

Instructor Solutions Manual

Fraud Examination

SIXTH EDITION

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Chapter 1

THE NATURE OF FRAUD

Discussion Questions

1. Fraud always involves deception, confidence, and trickery. The following is one of the most common definitions of fraud:
 - a. *“Fraud is a generic term, and embraces all the multifarious means which human ingenuity can devise, which are resorted to by one individual, to get an advantage over another by false representations. No definite and invariable rule can be laid down as a general proposition in defining fraud, as it includes surprise, trickery, cunning and unfair ways by which another is cheated. The only boundaries defining it are those which limit human knavery.”*

Fraud is deception that includes the following elements:

1. A representation
 2. About a material point
 3. That is false,
 4. Intentionally or recklessly so,
 5. Which is believed
 6. And acted upon by the victim
 7. To the victim’s damage.
2. Fraud affects individuals, consumers, and organizations in various ways. Fraud usually lowers organizations’ net income dollar for dollar. To recover these costs, consumers and individuals must pay more for goods and services. For example, health care fraud and insurance fraud increase premiums that individuals must pay. The cost of fraud eventually reaches every part of the economy, including individuals, consumers, and organizations.

The 2008 study by The Association of Certified Fraud Examiners estimates that U.S. organizations lose roughly 7 percent of their annual revenues to fraud. Applied to the U.S. gross domestic product (GDP), this 7 percent figure translates to approximately \$994 billion in fraud losses.

3.
 - a. **Employee Embezzlement:** In this type of fraud, employees deceive their employers by taking company assets. Embezzlement can be either direct or indirect.

- b. Management Fraud:** Distinguished from other types of fraud both by the nature of the perpetrators and by the method of deception. In its most common form, management fraud is deception perpetrated by top management's manipulation of financial statements. The victims of management fraud are typically stockholders, lenders, and others who rely on financial statement information.
 - c. Investment Scams or Consumer Scams:** A type of fraud that is perpetrated when fraudulent and usually worthless investments are sold to unsuspecting investors.
 - d. Vendor Fraud:** Perpetrated by vendors; comes in two main varieties: fraud perpetrated by vendors acting alone, and fraud perpetrated through collusion between buyers and vendors. Vendor fraud usually results in an overcharge for purchased goods, the shipment of inferior goods, or the nonshipment of goods even though payment was made.
 - e. Customer Fraud:** Usually involves customers not paying for goods purchased, getting something for nothing, or deceiving organizations into giving them something they should not have.
4.
 - a. Criminal law** is the branch of law that deals with offenses of a public nature. Criminal laws generally deal with offenses against society as a whole. Violators of criminal laws are prosecuted either federally or by a state for violating a statute that prohibits some type of activity.
 - b. Civil law** is the body of law that provides remedies for violations of private rights. Civil law deals with rights and duties between individuals. The purpose of a civil lawsuit is to compensate for harm done to an individual. Unlike criminal cases, where juries consist of 12 jurors, juries in civil cases may have as few as six jurors, and the verdict of the jury need not be unanimous. Additionally, judges often hear civil cases instead of juries. In civil lawsuits, plaintiffs must only prove their case by the "preponderance of the evidence." In other words, there need be only slightly more evidence supporting the plaintiff than supporting the defendant.
5.
 - a. Civil
 - b. Criminal
 - c. Civil
 - d. Criminal
 - e. Criminal
 - f. Civil
 - g. Criminal
 - h. Civil

6. Charles Ponzi was successful for several reasons. First, Charles Ponzi built confidence in his scheme by giving early investors a return on their initial investments. Second, Charles Ponzi presented his coupon scheme in a way that was easy for investors to understand. Although the coupon scheme never made any real profits, investors believed that it had. Third, Ponzi was extremely talented at manipulating victims' emotions. Ponzi was able to capitalize on individuals' greed. When people began to see their friends and family members receive dividends from investments, they too wanted in on the investment scam.
7. As the number of frauds and the amounts of fraud losses increase, so do the opportunities for successful careers in fraud prevention and detection. In Chapter 1, we have listed five areas in fraud fighting that will be rewarding and have high demand in the future. They include the following:
 - a. **Government:** This includes FBI, postal inspectors, Criminal Investigation Division of the IRS, U.S. Marshals, inspectors general of various governmental agencies, state investigators, and law enforcement officials.
 - b. **CPA Firms, Forensic Accounting Firms, Litigation Support Firms, and Law Firms:** These individuals will conduct investigations, support firms in litigation, do bankruptcy-related fraud work, serve as expert witnesses, consult in fraud prevention and detection, and provide other fee-based work.
 - c. **Corporations:** Individuals who work for corporations will prevent, detect, and investigate fraud within a company. This category includes internal auditors, corporate security officers, and in-house legal counsels.
 - d. **Lawyers:** Lawyers will defend or prosecute organizations in civil and criminal cases.
 - e. **Consulting:** University Professors, Hospital Management, Technology Corporations, etc. People who work in these areas will consult, serve as expert witnesses, extract evidence from computers and servers, investigate public records, and serve on grand or trial juries.
8. When employee fraud takes place, employees deceive their employers by taking company assets. Management fraud is distinguished from employee fraud and other types of fraud in that top management typically commits it to deceive financial statement users. Employee fraud is usually committed against an organization, whereas management fraud is perpetrated on behalf of an organization.
9. As the numbers of frauds committed and the total dollar amounts lost from fraud increase, the demand for careers to prevent and detect such fraud will increase. In fact, a few years ago, *Fortune* magazine identified forensic accounting or fraud examination as one of the fastest growing and most financially rewarding careers. The American Institute of Certified Public Accountants recently touted forensic accounting/fraud examination as one of the six fastest growing and most profitable opportunities for accountants.

10. There are a number of reasons why accurate fraud statistics are hard to find. First, it is impossible to know what percentage of fraud perpetrators are actually caught. Are there perfect frauds that are never discovered, or are all frauds eventually exposed? Second, many frauds that are discovered are handled quietly within the victim organizations and are never made public. In many cases, companies merely hide frauds due to public relations concerns and terminate or transfer perpetrators quietly.
11. Losses incurred from fraud reduce a firm's income on a dollar-for-dollar basis, reducing net income by \$1 for every dollar that is lost to fraud. To make up for the damage fraud does to net income, a company has to have much more revenue come in. For example, if a company has a profit margin of 10%, to make up for a \$1,000,000 fraud, the company would have to have additional revenue of \$10,000,000.
12. Since confidence is typically needed for fraud to occur, people who are not trusted will not be in a position to commit a fraud.
13. While answers may vary, the following is one possible answer: The case of Charles Ponzi involved deception, greed on behalf of the investors and the perpetrator and confidence in the perpetrator. These are traits that are common in many different cases of fraud.
14. The Association of Certified Fraud Examiners (ACFE) provides the opportunity for individuals to become a Certified Fraud Examiner or "CFE". CFEs are considered to be leaders in the antifraud community and have recognition as such throughout the world. They represent the highest standards held by the ACFE and possess expertise in all aspects of the antifraud profession. The CFE designation is acknowledged globally and preferred by many employers. The ACFE states that becoming a CFE immediately sets an individual apart from others and launches him or her to the top of the profession.
15. While answers may vary, the following is one possible answer: When an individual becomes a CFE, he or she automatically becomes a member of the ACFE. The ACFE is the world's largest antifraud organization and the premier provider of antifraud training and education. Together with more than 70,000 members throughout the world, the ACFE works toward the reduction of fraud and corruption around the globe.

True/False

1. False. In many cases, companies merely hide the frauds to avoid public relations issues and quietly terminate or transfer perpetrators rather than make them public.
2. True

3. True
4. True
5. False. Using physical force to take something from someone is robbery. Fraud involves deceit or trickery, not force.
6. False. Identity theft is stealing someone's personal information so the thief can pretend to be that person.
7. True
8. True
9. True
10. True
11. False. In civil cases, fraud experts often serve as expert witnesses.
12. True
13. False. Banks are required to report their frauds to the government because of their FDIC Insurance.
14. False. Technology has tended to increase the size and frequency of frauds committed.
15. True
16. False. Confidence is the single most critical element for a fraud to be successful.
17. True
18. False. Unintentional errors in the financial statements are not considered fraud. There must always be "intent" for something to be fraud.
19. False. Occupational fraud is usually committed against an organization.
20. True
21. False. Direct fraud does not involve third parties; indirect fraud involves a third party.
22. False: Customer fraud involves a customer who does not pay for goods or services. Vendor fraud involves a vendor who provides inferior goods, overcharges, or pays bribes to get favored treatment.

- 23. False. Only criminal lawsuits result in jail time for the perpetrator. Negative outcomes in civil lawsuits result in restitution and damage payments.
- 24. True
- 25. False. One of the seven elements of a fraud is that the deception must be intentional.
- 26. False. Fraud perpetrators come in all kinds and varieties, but always have to be trusted. If they did not have the trust of their victims, they would not have been put in a position where they could commit a fraud.
- 27. False: Management fraud most often means the deceptive manipulation of a company's financial statements.
- 28. True
- 29. True
- 30. False. A Certified Fraud Examiner (CFE) is considered to be a leader in the antifraud community. A CFE focuses on the prevention and detection of fraud. A Certified Public Accountant, on the other hand, focuses on all aspects of accounting.

Multiple Choice

- 1. a
- 2. d
- 3. a
- 4. d
- 5. a
- 6. b
- 7. b
- 8. c
- 9. d
- 10. d
- 11. d

12. b

13. b

14. c

15. b

16. b

17. c

18. d

19. a

20. d

21. c

22. d

23. a

24. d

25. b

Short Cases

Case 1

Clever, Inc., would have to generate up to another \$10,000, calculated as follows, to recover the losses from the fraud:

$$\text{Profit Margin} = \text{Net Income Divided by Revenue}$$

$$\text{Profit Margin} = \$2,000/\$20,000 = 10\%$$

With a profit margin of 10%, and especially being a manufacturing company, it could take up to another \$10,000 in revenue to recover the \$1,000 fraud loss.

Alexander, Inc., would have to generate no more than another \$4,000, calculated as follows, to recover the loss from the fraud:

$$\text{Profit Margin} = \text{Net Income Divided by Revenue}$$

$$\text{Profit Margin} = \$5,000/\$20,000 = 25\%$$

Because its profit margin is 25%, and because it is a service firm with no cost of goods sold, it would not take more than another \$4,000 to recover the \$1,000 fraud loss.

These amounts are different because the profit margins of these companies are different. Clever, Inc., is a manufacturing company, and for every \$1,000 of net income it must generate \$10,000. On the other hand, Alexander, Inc., must generate no more than \$4,000 for each \$1,000 lost from the fraud. It is usually easier for a service corporation with a higher profit margin to recover from fraud losses than it is for manufacturing companies that must generate more money to recover fraud losses, such as Clever.

Case 2

1. Unintentional errors and fraud are quite different from each other. An unintentional error is an error made by accident or without intent. Fraud, on the other hand, is intentional and most often involves trickery or deceit.
2. While advances in technology have helped to prevent and detect some fraud, these advances have opened up new ways for perpetrators to commit fraud that before were unthinkable. Computers, the Internet, and complex accounting systems have made it so easy that perpetrators need only to make a telephone call, manipulate a computer program, or press a key on the keyboard to commit fraud.

Case 3

1. Customer fraud
2. Investment scam/consumer fraud
3. Employee embezzlement
4. Management fraud
5. Vendor fraud
6. Miscellaneous fraud

Case 4

Fraud statistics are hard to obtain for several reasons. First, we can never know exactly what percentage of fraud is discovered. Are there “perfect frauds” that are never discovered, or do all frauds eventually come to light? Second, the victim organization quietly handles many frauds that are discovered, never making them public. Victim organizations often like to avoid publicity and the costs associated with investigating and prosecuting fraud. These and other factors make it very difficult to research fraud and for accurate statistics to be obtained.

Case 5

As the number of frauds and amounts of fraud losses increase, so do the opportunities for successful fraud-fighting careers. Many believe that fraud examination and forensic accounting will be among the fastest growing and most rewarding careers in the future. Government fraud-fighters, consultant fraud-fighters, corporate employee fraud-fighters, and defense and plaintiff lawyers are just a few of the possible careers related to fraud prevention and detection.

Case 6

When fraud is detected, companies should prosecute if possible, both in criminal and civil courts. By proceeding in a civil suit, the company can try to recover some of the money lost from the fraud. By pursuing a criminal suit, the company can ensure that when other companies hire the perpetrator, those companies will know that the employee has committed fraud in the past and will be able to prevent the prospective employee from being in a position that provides the opportunity to commit fraud again. Firms do not often pursue both civil and criminal remedies, and sometimes do neither because of litigation costs, time involved, or the desire to avoid negative press.

Case 7

1. Fraud occurs when individuals intentionally cheat or deceive others to their advantage. In this case, Bob is committing a fraud. Regardless of the magnitude of the charges, he is intentionally charging nonbusiness lunches to his employer. This is also known as employee fraud, or occupational fraud.
2. As an employee, you have an ethical responsibility to your employer to report Bob's fraudulent behavior. Fortunately, in this case nothing has been done that cannot be corrected easily. Since Bob is justifying his behavior by saying the recent memo pertaining to meal expenses does not apply to him because he is an intern, you should try to help Bob see the error of his logic and encourage him to correct the charges. If Bob is unwilling to change his behavior, the appropriate superior should probably be notified.

Case 8

In the worst case, the additional revenue needed will be the fraud loss divided by the profit margin, or \$50,000 divided by 0.07, which equals \$714,286.

Case 9

1. At 5%, a maximum of \$50,000,000 in additional revenue is needed. At 10%, a maximum of \$25,000,000 in additional revenue is needed. At 15%, a maximum of \$16,666,667 in additional revenue is needed.
2. Some of the various types of fraud that can affect an insurance company are:
 - a. Employee fraud—individuals involved in the benefits area can create false claims for nonexistent policyholders. The victim is the company, and the perpetrator is the employee.
 - b. Management fraud—the company can create nonexistent policyholders to make their revenues appear greater. The victims are the stockholders and other financial institutions that rely on the financial statements. The perpetrators are members of management with the company.
 - c. Customer fraud—policyholders can create false claims to collect money. The victim is the company, and the perpetrators are the customers.

Case 10

Fraud examiners investigate suspected fraudulent activity, whereas auditors are concerned about the overall fairness of the financial statements. One of the biggest differences between auditing and fraud examination is that with auditing, sampling is used to assess whether management's assertions are reasonable. The auditor uses sampling to test the account balances to make sure the accounts are not overstated or understated. Fraud examination cannot be done effectively through sampling. In fraud examination, each transaction should be reviewed and evaluated.

Case 11

1. There are many reasons why Cesar should be terminated from employment. However, one of the most apparent reasons is that organizations that do not work proactively at fraud prevention and detection find themselves as frequent targets of fraud schemes, with the fraud becoming more and more costly. A message that perpetrators will be prosecuted deters other potential fraud by reducing the perceived opportunity.
2. An individual who commits fraud and is not punished or is merely terminated suffers no significant penalty and often resumes the fraudulent behavior. If prosecuted, the individual suffers significant embarrassment when family, friends, and business associates find out about his or her offenses. Humiliation is often the strongest factor in deterring future fraud activity.

Case 12

Nancy should be concerned. First, the bank has a mandatory one-week long vacation policy. Bob should not be allowed to be an exception. Bob also fits many of the demographics for a fraud perpetrator: he has a lot of experience with the bank and is in a trusted position, he often works late into the night all by himself, everyone trusts him, and he likes to give the impression that he is tough on credit. Nancy should not assume that Bob has committed fraud; however, she should demand that Bob take a mandatory vacation, and she should be alert for additional signs of fraud.

Case 13

While answers may vary, the following is one possible answer: The management frauds to which your friend refers involve much more than just stealing money. They are sometimes simple, sometimes very complicated schemes which misstate financial statements and are intended to deceive the public, but that are also orchestrated so that the fraud is difficult to detect in an audit. Financial statement fraud can be very difficult to detect because of the sophistication of the perpetrators and their positions of trust and authority in the company.

Case 14

As fraud detection methods get more sophisticated, so do fraud perpetration techniques. Fraud examination is one of the fastest-growing and most financially rewarding careers. It is not part of a financial statement audit but a distinct profession.

Case 15

Fraud examiners are hired by many different kinds of organizations. Examples include the government, CPA firms, law firms, insurance companies, public and private corporations, universities and hospitals. Fraud examiners are hired to do a variety of tasks, and fraud examination is an exciting and intriguing career.

Case 16

This is a real investment scam that was perpetrated on an American university campus a few years ago. Before it was stopped, hundreds of students had invested hundreds of thousands of dollars. There are many warning signs that would suggest this “investment opportunity” is a scam, including:

- The promised rate of 44% is too high and unreasonable. If it seems too good to be true, it probably is. This promised rate of return does not make business sense.
- The nature of the investment is complicated and can’t be easily understood. Making the investment seem complicated is one way perpetrators try to conceal their frauds.
- You are excited about the investment because several of your friends have invested. Just because they didn’t exercise due care doesn’t mean you should also be stupid.

Case Studies

Case Study 1

1. Jane had suspicions of fraud for several reasons. First, she noticed that the accounts payable checks, which were payable to dual payees, lacked the required endorsement of both payees. Next, Jane observed that several different people wrote all the checks in similar handwriting. Then, both Jane and Gus realized that each of the five checks had been cashed at the same convenience store less than five miles from the home office, even though the mailing address of one of the payees was over 200 miles away. Finally, after beginning investigation, Jane and Gus found that there were no existing documents to support the payments made from the checks.
2. Fraud is often caught through inconsistencies in financial data. Therefore, any discrepancy, however small it seems, may have the potential of assisting the auditor in discovering fraud.
3. There is always motivation for a fraud perpetrator's dishonest actions. Some of these motivations might include, but are not limited to, financial pressures, income-consuming addictions (e.g., gambling, drugs, alcohol, and extramarital relationships), family struggles, work-related strains, tax liens, garnishment of wages, or other pressures. While researching the personnel files of employees, the auditors would be looking for any patterns, characteristics, or past occurrences in the lives of the employees that would indicate any possible motivations for committing fraud.

Case Study 2

1. Fraud occurs when someone deceives someone else through confidence and trickery in order to get gain. This appears to be fraud.
2. By using phrases like "guaranteed winner," Publishers Clearing House deceived many individuals into believing that they had won when in reality they hadn't. By doing so, prosecutors believed that Publishers Clearing House committed fraud.

Case Study 3

1. Those involved in the late-trading scheme have committed both a civil and a criminal offense. By performing trades after approved trading hours, the perpetrators have allowed certain traders to trade with perfect information and have prevented other traders and brokers from trading equities at a price at which they normally would. As such, this case is in violation of civil law. If proven guilty, the perpetrators will be forced to compensate monetarily for the damages they caused to others. They have also committed a criminal offense by breaking the law that regulates approved trading hours. If proven guilty, the perpetrators could be sent to jail.

2. While the Prudential traders involved in the late-trading scheme realized quick and easy profits, other stock and mutual fund traders were hurt. They had an apparent disadvantage to those traders and brokers who practiced late trading. The other traders were forced to buy stocks and invest in mutual funds at a higher price and then sell them at a lower price than they would have if there were no fraud involved. Eventually, however, the perpetrators will incur the most damage as they are forced to fulfill their civil obligations and endure tarnished reputations.

Case Study 4

This is a real case that happened to a U.S. company. The answers to the questions are as follows:

1. In this case, you must do whatever is necessary to determine if there is any validity to the whistle-blower complaint. You must discover the truth and then do the right thing, whatever that is. In this case, that probably means that you hire an investigative law or forensic firm to perform interviews, image hard drives and servers and gather other evidence to determine if, in fact, costs are being understated. You would do as much of this as possible without arousing suspicion.
2. Unfortunately, because top management of the company may be involved, you cannot initially involve them in the investigation. Only after you are certain they are not involved can you bring them “over the wall” and let them know and even participate in the investigation. If this problem is contained to one country it is one thing; if it also involves the top management of the company, you have a much bigger problem.
3. If the fraud is real and is material to the financial statements, then the company will probably have to restate its financial statements. Restatements usually result in a drop in the company’s stock price and shareholder class action lawsuits against the company. Regardless of the cost, as a board member, you must take the high road and get to the bottom of this issue. You must find the truth and then do the right thing.

Debate

Due to the subjective nature of this ethics case, no exact solution is provided. However, the authors do believe that in this situation, students have a proactive responsibility to at least terminate employment. (You may later be sued if you do not).

Answers to Stop and Think Questions:

1. **Why is it more difficult to tell if someone can be trusted on the Internet than in person?**
 - a. When you are dealing with someone in person, you can learn much from their personality, body language, and mannerisms. You can also get to know them better. You can see the person you are dealing with. On the Internet, you have no idea who you are dealing with or whether the person or organization is an imposter. Because Internet perpetrators cannot see their victims, such frauds seem more like a victimless crime.

- 2. Why do you think it is easier for top management to manipulate the financial statements than for other individuals in an organization?**
 - a. Top management can more easily override internal controls than others can in an organization. Also, it is easier for others to follow the instructions of top management than others because employees will say, “it doesn’t make sense to me but if the boss is asking me to do it, he or she probably knows what is right or wrong, so I better do it.” The combination of deference to executives and the ease of overriding controls make it easier for top management to manipulate financial statements than it is for others. They also see the entire financial picture of an organization where as others would only see parts.
- 3. O.J. Simpson was tried for murder both criminally and civilly. He was found innocent in the criminal trial but guilty in the civil trial. Why do you think that is the case?**
 - a. In a criminal case, the jury must reach a unanimous verdict—even one person who feels differently can cause a hung jury or an innocent verdict. In a civil case, only the majority of the jurors must believe that the person was guilty. The conviction standard is lower in civil cases.

Internet Assignment

One solution is to search the home page of the Association of Certified Fraud Examiners at www.acfe.com for more information about careers. There, you will find several links to companies and government agencies that are involved in combating fraud and other white-collar crime.

The Federal Bureau of Investigation (FBI) is probably the largest government agency that employs fraud-fighters. The FBI’s Web site can be found at www.fbi.gov. By clicking on “employment” and “special agent vacancy” links, students can see what an FBI agent actually does.

The Internal Revenue Service (IRS) is another government agency that offers careers in fraud examination. Their employment Web site contains a page giving a description of and qualifications needed to become a criminal investigator. Search www.jobs.irs.gov and then click on the link entitled Criminal Investigation “Special Agent” opportunities.

Chapter 2

WHY PEOPLE COMMIT FRAUD

Discussion Questions

1. Research shows that anyone can commit fraud. Fraud perpetrators usually cannot be distinguished from other people on the basis of demographic or psychological characteristics. Most fraud perpetrators have profiles that look like those of honest people. In other words, the types of people who commit fraud are ordinary people, just like you and me.
2. People can be motivated to commit fraud because of financial pressures, vices, or because of work-related pressures. As well, perpetrators of fraud can be motivated by a perceived opportunity to commit fraud and the ability to rationalize that what they are doing is not wrong. Their motivations are usually combined into the fraud triangle of perceived pressure, perceived opportunity, and rationalization.
3. The fraud triangle includes three elements that almost always must be present in order for someone to commit fraud: a perceived pressure, a perceived opportunity, and some way to rationalize the fraud as acceptable. The fraud triangle is important because it helps us to determine the motives, reasons, and opportunities that someone had in committing fraud. By using the fraud triangle, we can better focus on areas in an organization that will help us detect and prevent fraud.
4. The fraud scale illustrates the relationship between the three elements of the fraud triangle. It shows that perceived pressure, perceived opportunity, and rationalization are interactive. In other words, the greater the perceived opportunity or the more intense the perceived pressure, the less rationalization it takes to motivate someone to commit fraud. Likewise, the more dishonest a perpetrator is, the less opportunity and/or pressure it takes to motivate fraud.
5. Many types of pressures motivate someone to commit fraud. They include financial pressures, vices, work-related pressures, and other types of pressures. Financial pressures include greed, living beyond one's means, high bills or personal debt, poor credit, personal financial losses, and unexpected financial needs. Vices include addictions, such as gambling, drugs, alcohol, and extramarital relationships. Work-related pressures include feeling overworked or underpaid.
6. The controls that prevent and/or detect fraudulent behavior have to do with providing deterrence to those who are thinking about committing fraud. Having an effective control structure is probably the single most important step that organizations can take to prevent and even to detect fraud. There are five components in a company's control structure: the control environment, risk assessment, information and communication, control procedures or activities, and monitoring.

7. Many factors provide opportunities for fraud including the inability to judge the quality of performance; failure to discipline fraud perpetrators; lack of access to information; ignorance, apathy, and incapacity; and lack of an audit trail.
8. Nearly every fraud involves the element of rationalization. Most perpetrators are first-time offenders who would not commit other types of crimes. Rationalizing helps minimize the perceived dishonesty of their acts. Common rationalizations include:
 - The organization owes me.
 - I am only borrowing the money—I will pay it back.
 - Nobody will get hurt.
 - I deserve more.
 - It's for a good purpose.
 - We'll fix the books as soon as we get over this financial difficulty.
 - Something has to be sacrificed.

When interviewed, most fraud perpetrators say things like, "I intended to pay the money back. I really did." They are sincere. In their minds, they rationalize that they will repay the money, and since they judge themselves by their intentions and not by their actions, they do not see themselves as criminals.

9. Jim Bakker rationalized his actions by convincing himself that the PTL network had a good purpose and that he was helping others. Bakker believed that any money he received would directly or indirectly benefit his followers. He had numerous pressures, including greed, selfishness, and a lust for power, and Bakker was in a position of trust. As with most people in positions of trust, he had numerous opportunities to commit fraud.
10. Dr. Sam Waksal committed fraud by transferring shares into his daughter's trading account and then having her trade in his company's stock (insider trading). Because he had insider information, he understood that it would be unethical for him to make trades. However, he rationalized that if he had his daughter make the trades, rather than himself, then his actions would be legal and ethical.

Later on, when explaining his actions, Waksal said the following: "I could sit there and think that I was the most honest CEO that ever lived. And, at the same time, I could glibly do something and rationalize it because I cut a corner, because I didn't think I was going to get caught. And who cared? Look at me. I'm doing "X," so what difference does it make that I do a couple of things that aren't exactly kosher?"

Waksal's rationalization allowed him to have a long history of ethical lapses, reckless behavior, and embellishing the truth. He had been dismissed from a number of academic and research positions for questionable conduct, for example. One former colleague said "cutting corners for Sam was like substance abuse. He did it in every aspect of his life, throughout his entire life."¹

¹ CBSNews.com, "Sam Waksal: I Was Arrogant," 6 October 2003, <www.cbsnews.com/stories/2003/10/02/60minutes/main576328.shtml>, accessed on May 22, 2004.

11. Power is defined as the ability to influence someone else. When a fraud takes place, the conspirator has the desire to carry out his or her own will—influence another person to act and do as the perpetrator wishes—regardless of resistance.
12. Fraud perpetrators use power to influence and persuade individuals to participate in fraud. Fraud perpetrators can get potential co-conspirators to join the fraud by promising a reward or benefit (reward power), by following the orders of a person who is in a position of authority (legitimate power), by making the potential recruit feel fear for not joining the fraud scheme (coercive power), or through deceiving someone because the potential recruit has a lack of knowledge (expert power). Finally, perpetrators can get potential perpetrators to join the scheme through the influence of a relationship (referent power).

True/False

1. True
2. True
3. False. Management's example is a very important part of the control environment.
4. False. Good controls usually decrease opportunities for individuals to commit fraud within an organization.
5. False. Effective fraud-fighters put their efforts into trying to eliminate all three parts of the fraud triangle, especially reducing opportunities.
6. True
7. True
8. False. Fraud perpetrators who are prosecuted, incarcerated, or severely punished usually do not commit fraud again. In fact, they have a very low rate of recidivism, while perpetrators who aren't prosecuted have a high rate of recidivism.
9. True
10. False. Appropriate hiring will decrease an organization's risk of fraud because people with high integrity are less likely to rationalize and commit fraud.
11. False. An individual who owns his or her own business and is the sole employee probably does not need many control procedures. While such people may have ample opportunity to defraud their companies, they have no incentive to do so.
12. True

- 13. False. Documents rarely serve as preventive controls, but they provide excellent detective controls.
- 14. True
- 15. False. Power is almost always used to influence another person to participate in an already existing fraud scheme.

Multiple Choice

- 1. b
- 2. d
- 3. c
- 4. a
- 5. d
- 6. d
- 7. c
- 8. e
- 9. b
- 10. a
- 11. b
- 12. c
- 13. c
- 14. b
- 15. b
- 16. e
- 17. e
- 18. c

19. c

20. b

Short Cases

Case 1

1. **Authorization.** The managers of the stores should follow the authorization policy and review all requests for large amounts of credit and the approval of new credit customers.
2. **Segregation of duties and independent check on performance.** A second individual, preferably someone not in the accounting department, should perform the bank reconciliation.
3. **Segregation of duties and/or independent checks.** With respect to separation of duties, various functions should be assigned to different people. If two separate individuals performed the record keeping and physical handling of inventory, the opportunity for theft would be greatly reduced. With respect to independent checks, test counts of his record keeping could be performed.
4. **Adequate document and records.** A well-designed document should be formatted so that it can be handled quickly and efficiently.

Case 2

While many people would question whether the accounting is appropriate, there is a ready market for the refined products, and both the selling prices and the cost of refining the oil can be reasonably quantified or determined. Accounting rules actually allow recognition in this case. This is a good case to debate because it provides students with experience regarding the impreciseness of accounting rules. In this instance, experts for the plaintiffs argued that the treatment was inappropriate, while experts for the defense argued that the treatment was appropriate. There are many examples concerning revenue recognition, inventory, and other issues where the proper accounting treatment is not absolutely determined. These examples show that accounting is not an exact science. However, aggressive accounting often is motivated by pressure to “cook the books” and is a precursor to and warning of fraud. It certainly was in this case.

Case 3

1. The company lacks good control activities or procedures. Mainly, it lacks segregation of duties, a good system of authorizations, independent checks, physical safeguards, and documents or records. Helen was allowed to sign the payment voucher for services rendered, and she was also allowed to sign for all voucher payments less than \$10,000.

2. Helen was a trusted employee. The company also lacked good control activities. To perpetrate the fraud, all she had to do was continue to process the checks to the terminated vendor and sign the vouchers.
3. The fraud would have been detected if the company had possessed a good internal audit department, combined with security or loss prevention programs. A good accounting system would have helped in the discovery of the fraud and would have made it difficult for Helen to conceal.

Case 4

1. Ruth Mishkin was a trusted employee and she was in charge of paying bills, balancing accounts, and handling cash management.
2. A gambling addiction caused Ruth to have an immense pressure to commit fraud so that she would have additional funds with which to gamble.
3. Because Ruth was a trusted employee, her bosses put her in charge of paying bills, balancing bank accounts, and handling other cash management chores. This lack of segregation of duties provided an easy opportunity to commit fraud.
4. When people are addicted to a vice such as gambling, they feel tremendous pressure. With so much pressure, it takes only a little rationalization and a small opportunity for someone to perpetrate a fraud.

Case 5

1. The company should implement independent checks and segregation of duties controls. The accountant should not be posting to the General Ledger, paying the bills, and signing the checks. The CEO or someone else should sign the checks. Also, the accountant's work should be reviewed for errors and fraud by an independent source. The accountant should be prosecuted civilly and criminally for mail fraud, embezzlement, and money laundering. In addition, it would be a simple task to have the auditors run a computer analysis on the addresses of vendors to look for companies with the same addresses.
2. The company should implement segregation of duties controls. The warehouse manager should not be able to both receive returned items and issue the credit memos. The accounts receivable department should create credit memos, which are then taken to the warehouse where additional goods can be issued. In addition, another worker must process returned defective merchandise. Both the manager and the worker should sign off. The warehouse manager should be prosecuted, and his son should spend more time in the gym.

3. A system of authorizations should be implemented. The board should not allow the CEO to fire his employees and rehire them as contractors. The accountant who prepares payroll records should notice this problem. In addition, if the CEO prepares payroll records, there is also no segregation of duties. The CEO should be prosecuted for tax fraud and money laundering.
4. Authorization and segregation of duties controls should be implemented. The accounts payable clerk should not have custody of the supplies she purchases. Supplies should be logged into a warehouse and then distributed as needed. The accountant should also independently record the clerk's activities. She should not be able to sign checks.

Case 6

1. The pharmacy has a high risk of fraud. Alexia has great pressure to provide well for her family. Alexia also has the opportunity to commit fraud, as she has the responsibility for accounting and is the only worker. She could easily steal cash and manipulate the accounting records.
2. While we don't know if Alexia's rationalization is high or low, we do know that the opportunity and pressure are high. By understanding the fraud scale, we can determine that if pressure and opportunity are high, it doesn't take very much rationalization for someone to commit fraud. Therefore, the risk for fraud is high in this case.
3. It would be very important to explain to the owner the high risk of fraud at the pharmacy. Important control activities are missing. Background checks, segregation of duties, and other controls would lower the risk of fraud.

Case 7

1. Joel has many opportunities to commit fraud. He is a trusted friend of the family. At the restaurant, there is no segregation of duties, system of authorizations, independent checks, or physical safeguards to prevent Joel from committing fraud.
2. An increase in revenues accompanied by a decrease in profits may signal a possible fraud. The changed profit margin ratio (net income/revenues) is a possible symptom of fraud.
3. In this case, as in most cases, a few simple controls could substantially reduce the opportunities for fraud. For example, Bob and Tom could install an automated register into which all sales would be recorded. They could have mystery shoppers eat at the restaurant and pay in cash in order to see if the receipts were recorded. They could make the deposits and reconcile the bank account themselves.

4. Possible answers might be:

- Segregation of duties—do not allow Joel to do everything he is doing.
- System of authorizations.
- Independent checks.
- Physical safeguards—such as automated registers.

Case 8

The major fraud opportunity in this case was the inability to judge the quality of performance of the optometrist. Although the insurance companies clearly could have said that the services rendered by the optometrist were not consistent with what they were paying for, they never had reason to believe they needed to assess the optometrist's services.

Another factor was the lack of access to information. The insurance companies had no way of knowing that many of the services being billed for were not actually being performed, or that many of the patients did not even exist.

Case 9

A couple of possibilities may explain the rationalization element of the fraud triangle. First, since many of the clients were expatriates working outside the United States, there may have been rationalization on the part of Hammond and FCS that it was okay to sell them high-yield investment schemes because they couldn't follow the stock market on a daily basis. The second possibility is that Hammond knew that the accounts were or might be misleading, false, or deceptive. Although he may have thought this, if the other two factors are present, it is easy to rationalize that even though they may be false, they also may be real or genuine. Instead of looking at the situation objectively, he probably rationalized the possibility of it being a legitimate opportunity.

Case 10

1. Reasons why Len should pursue prosecution:

- a. Prosecution sets precedence within the company that fraud will not be tolerated.
- b. Prosecution brings about justice.
- c. Prosecution may result in recovery of stolen funds because of ordered restitution payments.
- d. Prosecution will help prevent dishonest employees from defrauding other organizations.

2. Reasons Len might not want to pursue prosecution are:

- a. Fear that negative publicity will hurt the image of the CPA firm.
- b. He might feel badly for the employee or his family.
- c. He doesn't want to accept responsibility for the lax internal controls that existed in his firm.

3. Answers may vary. However, prosecution is probably more beneficial in deterring future fraudulent activities within the firm.

Case 11

1. Yes, it is a fraud to charge the company for personal lunches that you submit as business expenses. Fraud is often defined by the rules of an organization, and charging the company for personal expenses is intentionally not following the rules.
2. In this example, all three elements of fraud may be present: pressure, opportunity, and rationalization. The opportunity to commit fraud is high, and certainly rationalization is present. It is difficult from the limited facts to know whether a pressure is present.
3. How one responds to the mentor is a subjective answer. If the new employee was aware that such charges represented fraud, she should decline to participate and let the mentor know that she does not agree with charging lunches against company policy. Additional steps could be taken to notify supervisors and suggest that they further educate company personnel regarding company policies.

Case 12

1. Opportunity and pressure are both present in this case. Although the owner of the store maintains close relationships with employees, controls are minimal, and should an employee choose to be dishonest (as this example illustrates), he or she would have ample opportunity to steal. The third ingredient for fraud to occur is rationalization, and given the high pressure and opportunity, rationalization only needs to be low to moderate in this case.
2. This fraud might have been detected earlier by implementing basic cash accounting and reconciliation techniques—separate employee ID numbers to log into registers, independent checks on register totals, two employees always being present to count cash, periodic employee rotations and vacations, and basic analytic reviews.
3. In the future, you should be more concerned with internal controls, greater emphasis on segregation of duties, potentially implementing better computer systems and login authorizations, and possibly even surveillance cameras.
4. Fraud is always less costly to prevent or detect early, and anything you can do to reduce fraud would be wise.

Case 13

1. Lauersen could have felt some pressure to make fertility treatments affordable for his patients.
2. Lauersen perceived that the insurance company did not check carefully on the types of surgeries performed, and therefore it was easy for him to lie about the surgeries.

3. Lauersen may have felt that he was helping women who could not afford to have children. This was the primary factor in his decision to commit fraud.
4. Lauersen could have recommended different insurance companies that covered fertility surgeries. Or, to help maintain his and his clients' integrity, he could have recommended adoption services for those patients unable to afford fertility surgeries.

Case 14

1. The fraud triangle includes perceived pressures perceived opportunity, and some way to rationalize the fraud as acceptable.
 - **Perceived Pressure:** As a single mother of four, it may be difficult for Nancy to provide for her family. Additionally, she feels the pressure to provide some of the “finer things” for her children and give them the best possible care. These perceived financial pressures could motivate Nancy to take money from the doctor.
 - **Opportunity:** Because there is no segregation of duties, Nancy has the opportunity to keep the cash she collects from the customers and write off the account when the books show that all funds have not been collected. Without appropriate controls in place, Nancy has several opportunities to commit fraud.
 - **Rationalization:** Nancy does not feel that she is paid enough to meet her current financial needs. She may rationalize that she deserves an increase in pay to meet her needs. Furthermore, Nancy may feel that she deserves an increase in pay because she does so much work for the doctor's office. Nancy may rationalize that she is just borrowing the money and will repay it later. As a trusted employee, she may rationalize that the doctor would want her to take a little extra money for her needs; after all, she needs the money much more than the doctor.
2. The critical duties of writing checks, making bank deposits, and reconciling bank statements should be segregated and dual custody control should be implemented. Nancy should not be collecting, recording, and depositing payments all by herself. An additional employee may need to be hired. Commonly, an outsourced billing office is used as a check and balance. Each of these activities can be given dual custody by both Nancy and another person. Although this control can often be expensive, it may be worth it to the doctor. The doctor should analyze the risk/benefits of hiring another person.

Case 15

1. Joe had several financial pressures: his wife just had a fourth child; they had just purchased a new home; and he had experienced a severe drop in commissions earned. His opportunity arose from the fact that the company had poor internal controls over petty cash. Shortages were usually written off. Joe's rationalizations could have been that his thefts were only temporary; the company owed him more money; or he worked hard and deserved the money.

2. The company could have prevented the fraud from occurring by having better controls over the petty cash. For example, the company could have had one person be the petty cash custodian requiring anyone with a need for petty cash to go through that person. There should also have been periodic reconciliations of the petty cash fund.

Case Studies

Case Study 1

1. The office manager works alone and has significant opportunities to alter the books or accounts of customers and pocket money for himself. Employees working unaccompanied can also take side jobs and pocket the receipts for themselves. Additionally, they can use the chemicals to provide lawn care to family and friends at no cost.
2. Fraud symptoms that should be looked for or that are evident in this case include: less time with office manager, more chemicals being used than necessary, employee homes receiving unpaid services, and increased revenues with declining profits. Employees may have taken on new customer jobs and pocketed the money because the customers are not entered on the computer system.
3. The office manager should be monitored more closely, and the accounts should be checked on a more regular basis. The owner will have to spend more time ensuring that the office work is done correctly. Daily checks on supplies may be necessary to make sure employees are not using chemicals for personal gains. Employees' work habits should be watched. Putting these controls in place will cost more employee time but may provide greater benefit by reducing costs.

Case Study 2

1. Pressures, opportunities, and rationalizations for James's fraud:
 - Pressures: James was heavily in debt. Also, the financial position of Best Club was declining significantly.
 - Opportunities: Complexities in insurance policies and procedures, James's management position, and "a reputation as an entrepreneurial talent."
 - Rationalizations: Despite his debt, James thought that it was temporary. He had confidence in Best Club/Red House's future potential to bring him financial success.
2. Some of the fraud symptoms are: no equipment and work order contracts existed to secure loans; money orders disappeared; there were unusual zeros in the customers' bills; James was living the "good life," with an expensive house and a new sports car; and too many insurance claims were filed.

3. Controls or actions that might have detected the fraud are: independent checks by the insurance company, investigations of complaints by customers being charged too much, and investigations of the apparently rapid growth of his company.

Case Study 3

1. Johnson Manufacturing does not have a very active board of directors, and there is little monitoring of employees.
2. Employee compensation is dependent on the performance of the unit. If the division doesn't do well, salaries and bonuses will be cut.
3. Harris's rationalization was that she was providing a short-run solution to the profit decline resulting from the competitor's price-cutting, and the decline would be only temporary.

Case Study 4

1. Mr. Armstrong had the trust of his investors. Because investors trusted him, they put substantial amounts of money into his funds. If the investors had trusted Mr. Armstrong less, they would not have given him unlimited control of their money.
2. If investors had known of Mr. Armstrong's background, they would have been less likely to trust him and probably wouldn't have allowed him complete control over so much money.

Case Study 5

1. You trust your cousin but how do you know that her friend's request is legitimate?
Without doing some investigation, you don't really know that your cousin's friend's request is legitimate. If you make a contribution without checking, you are placing confidence in both your cousin and her friend, something that is necessary for someone to con you out of your money.
2. Would you make a contribution to help this little girl?
It would be smart to do some background checking first, although medical records are protected in the U.S. and it would be hard to discover whether or not the 4-year old girl really has cancer or not and whether the woman needs financial assistance even if the girl does have cancer.
3. What kind of fraud could your cousin's friend be committing?
Either your cousin or her friend could be deceiving you into believing the girl has cancer when she really doesn't or that, even if she does have cancer, money is needed for medical help.

4. How could you make sure the request is legitimate?

As stated in part 2, because of HIPAA (Health privacy) laws, it would be very difficult to know for sure if you are being told the truth. In fact, in this case, it was all a lie. Here are news articles about the fraud with the names and the locations changed.

Formal charges have been filed against a NewTown woman who police say made up a story about her 4-year-old daughter having cancer and solicited more than \$3,000 from sympathetic donors. Jane Doe, 30, was charged Tuesday with one count of felony communications fraud and is set to appear in court Sept. 9. NewTown Police said they began investigating Ms. Doe in July after multiple people complained that she duped them into donating. The girl's father told police he had no knowledge of any cancer treatments or any diagnosis of leukemia. Detective Myran Hansen told the NewTown News the little girl herself believed she was sick. After reviewing medical records for the girl and Doe's two other children, detectives said they found no evidence of a leukemia diagnosis or anything similar. Police said Doe admitted to making up the story in an effort to get her ex-husband's attention, but said "things got out of hand," police wrote. She said she'd used the funds to pay bills. Doe was arrested Aug. 13, and has since posted bail. Authorities said Doe received at least \$3,183 from fundraising events and personal donors, including people whose own children had legitimate cancer diagnoses.

- *Another news article a couple of months later stated that friends and family say there's a reason Jane Doe was able to convince everyone around here that her 4-year-old daughter had leukemia. She's done it before. "This is her third scam involving cancer," Mary Smith said Wednesday during Doe's sentencing hearing in 6th District Court.*

Internet Assignment

1.

- a. More than 70,000 professionals.
- b. An extensive application process and passing the uniform CFE examination.
- c. The mission of the Association of Certified Fraud Examiners is to reduce the incidence of fraud and white-collar crime and to assist the membership in its detection and deterrence.
- d. Certified Fraud Examiners (CFEs) come from various professions, including auditors, accountants, fraud investigators, loss prevention specialists, attorneys, educators, and criminologists. CFEs gather evidence, take statements, write reports, and assist in investigating fraud in its varied forms. Most major corporations and government agencies employ CFEs, and others provide consulting and investigations services.
- e. Hopefully you do have what it takes.
- f. Examples might be the "Auditing Accounts Receivable" workbook, "Fraud-Related Internal Controls" workbook, and the "Beyond the Numbers:

Professional Interviewing Techniques” self-study video. All of these materials and many others offered on the site would help anyone who wants a fraud-fighting career.

- g. The “EthicsLine”—EthicsLine provides a toll-free number used to report anonymous allegations of ethical violations, fraud, waste, and abuse. EthicsLine is manned 24 hours a day, 365 days a year by contract law enforcement personnel, Certified Fraud Examiners, and trained professionals. When an employee of a subscriber company calls, he or she will be asked to describe the nature of the suspected problem. From there, the EthicsLine service will promptly relay the information to your company. Your company then decides about what action is necessary.

Debate

1. The purpose of the debate is to help students wrestle with ethical issues before they are actually faced with those issues later in their career. While there is no correct answer to the debate, we strongly encourage students to look at the various options, and consequences to those options, that are available.

Answers to Stop and Think Questions

1. Think about a time in your life when you compromised your own ethical standards. How did the elements of pressure, rationalization, and opportunity affect your decision making? Were the three elements interactive—in other words, did it take less opportunity to make the decision when you were under tremendous pressure?
 - a. Answers to this stop and think will vary by person. However, most individuals in the class will have compromised at some time in their life. You shouldn’t let them off the hook too easily.
2. How have individuals you know used power to influence your actions? Have you done something simply because a person(s) had legitimate authority (such as a boss or teacher) over you? Have you ever done anything because a person offered you a reward or benefit for your actions? Have you ever been influenced to participate in something simply because you were asked by a close friend or colleague? Perhaps, in a group project at school you have agreed to do an assignment a certain way because you felt a classmate knew more about the subject matter than you did. Have you ever done anything because you feared possible punishment for not doing it? Chances are that all of us have been influenced to do something based upon power that was exerted by others. These five types of power influence all of our actions everyday.
 - a. Again, the answers will vary by student. Again, you shouldn’t let them off the hook by answering that they haven’t been influenced by the power of others—all of us have.

Chapter 3

FIGHTING FRAUD: AN OVERVIEW

Discussion Questions

1. Fraud prevention is important because it is the most cost-effective way to reduce losses from fraud. Once fraud occurs, there are no winners.
2. Creating a culture of honesty and high ethics helps to reduce fraud in various ways. Management through its own actions can show that dishonest, questionable, or unethical behavior will not be tolerated. By hiring the right kind of employees, management can select people who are less likely to rationalize their illegal or unethical actions as acceptable. By communicating expectations, management can give fraud awareness training that helps employees understand potential problems they may encounter and how to resolve or report them. And by creating an honesty-driven culture, management can help to develop a positive work environment. Research indicates that fraud occurs less frequently when employees have feelings of ownership toward their organization than when they feel abused, threatened, or ignored.
3. Identifying sources and mitigating risk means that an organization needs a process in place that both defines areas of greatest risk and evaluates and tests controls that minimize those risks. Risks that are inherent in the environment of an organization can often be addressed with an appropriate system of control. Once risks have been assessed, the organization can identify processes, controls, and other procedures that can minimize risks. Appropriate internal systems include well-developed control environments, effective accounting systems, and appropriate control procedures.
4. Because most frauds increase dramatically over time, it is extremely important that when frauds occur they be detected early. Once a fraud has been committed, there are no winners. Perpetrators lose because they suffer humiliation and embarrassment as well as legal punishment. Usually, they must make tax and restitution payments, and there are financial penalties and other adverse consequences. Victims lose because assets are stolen and they incur legal fees, lost time, negative public exposure, and other adverse consequences. The investigation of fraud can be very expensive. Organizations and individuals that have proactive fraud prevention measures usually find that those measures pay big dividends.
5. When fraud is suspected it is important to conduct a thorough review in order to (a) avoid wrongly targeting innocent people; (b) gather sufficient factual evidence about the suspected fraud; and (c) ensure a complete report of all the facts and circumstances, both incriminating and exonerating, is prepared.

6. The types of evidence produced while investigating fraud can be classified into *evidence square*. The evidence square includes testimonial evidence, documentary evidence, physical evidence, and personal observation. Testimonial evidence includes evidence gathered from interviews, interrogations, and honesty tests. Documentary evidence includes evidence gathered from paper, computers, and other written or printed sources. Physical evidence includes fingerprints, tire marks, weapons, stolen property, identification numbers or markers on stolen objects, and other tangible evidences that can be associated with theft. Personal observation includes evidence collected by the investigators themselves, including invigilation, surveillance, and covert operations.
7. The evidence square allows us to identify the different types of evidence that can and should be gathered, to identify the evidence gathered, and then to categorize possible evidence so that it is easily understood and correlated with all other sources of evidence in the investigation.
8.
 - a. **Surveillance** – personal observation
 - b. **Tire marks** – physical evidence
 - c. **Honesty test** – testimonial evidence
 - d. **Interview** – testimonial evidence
 - e. **A computer hard drive** – physical evidence (Some would classify this as documentary evidence.)
 - f. **A financial statement analysis** – documentary evidence
 - g. **A paper report** – documentary evidence
 - h. **Identification numbers on vehicles** – physical evidence
 - i. **Audit of financial statements** – personal observation (Some would classify this as documentary evidence.)
 - j. **Check stubs** – documentary evidence
 - k. **Fingerprints** – physical evidence
 - l. **Background checks** – documentary evidence (Some would classify this as personal observation.)
9. One of the major decisions a company or fraud victim must make when fraud is committed is what kind of follow-up actions should be taken. Most organizations and other victims of fraud usually make one of three choices: take no legal action, pursue civil remedies, and/or pursue criminal action against the perpetrators.
10. Civil proceedings seek to reclaim the assets stolen in the fraud. Often, with employee fraud, the employee quickly liquidates and spends the proceeds of the fraud. Thus, there is usually very little to reclaim in a civil suit. However, when fraud involving organizations occurs, civil actions are often useful because those organizations have assets (deep pockets) from which they can pay the damages.
11. Management often avoids taking legal action against fraud perpetrators because of the legal cost and the bad publicity for the company. They justify that the legal costs and

time spent are more than the value of what was stolen, and what was stolen is less valuable than the company's good reputation. They fail to recognize that they are destroying the company's culture of honesty, and opening themselves up for future, potentially larger, frauds.

True/False

1. True
2. False. While a hotline for tips can help detect fraud, there are two fundamental activities that prevent fraud: taking steps to create and maintain a culture of honesty and high ethics, and assessing the risk of fraud and developing concrete responses to mitigate the risks and eliminate opportunities for fraud.
3. False. An important step in creating a culture of honesty involves developing a positive work environment.
4. True
5. True
6. True
7. False. When a perpetrator is not caught, his confidence in the fraud scheme will increase and he will usually become increasingly greedy.
8. True
9. True
10. False. Physical evidence includes fingerprints, tire marks, weapons, stolen property, etc. Paper, computer, and written documents are usually classified as documentary evidence that are part of the concealment scheme.
11. True
12. False. Preventing fraud is generally the most cost-effective way to reduce fraud losses.
13. True
14. True

15. False. Expectations about punishment must be clearly communicated from top management throughout the organization to effectively implement a fraud prevention program.
16. False. Frauds usually start small and get larger and larger if not detected.
17. True
18. True
19. True
20. True
21. False. Many frauds involve the CEO, so telling only the CEO could be ineffective. For this reason, Sarbanes-Oxley requires public companies to have independent whistle-blowing systems, so company management is not involved in the whistle-blowing system. Sherron Watkins of Enron notified the Chairman of Enron of a brewing scandal, but it was not enough.
22. False. Even though complete prevention is usually not possible, “preventing fraud” is generally the most cost-effective way to reduce losses from fraud.
23. False. Preventing fraud is generally the most cost-effective way to reduce losses from fraud.
24. False. Most fraud perpetrators are first-time offenders who have positive reputations in their work, community, family, and church environments.

Multiple Choice

1. c
2. d
3. b
4. a
5. a
6. b
7. d

- 8. c
- 9. d
- 10. d
- 11. d
- 12. d
- 13. d
- 14. a
- 15. d
- 16. a
- 17. a
- 18. c
- 19. d
- 20. d
- 21. c
- 22. b

Short Cases

Case 1

1. There are at least five critical elements in creating an ethical culture:
 - a. Having top management model appropriate behavior.
 - b. Hiring the right kind of employees.
 - c. Communicating expectations throughout the organization and requiring periodic written confirmation of acceptance of those expectations.
 - d. Creating a positive work environment.
 - e. Developing and maintaining an effective policy for handling cases of fraud.
2. Each of the elements listed above would need to be implemented within the company. In order for management to model appropriate behavior, they would need to accept and understand company policy and choose to model that behavior. To hire good

employees, the company should perform background checks on potential employees. Expectations for company employees should be clearly communicated through a corporate code of conduct. Management would need to take the necessary steps to create a positive work environment. When fraud does occur, management must handle the case efficiently and effectively and then perform the necessary steps to ensure that fraud does not occur again. As well, management must communicate to employees that fraud will not be tolerated within the company.

Case 2

Detection and investigation are steps that are taken once fraud has occurred. At this point, much of the damage has already been sustained—victims' assets are stolen, victims must incur legal fees, lost time, negative public exposure, and other adverse consequences. Investigation of fraud is typically very expensive. Organizations and individuals that have proactive fraud prevention measures generally find that those measures pay big dividends.

Case 3

Because most frauds increase dramatically over time, it is extremely important that when frauds occur they be detected early. In most cases, the fraud losses that an organization experiences in the final few months of a fraud are higher than the total losses in the first few years of the fraud.

Case 4

1. Research has shown that it is employees and managers, not auditors, who detect most frauds. To effectively prevent and detect fraud, employees and managers must be taught how to watch for and recognize fraud symptoms. By training employees and managers about fraud, the company will save thousands of dollars; many frauds will be prevented, and if a fraud does occur, it will be detected earlier.
2. One of the most effective ways to involve employees in fraud prevention and detection is to provide a formalized protocol for communication that informs employees and others to whom they should report suspected fraud and what form that communication should take. The protocol should assure confidentiality and stress that retribution will not be tolerated. Organizations that are serious about fraud prevention must make it easy for employees and others to come forward and must reward them, not punish them, for doing so. These types of reporting systems (whistle-blowing systems) are now required for public companies under the Sarbanes-Oxley Act.

Case 5

1. It would be important to tell your boss that fraud occurs less frequently when employees have positive feelings about the organization or when they feel ownership in the organization. When employees feel abused, threatened, or ignored, the risk for fraud increases.

2. Factors that have been associated with high levels of fraud and that detract from a positive work environment include a top management that does not care or pay attention to appropriate behavior, negative feedback, and a lack of recognition. Perceived inequities in an organization, autocratic rather than participative management, low organizational loyalty, unreasonable budget expectations, unrealistically low pay, poor training and promotional opportunities, high turnover and/or absenteeism, lack of clear organizational responsibilities, and poor communication practices within the organization also contribute to a high risk of fraud and detract from a positive work environment.

Case 6

This case should provide the basis for discussing several aspects of ethics in business. Students will likely have different points of view. The authors believe that ethics can be “taught,” although not in the same way that history or math is taught. A student’s sense of ethics develops over time and is reinforced by dealing with ethical dilemmas. The way people approach and deal with ethical issues seems to be affected by life experiences, including formal education.

There are four levels of ethics: a basic sense of right and wrong; application of that basic sense of right and wrong to business—interpretation of values; ethical courage to make the decision you know is right even when faced with adverse consequences; and ethical leadership—modeling ethical behavior. While the first one—basic sense of right and wrong—may not be effectively taught in school, the other three can.

The authors have tried to expose students to fraud cases where dishonest acts were rationalized because of low ethics. By incorporating ethical issues in several end-of-chapter cases throughout the book, hopefully students will have an increased awareness of ethical dilemmas encountered in business.

Case 7

Fraud investigation is a complex and sensitive matter. If investigations are improperly conducted, the reputations of innocent individuals can be irreparably damaged, guilty parties can go undetected and be free to repeat the act, and the offended entity may not have information to use in preventing and detecting similar incidents or in recovering damages. Therefore, it is important that fraud investigations not be conducted without predication.

Case 8

There are three follow-up alternatives available to organizations once fraud has occurred: take no legal action, pursue civil remedies, and/or pursue criminal action against the perpetrators.

Case 9

As is the case in many organizations, the likelihood of fraud increases when employees are hired based on their ability to get the job done rather than being hired for their honesty and integrity. Although Fujimori was successful as a president, his alleged lack of integrity led to a scandal and left a nation without a leader for an extended period of time. The people would probably have been better served by choosing someone with more integrity to lead them.

Case 10

Background checks are a very good way to determine whether people have a past that may be indicative of future fraud. Some fraud perpetrators have deceived even the best interviewers into thinking that they are hard-working, honest people. Especially in the early stages of a business, the individuals hired mold and create a culture at the organization. A culture of honesty or dishonesty, as well as potential losses from fraud, are at stake if the wrong people are hired.

Case 11

Here is a news article about this case. **G.M. Missing \$436 Million, Accuses L.I. Dealer of Fraud** By THOMAS J. LUECK Published: April 09, 1992

Life in this Suffolk County village hasn't been quite the same since sheriff's deputies began removing 700 new cars from John McNamara's sprawling dealership on Friday and General Motors accused him of fraud in obtaining hundreds of millions in loans from the company. As a car dealer, developer, newspaper publisher, Republican Party insider and philanthropist, there was no one to match Mr. McNamara, the "Mr. Big" of this community and a quintessentially American small-town entrepreneur. For now, all that is clear about Mr. McNamara's problems can be found in papers filed in civil court by the General Motors Acceptance Corporation, which charged him with obtaining loans to finance cars that did not exist, falsifying documents and failing to divulge his business dealings. General Motors said Mr. McNamara owes it \$436 million, and it obtained a court order from State Supreme Court in Hauppauge to have his dealership, McNamara Buick-Pontiac, shut down and 700 cars and trucks in his lot, worth \$13 million, removed.

Here are the answers to the questions.

1. The amount of revenue needed to make up for the fraud depends on the profit margin or how much net income is made for each dollar of revenues. If the profit margin is 10%, then 10 times the fraud losses would be needed or a total of \$4.36 billion. If the profit margin is 5%, then twice that much revenue would be necessary.
2. Reducing future frauds would require the company to embark on a journey to do all of the things mentioned in the chapter, including: (1) taking steps to create and maintain a culture of honesty and high ethics and (2) assessing the risks for fraud and developing concrete responses to mitigate the risks and eliminate the opportunities for fraud.

3. In a company as big as General Motors, it is certainly not possible to eliminate all frauds, regardless of how good the internal controls and other fraud prevention initiatives are. There will always be some dishonest employee who will perceive an opportunity and be able to commit fraud. However, companies like GM can substantially reduce the occurrences of fraud and, when a fraud occurs, can detect it before it gets huge like this one did.
4. This fraud was probably allowed to occur because of a lack of internal controls or because internal controls that were in place were not being followed or were being overridden. There were probably other factors that allowed the fraud to occur but without being there, it is impossible to know what they were.

Case 12

Prior to the policy change, employee fraud was not seen as a serious issue, and prosecutions were unlikely. The general message was that nothing serious will happen to you if you commit fraud (fraud was acceptable), and so it proliferated. But, creating a policy that would essentially prosecute everyone involved in fraud (minimizing these bad-news reports to the CEO), it was clear that fraud would not be tolerated. As a result, fraud within the organization decreased.

Case 13

Jamie needs to understand that most fraud perpetrators have no past history of fraud, and so seemingly “good” people are sometimes involved in fraud. Since fraud requires “confidence,” it is usually those you trust most who are in the best position to commit fraud. By not taking action Jamie is putting in jeopardy the culture of the organization; this destroys the culture of honesty that could exist if it was well known that all fraud would be handled seriously.

Case 14

1. The management of this company seems too relaxed. They did not provide for an independent check of the accounting records and cash. They created an easy opportunity for Mary to embezzle.
 - a. There was an inadequate segregation of duties in the company. Peter Jones should have been assigned to do some of Mary’s duties so that there was a reduced opportunity for embezzlement.
2. The company should have paid more attention to internal controls, both preventive and detective. Mary had no accountability to anyone, and no one ever checked her work.

Consistent communication could have been one of the effective ways of reducing the fraud. This would have helped identify and remind the employees of what is expected

of them by the company. They could have also required a written and signed statement that stated the possible punishment for committing fraudulent acts.

Periodically, XYZ's management should have asked Peter Jones to take care of Miller's books while she was required to take vacation time. This would have helped detect the fraud at its early stages. Additionally, it might have prevented the fraud, since Mary would have known that someone else would be checking her work.

CASE STUDIES

Case Study 1

1.

a. The potential pressures for Chris to commit fraud are:

1. The pay that he is receiving relative to the expenses of school, family, and technology widgets was low. While living on a tight budget, the unexpected extra expenses, such as car repairs or medical expenses can put individuals in a pinch and add to the pressure to commit fraud. To get even with his employer for not promoting him or feeling underpaid for the responsibility with which he contends daily.

b. The potential opportunities for Chris to commit fraud are:

1. Lack of controls within a growing technology company. The company is integrating software and corrupting accounts and it is easy to disguise fraud in such an environment. Little or no monitoring system on the phony credit card that was provided him. Failure to experience discipline for past actions.
2. He is the most technologically advanced in the group; therefore, he may be able to devise a way to manipulate systems without the knowledge of his supervisor.
3. He was a trusted employee and was allowed latitude in making decisions.

c. The potential rationalizations that Chris could use to justify his actions include:

1. Chris could feel that he deserves higher pay as he has increased the efficiency of the team and holds the responsibility of training those around him. In other words, his responsibilities have increased but his pay has remained the same.

2. The credit card is a phony credit card that results in no bills and does not charge anyone for services put on the card. In the end, someone will pay for the transactions, but the changes won't be recognized immediately.
3. The money that Chris could steal would be for a good purpose—to further his education, which would ultimately increase his value to the company; therefore, the company is really benefiting from the fraud.

2. The potential symptoms of fraud include:

- a. Chris increasing spending on the latest technology (lifestyle symptom).
- b. Chris moving his monitor into a position where no one could see his screen (behavioral symptom).
- c. Chris changing his spending habits without a change in salary (lifestyle symptom).
- d. Chris creating multiple usernames for testing purposes (analytical symptom).

3. Jonathon could have reduced the possibility of fraud by:

- a. Punishing Chris for his actions in order to create an environment that tells employees that the company does not tolerate or justify dishonesty in any form.
- b. Creating an internal report that monitors the usage of the phony credit card. This could be done in conjunction with requiring that employees maintain an activity log of all transactions using the phony credit card. These two reports would be compared every month for accuracy. The company can also require that a manager approve any transaction requiring the use of the credit card.
- c. Providing a hotline for fellow employees to report suspicious activity.
- d. Having individuals rotate responsibility and audit each other's performance.
- e. Performing random checks on individuals' computers as part of company policy.
- f. Establishing tighter controls and monitoring systems for the operations team so that reports are run in order to determine effectiveness and any outliers within a normal distribution.

Case Study 2

1. The definition of fraud is "... a generic term that embraces all the means which human ingenuity can devise, which are resorted to by one individual, to get an advantage over another by false representation." Fraud is deception that includes the following elements:
 - A representation
 - About a material point
 - That is false,

- Intentionally or recklessly so,
- Which is believed
- And acted upon by the victim
- To the victim's damage

Based on the definition of fraud, we can analyze the situation as follows: Derek's company represented Derek as an SAP expert implying certain training capabilities. This representation was false and was intentional. The client believed that Derek was an expert because they were told in good faith that he was. The client was billed at an "expert" billing rate. This meant that the client overpaid for Derek's work since he wasn't an expert.

This kind of misrepresentation may be standard practice in this type of business situation. Some could argue that if Derek's firm delivered the system on time and that it worked properly, it doesn't matter what you call the people that implemented it; they got the job done, so where's the fraud?

On the other hand, the firm intentionally misrepresented its consultants' credentials (material point) even though the credentials were false. The client believed the firm and paid the fees (acted upon), believing that Derek was in fact an expert. Even though this practice may be standard in this industry, the authors believe this would still be considered a form of fraud. If the client were to find out about the fraud, the fraud would probably not bring the company down, but it could jeopardize the relationship with the client. If something were to go wrong with the project, both firms could end up in court.

2. Mike, the purchasing manager, exhibited lifestyle characteristics such as certain clothing and the new model BMW that were atypical of someone working in his position at his company, and he enjoyed talking with his colleagues about the clothes and cars. He liked the attention. In addition, his relationship with his suppliers seemed a little suspicious. The amount of time he spent getting to know his suppliers could mean that he was doing an excellent job for his company, but it could also be seen as a symptom that he wasn't keeping the purchasing transactions at "arm's length." He guarded his supplier relationship closely; these relationships could be further evidence that fraud was occurring. His unpredictable behavior could signal fraud, too, as people who commit fraud may feel scared and guilty depending on when they perpetrate their fraud. Finally, the fact that Mike never took vacations is another red flag. The fact that he never took vacations coupled with his lengthy term as an employee could have meant that he knew there were flaws in the system and he could work them to his advantage. People in the company thought this is how he saved money for his clothes and car, but it also could have been the opportunity to perpetrate his fraudulent activities. Combining the clothes and car, the close supplier relationships, the personal unpredictability, and the lack of vacations probably gives predication of fraud, and an investigation should take place. These symptoms don't mean that fraud is happening, but it does look suspicious.

3. Kathy obviously felt work pressure to make her quarterly sales numbers. Whether she realized it or not, the sales she was able to generate by shipping product to customers who didn't order them was a fraudulent activity; it probably strained relationships with customers, too. This activity misrepresented the actual sales of the company to shareholders.

In this environment, sales should be recognized when they are shipped. By manipulating revenues, the company was able to misrepresent monthly sales. Even though the following month's sales were proportionately lower, the company used this practice because they believed they could have another month to try to reach sales goals.

This type of fraud is definitely revenue fraud. The company is shipping products without customer orders and recording them as sales, even though many of the products are returned. These "sales" should never be recorded.

Case Study 3

1. Conditions that could contribute to a poor work environment:
 - High Turnover: The ABC retention department has recently experienced a high level of management turnover, which makes it impossible for a consistent control environment. It is likely that employees do not feel a high sense of loyalty to the current manager.
 - Poor Communication/Training: The new manager is so busy catching up on his new responsibilities that he has been unable to hold a training or orientation with his department. This lowers the employees' commitment to the company and established processes.
 - Perceived Inequities: One potential control environment risk is that management drives fancy cars to work, which portrays to employees a lavish and rich lifestyle. This sort of example can cause employees to feel like they also deserve a rich lifestyle and can lead to increased employee fraud as they rationalize their actions.
 - Low Pay: Retention agents are paid a lower commission rate than what they consider to be industry standard. This can be a very relevant fraud risk. Employees often commit fraud when they do not feel they are being adequately paid for their work. Employees can easily rationalize that they are not stealing, but are simply taking the wages that they rightfully earned.
2. Symptoms the auditor should look for to determine if fraud is occurring within the retention department:

There are not adequate controls around the submission and review of retention agents reported account saves. If retention agents were submitting fraudulent accounts you would expect to see decreasing profitability. The decreasing profitability is due to increasing commission expense that is not accompanied by revenue increase. If all retention agents saves were legitimate we would expect profitability to not decrease, as all commissions paid will be accompanied by customer accounts that renew and continue to make monthly payments.

3. Five primary control procedures:

- **System of Authorizations:** Retention agents should not be authorized to update customer contract date information in the CCS. It would be simple for a retention agent to extend a customer contract and take credit for a customer save when in fact the customer never agreed to the extension. If a separate department or person is responsible for updating the customer contract date information in the CCS, they could confirm the legitimacy of the contract extension before authorizing the update to customer contract date information in the CCS.
- **Segregation of Duties:** Retention agents should not be able to update customer contract date information in the CCS. A separate person or department should update the contract date information in the CCS. If the duties of making a contract extension and updating the CCS are not separated it opens up the possibility of a retention agent fraudulently updating the contract date information in the CCS, and thus getting paid on fake retention saves. The duties of updating the CCS and making retention saves should be separated.
- **Documents and Records:** Proper documents and records allow for an audit trail. Currently the supervisors do not maintain the record of each agent's contract saves for the month. This documentation should be maintained so that control effectiveness (the supervisor's independent check) can be audited and followed up on.
- **Independent Checks:** Supervisors should be given adequate time to review a statistical sample of each retention agent's contract saves. The supervisor can verify the legitimacy of the save by listening to the verbal contract that is attached to the customer account. Once the supervisor confirms a sample of the account saves, he/she can process the payroll. Additionally, the department policy should be updated to include a rule that any employee found to have submitted a fraudulent customer account save will be terminated.
Physical safeguards are more important when cash or physical assets are at risk to be misappropriated, which is not the case in the retention department.

Case Study 4

This is an example of the fraud of corruption and bribery. Corruption in the form of bribery is one of the oldest and most prevalent of all forms of fraud. In certain countries this practice is so prevalent that it has become very difficult for legitimate companies to conduct business without paying bribes. This situation led to the passage of the Foreign Corrupt Practices Act in an attempt to reduce the prevalence of bribes. Fortunately, bribery and corruption are not generally seen as acceptable in the United States, and many companies implement effective policies to prevent such fraud against organizations. In this section we outline several key actions that Biogenecyte (as well as other companies) should implement to prevent corruption within their organization.

This kind of fraud could be eliminated by:

Having a better Tone-at-the-Top

Perhaps the best way to prevent corruption is to have a tone-at-the-top that discourages employees from accepting or paying bribes. The board of directors should carefully select executives that uphold the highest of ethical standards, and instruct those executives to create written policies that discourage bribery and outline the company's policies regarding the investigation and prevention of such actions. Not only should these policies exist, but they should be frequently discussed within the organization so employees understand expectations. Employees should receive periodic ethics trainings and be required to sign the company code of conduct pertaining to corruption at least annually.

Another way to prevent this type of fraud is to have good Background Searches. Background searches should be conducted for all employees who handle disbursement/receipt of corporate money. Employees should be required to regularly report any personal relationships they have with vendors or customers. These relationships should be monitored closely to ensure any transactions that take place are arms-length transactions. In addition, the auditors in our case investigated the personal relationships of the top executives. This investigation revealed potential conflicts of interest. Corruption is frequently associated with top officials and company officers, so external and internal auditors should carefully monitor these relationships to make sure all disclosure requirements are properly met.

Another way to help avoid these kinds of frauds is to insist on complete documentation. With most bribes and illegal gratuities, a company or employee will try to hide the fact that the transaction occurred by foregoing document creation or falsifying proper documentation. Biogenecyte seemed have documentation policies in place because there was an account related to the bribes made to both the valuation expert and FDA officials. This account and supporting documentation allowed the auditor to gather evidence to support their finding of the fraud occurrence. All companies should ensure that they have the proper documentation policies and controls that prevent employees from overriding these policies.

Finally, in cases like this, it would be important (in fact, it is now the law) to have a good Whistleblower Hotline in place. Since bribes typically take place "under the table" they can be very difficult (if not impossible) for auditors to detect. Perhaps the best way to detect this type of fraud is internally. In addition to creating a culture that rewards honesty and ethical behavior (tone-at-the-top), companies should provide a way for employees to anonymously report corruption they observe. Fellow employees are much better positioned to observe bribery than top executives or auditors. Management and the board of directors should provide an anonymous hotline for employees to report ethical violations they observe, and information about this hotline should be published so employees know of its existence.

Internet Assignments

1.
 - a. The report states that theft by employee's accounts for approximately 30 to 50 percent of all business failures.
 - b. The report states that three-quarters of all employees have stolen from their employers and that some employees may engage in theft behavior as a regular part of their lives on the job.
2. The National Fraud Information Center (NFIC) was established in 1992 by the National Consumers' League to fight the growing menace of telemarketing fraud by improving prevention and enforcement. It is the only nationwide toll-free hotline for consumers to get advice about telephone solicitations and report possible telemarketing fraud to law enforcement agencies. In 1996, the Internet Fraud Watch was created, enabling the NFIC to offer consumers advice about promotions in cyberspace and route reports of suspected online and Internet fraud to the appropriate government agencies.

Consumers can call the NFIC hotline or send their questions to the NFIC Web site. The NFIC's trained counselors help consumers identify the danger signs of possible fraud and direct them to the right places for more information, if needed. Consumers can also report suspected telemarketing or Internet fraud through the NFIC hotline or Web site. These reports are relayed to a variety of local, state, and federal law enforcement agencies, alerting them to problems that they may wish to investigate and providing them with the ammunition they need to stop fraud.

Debate

We believe Fred should be encouraged to turn himself in. If he does not, you should tell him that for his own good, you are going to report him. If he is not reported, his frauds will probably increase.

Answer to first Stop and Think Questions

1. **Why do you think a fraud perpetrator who is caught would suffer more humiliation and embarrassment than a bank robber or other property offender?**
 - a. Fraud perpetrators are usually first-time offenders. In addition, they are usually in positions of trust. They often have families and backgrounds that look exactly like those of honest employees. When they are caught committing a fraud, even telling their families is extremely difficult. On the other hand, bank robbers and similar property offenders are usually repeat criminals with the average bank robber having a rap sheet of 11 previous offenses. To them, getting caught and sent to jail is just another free meal and more of what they are already used to. In addition, they usually don't hold positions of trust like white-collar criminals do and they usually don't have

family structures like fraud perpetrators. In fact, the research shows that because of the embarrassment factor, white-collar-criminals who are prosecuted have a very low recidivism (repeat offenses) rate while white-collar criminals who aren't prosecuted have a very high recidivism rate (why not, nothing serious happened to them.)

2. Do you really believe that having a written code of conduct will reduce fraud and other dishonest acts in an organization?

- a. Codes of conduct are usually worthless if they are created and then ignored. Posting a code of conduct on a Web site or even including them in employee handbooks does little good if constant attention isn't paid to them. That is why companies like Red Hat require annual certification of abiding by the code by every employee and why the company spends large amounts of resources in regular ethics training. To be effective, codes of conduct must be endorsed by management, prominently displayed, and reinforced constantly.

Chapter 4

PREVENTING FRAUD

Discussion Questions

1. Three factors are crucial in creating a culture of honesty, openness, and assistance: hiring honest people and training them in fraud awareness; creating a positive work environment; and providing employee assistance programs (EAPs).
2. Five methods that companies can use to reduce actual or perceived opportunities for fraud are as follows:
 - a. Install good internal controls.
 - b. Discourage collusion, and alert vendors and contractors to company policies.
 - c. Monitor employees, and install tip hotlines.
 - d. Create an expectation of punishment.
 - e. Proactively audit for fraud.
3. Clearly defined codes of ethics delineate between what is acceptable and what is unacceptable. Having employees periodically read and sign the company's code of ethics not only reinforces their understanding of what constitutes appropriate and inappropriate behavior; it also underscores the fact that their behavior is important to the company. Expectations are clarified, and clear expectations reduce fraud. Clearly specified codes also inhibit rationalizations, and, as previously discussed, rationalization is an important element of nearly every fraud.
4. The most widely recognized way to deter fraud is with a good system of internal controls. Internal controls include a good control environment, a good accounting system, and good control procedures as well as good communication and monitoring.
5. Much collusion can be prevented by simply enforcing mandatory vacations or job transfers, because collusive fraud develops slowly (it takes time to get to know others well enough to trust that they will cooperate and not blow the whistle). When organizations leave one employee in close contact with the same vendors or customers for long periods of time, the risk of individuals deciding to profit personally increases dramatically.
6. Sometimes otherwise innocent vendors and customers are drawn into fraud by perpetrators because they fear that if they do not participate, they will lose the business relationship. In most cases, such customers or vendors have only one or two contacts with the firm, and the person who requested illegal gratuities or suggested other types of illegal behavior often intimidates them. A periodic letter to vendors that explains the organization's policy of no gifts or gratuities helps vendors understand whether company buyers and sellers are acting in accordance with the rules. Such