are their actions moral? Do they take responsibility for their actions? Do they show genuine concern for others? Do they put others' interests before their own? Do they apply their values when making behavior and management decisions?

The actions being displayed by public officials and employees must be consistently applied to all without bias. The communicated actions must be for the intended purpose of the entity interest and not the public official or employees.

Being a moral manager involves proactively promoting ethical behavior in others through the use of role modeling, communication, and formal reward systems, not only with a monetary perspective. Ethical leaders recognize that subordinates are searching for ethical guidance and that people in these authoritative positions can influence the ethical behavior of others in a positive or negative way.

Achieving ethical behavior is not just a matter of finding the few bad apples that commit fraud, but instead involves helping all the people in the public entity achieve high ethical standards, which can be accomplished through the demonstration of ethical leadership. "Actions speak louder than words."

Examining the visual actions and verbalization behavior by these trusted people is key in developing effective systems and structures—especially examining where these people have access to the organizational value within the organizational processes.

Through this book's exploration of varied histories, the reader will be amazed at how simple it actually is to commit fraud. At issue: Is it necessary to see the theft of money as the only form of fraud and mismanagement? No, because many of the frauds that are perpetrated do not involve money but, rather, theft of time, the gifting of jobs to the unqualified, and even hiring one person to do many jobs. While all of that reeks of a lack of ethics, it may not actually be illegal. Immoral, yes. Illegal, not always. One can consider

why actions such as this have not been made illegal and who would have to pass laws making such hiring illegal. Laws cannot be relied on to legislate moral behavior. The law cannot be the driving force behind a free society that leads to the American dream. It is important to distinguish between the immoral (subjective) and illegal (definitive). Mismanagement may be the result of nothing more than poor work performance.

Some examples of behavior that are illegal (definitive) but morally acceptable (subjective) are: drinking under age, driving over the speed limit, smoking marijuana, cheating on a tax return, or splitting a cable signal to send it to more than one television.

Often the people breaking these laws do not think of themselves or others as immoral. Often the person who is involved in the mismanagement and/or fraud may not see the act as illegal. That in mind, it's important that definitive standards be established and applied to all equally to achieve a proper ethical tone.

Some examples of immoral (subjective), but not illegal behavior are: cheating on a spouse in a marriage, breaking a promise to a friend, or creating budget accounts that are not expected to be spent so funds are available for other expenditures that the public may not want. Many examples of mismanagement are immoral acts that may be self-serving or expedient.

People do not go to jail or get fined for doing these things. These acts may be morally wrong, though, depending on whom you're talking to. When examining behavior associated with potentially poor ethics, these often gray areas need to be examined closely. The immoral view is dependent upon who is viewing the behavior. Minor breaches in ethics that are not illegal serve as a reminder that often in government, or the public sector, the money is lost and debt grows because the person is viewing facts that are subjective and not definitive. These areas of moral judgment are the ones that create the subjectivity we examine in this book. The problem is that *immoral* can mean "criminal" to some and not to others. Only reasonable thinking applied by the whole group of interested parties can set a tone for an ethically balanced society and lead to the mitigation of fraud and mismanagement.

In government and public agency accounting, valuing some assets and liabilities on the balance sheet involves subjective judgment. For example, the management has some discretion with respect to what provisions they need to make for accumulated sick time. Often, the accounts in the government communications are intricately detailed records replete with explanations of past actions. The risk of material misstatement associated with accounting estimation varies as significantly as the complexity and subjectivity associated with the process being examined. The availability and reliability of sufficient

relevant data, the number and reliability of assumptions made, and the degree of uncertainty associated with the assumptions are all key factors that increase the subjectivity and reliability of the findings.

Accounting is a social science involved in the studying, identifying, measuring, and analyzing of the assets of the government or other public-sector entity. Accounting assists in providing the decision making and control for stakeholders, with information previously recorded, in a systematic and useful manner. Accounting produces systematic, structured, and valuable quantitative information. That information is expressed in monetary units, explaining transactions that affect certain identifiable and measurable economic events that have an effect on the government and/or public entity. This is then communicated to interested parties.

Accounting provides information on economic and financial situations for the government and/or public entity at a given time and accumulates those results over a period of time. This means that the information becomes historical, or stagnant. While this information can aid the users in making decisions based on existing management controls in place, it will not lead to the needed projected future controls. Finance professionals will generally provide estimates of future financial conditions of an entity via various forms of financial forecasting. The combination of the historical and projected information would provide financial context for firm managers on a continuous basis.

Thus, sound decisions that are rational and lead to efficiency are made on an ongoing basis rather than from this type of historical perspective. Remember, mismanagement and/or fraud is best mitigated when the proper ethical tone is established while formulating the economic and financial information. This should be supported by continually updating the controls in place on an ongoing, as-needed basis.



RULES: DO THEY STOP FRAUD AND MISMANAGEMENT?

There is a great debate in the accounting world between a rules-based approach and a principles-based approach when preparing financial statements. Without a rules-based approach, these authors think that the accountant's work product, when examined in a court of law, would expose the accountant's judgment to significant discussion of methods and thus increase liability.

Consistency, conservatism, and control lead to balance, while independence, integrity, and objectivity lead to ethics and sound, principled thinking. There needs to be some rule-based standard in order to have consistency and objectivity in financial communications. The English language has a vast range of words, each of which has one meaning, so that we can communicate with each other clearly. Imagine if people could choose the meaning of the words they use. There would be no way to understand each other. Unfortunately, in striving for consistency and objectivity, the opportunity for fraud and mismanagement still seeps in, because things and events often become predictable. Words like *routine* and *expected* need to be replaced with surprise visits, different thinking, and consistency in form rather than substance.

Substance over form in accounting is the concept that the financial statements and accompanying disclosures of an entity should reflect all the underlying realities of the transactions. The information appearing in the financial statements should not merely comply with the legal form. Principles-based thinking means it should make sense versus rules-based thinking that says, “This is the way to do it whether or not it makes sense.” This thinking does not prevent fraud and mismanagement.

For example, someone intent on hiding the true purpose of a transaction could structure it to just barely meet Generally Accepted Accounting Principles (GAAP) rules, which would then allow that person to record the transaction in a manner that hides the true intent of the transaction. Conversely, International Financial Reporting Standards (IFRS), being more principles-based, make it more difficult for someone to justify hiding the intent of a transaction, if they apply the IFRS framework. Using the rules to make the transactions appear correct versus applying the rules with principles-based thinking that reflects the transactions’ real intent prevents fraud and mismanagement.

It is important to abide by this one set of ground rules with respect to exposing mismanagement and fraud—that is, only a judge and jury can convict someone of fraud. Rule 2, as Mr. Miyagi said in *The Karate Kid*, is “Remember Rule 1.” Another key point is that often mismanagement, errors, and other variables exist that may not rise to the level of criminal fraud. Therefore, understanding the requirements of what a judge and jury need to find to establish that someone is guilty of committing fraud is critical. It is all relative to the circumstances and the environment. In Colorado, marijuana is legal; in New Jersey, it’s not. The determining factor is made by the societal views. No one is caught until others say it’s wrong and bring it to light.

MIRD: THE FOUR CRITERIA TO PROVE FRAUD

Here we set forth the elements required to meet the burden of proof associated with fraud. **All—yes, all**—of the elements must be present to find fraud.

The first element necessary for fraud to be determined is that there must be a **material misrepresentation** made. Materiality is one of the judgment-based accounting principles that we discuss in other chapters with regard to developing the proper systems and structures within government entities to prevent fraud and mismanagement.

The second element necessary in determining fraud is that there must be **intent** “to deprive or defraud the true owner of his property.”⁵ Intent is not always easy to prove. There are two burdens of proof. Preponderance of the evidence, also known as *balance of probabilities*,⁶ is the standard required in most civil cases.⁷

“Beyond reasonable doubt” “is the highest standard used as the burden of proof in Anglo-American jurisprudence and typically only applies in criminal proceedings.”⁸ These authors like to use accounting language that equates to the legal term *preponderance of the evidence* by comparing it to the “more likely than not” accounting standard for contingencies for probable, which is defined as 50.01 percent of the proofs on our side. We win. To tip the legal scale the accountant’s way with a high level of confidence usually requires far more than 50 percent certainty. Just hitting 50.01 to 49.99 percent leaves a “flip the coin feeling” to judgment. On the other hand, the “beyond reasonable doubt” in accounting terminology would be equivalent to confirming the cash movement and “the money is in the bank,” leaving no room for doubt. The bank being a third party verification source is considered a strong piece of evidence.

When dealing with criminal fraud, one should look to hold to the “beyond reasonable doubt” standard. In tandem, when dealing with mismanagement, the preponderance of the evidence, or lesser civil standard, is required to correct mismanagement in a government unit.

Fraud and mismanagement are often similar; and it often comes down to whether or not the act itself is a definitive or a subjective one. It’s a matter of legal versus illegal. To clarify, mismanagement is the process or practice of managing ineptly, incompetently, or dishonestly but does not rise to a criminal classification.

One area of concern in the public entity is the mismanagement of funds. This often involves situations in which a person fails to follow the policies and/or guidelines with respect to the public entity’s funds. Most mismanagement, based on the authors’ experience, involves some form of negligence