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CHAPTER

2

Why People Commit Fraud

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LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- Know the types of people who commit fraud.
- Explain why people commit fraud.
- Describe the fraud triangle.
- Explain the fraud scale.
- Understand how pressure contributes to fraud.
- Understand why opportunity must be present for fraud to occur.
- Understand why people rationalize.
- Understand how people are recruited to participate in fraud schemes.

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Who Commits Fraud

- Research shows that anyone can commit fraud.
- Fraud perpetrators usually can't be distinguished from other people on the basis of demographic or psychological characteristics.
- Most employees, customers, vendors, and business associates and partners fit the profile of fraud perpetrators and are capable of committing fraud.
- It is impossible to predict in advance which employees, vendors, clients, customers, and others will become dishonest.

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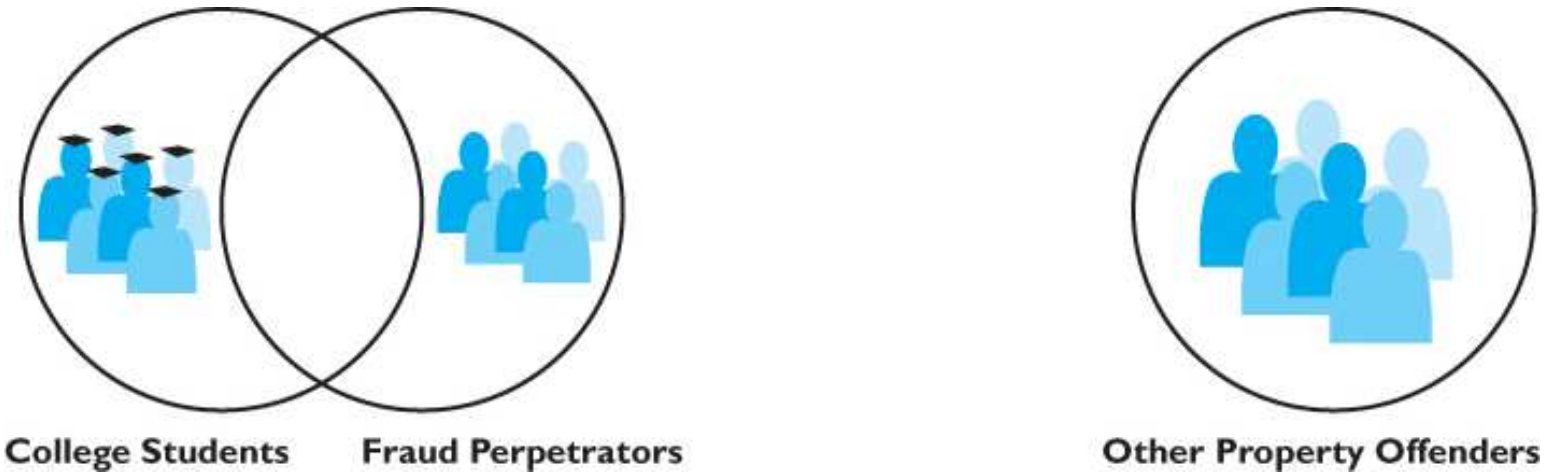
Figure 2.1 Profiles of Fraud Perpetrators



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The Fraud Triangle

- Three elements of the fraud triangle
  - Perceived pressure
  - Perceived opportunity
  - Some way to rationalize the fraud as acceptable

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Figure 2.2 The Fraud Triangle

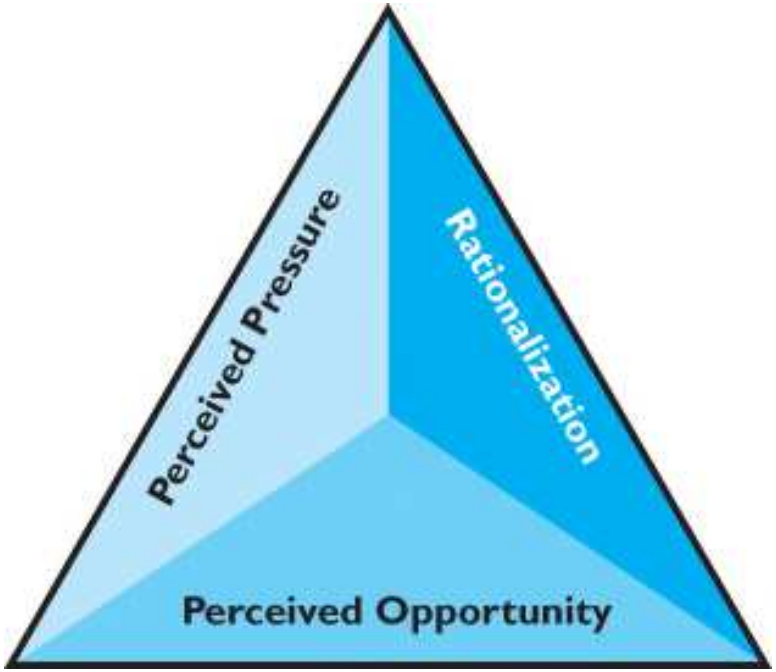

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Figure 2.3 The Fire Triangle

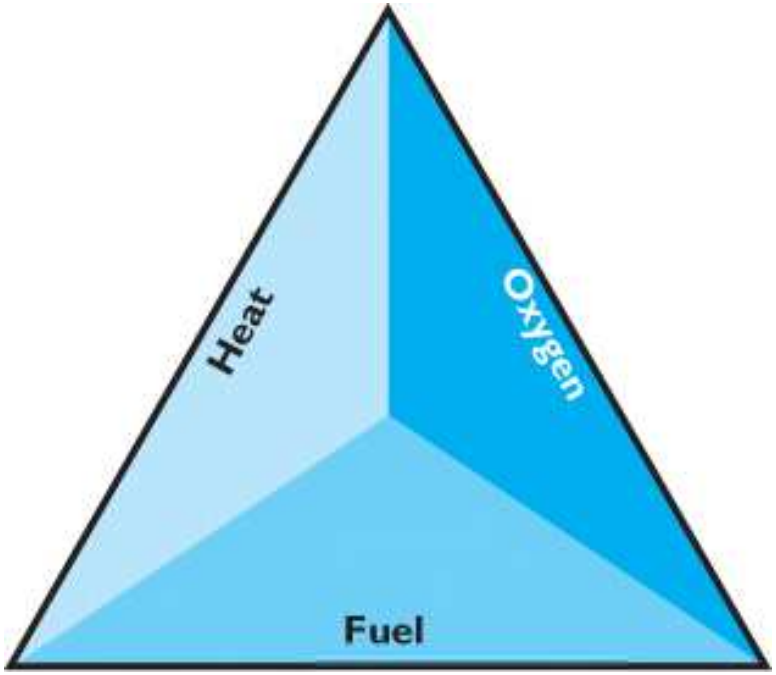

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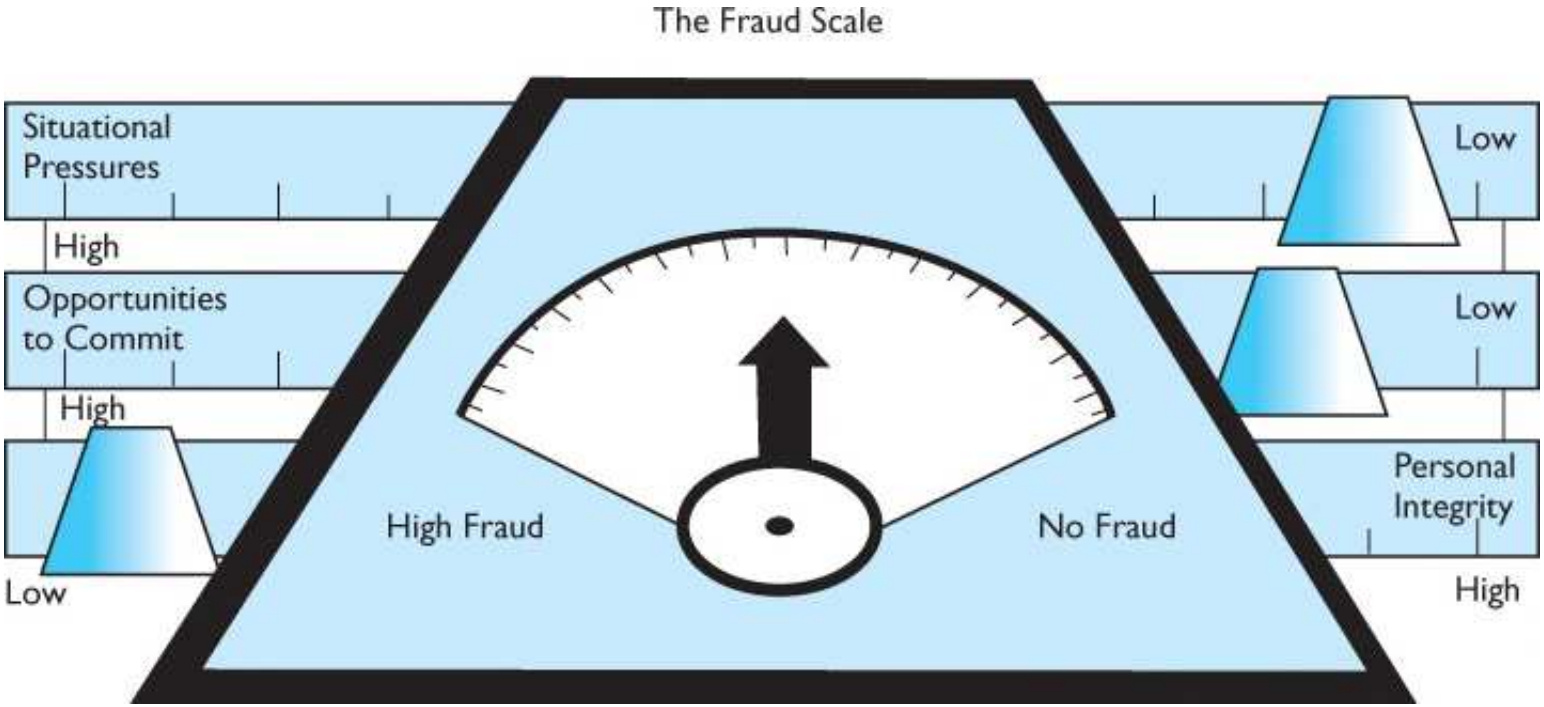
Figure 2.4 The Fraud Scale



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The Element of Pressure

- Financial Pressures
- Vice Pressures
- Work-Related Pressures
- Other Pressures

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Financial Pressures

Individual Perpetrators

- Common real or perceived financial pressures associated with fraud that benefits perpetrators directly
  - Greed
  - Living beyond one's means
  - Inability to pay bills or personal debt
  - Poor credit
  - Personal financial losses
  - Unexpected financial needs

Organizations

- When management fraud occurs
  - Companies overstate assets on the balance sheet and net income on the income statement
  - Some causes of pressure
    - A poor cash position
    - Receivables that aren't collectible
    - A loss of customers, obsolete inventory
    - A declining market
    - Restrictive loan covenants that are being violated

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Vice Pressures

- Closely related to financial pressures are motivations created by vices
- Examples
  - Gambling
  - Drugs
  - Alcohol
  - Expensive extramarital relationships

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Work-Related Pressures

- Some people commit fraud to get even with their employer or others.
- Motivating factors
  - Getting little recognition for job performance
  - Having a feeling of job dissatisfaction
  - Fearing losing one's job
  - Being overlooked for a promotion
  - Feeling underpaid

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Other Pressures

- Family pressures
- Challenge to beat the system
- Envy
- Desire for success

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The Element of Opportunity

- A perceived opportunity to commit fraud, conceal it, or avoid being punished is the second element of the fraud triangle.
- At least six major factors increase perceived or real opportunities for individuals to commit fraud within an organization.
  1. Lack of internal controls that prevent and/or detect fraudulent behavior
  2. Inability to judge quality of performance
  3. Failure to discipline fraud perpetrators
  4. Lack of access to information or asymmetrical information
  5. Ignorance, apathy, or incapacity
  6. Lack of an audit trail

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Internal Controls That Prevent and/or Detect Fraudulent Behavior

- The control environment
- Management's role and example
- Management communication
- Clear organizational structure
- Effective internal audit department
- Information and communication
- Control activities (procedures)
  - Segregation of duties, or dual custody
  - System of authorizations
  - Independent checks
  - Physical safeguards
  - Documents and records

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Summary of the Controls That Prevent or Detect Fraud

- Three components work together to eliminate or reduce the opportunity for employees and others to commit fraud
  - Control environment
    - Establishes an atmosphere in which proper behavior is modeled and labeled, honest employees are hired, and all employees understand their job responsibilities
  - Accounting system
    - Provides records that make it difficult for perpetrators to gain access to assets, to conceal frauds, and to convert stolen assets without being discovered
  - Many variations of the five control activities or procedures
    - Prevent and detect fraudulent behavior

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SAPID

- SAPID is an acronym to help you remember the five types of control activities
  - **S**eparation of duties
  - **A**uthorizations
  - **P**hysical controls
  - **I**ndependent checks
  - **D**ocuments and records.
- Two parts of the acronym
  - First three activities (SAP) are the control activities that prevent fraud from occurring but are often the most expensive to implement.
  - Last two activities (ID) don't prevent fraud but are instead detective controls that help catch or detect fraud before it gets too large.

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Table 2.1 Internal Control Structure

TABLE 2.1 INTERNAL CONTROL STRUCTURE

CONTROL ENVIRONMENT	ACCOUNTING SYSTEM	CONTROL ACTIVITIES OR PROCEDURES
1. Management philosophy and operating style, modeling	1. Valid transactions	1. Segregation of duties
2. Management communications (labeling)	2. Properly authorized	2. Proper procedures for authorization
3. Effective hiring procedures	3. Completeness	3. Adequate documents and records
4. Clear organizational structure of proper modeling and labeling	4. Proper classification	4. Physical control over assets and records
5. Effective internal audit department	5. Proper timing	5. Independent checks on performance
	6. Proper valuation	
	7. Correct summarization	

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Inability to Judge the Quality of Performance

- Judging quality of performance
  - Situations where it is easy—fence example
  - Situations where it is difficult—hiring lawyer, a doctor, a dentist, an accountant, an engineer, or an auto mechanic
    - Often difficult to know whether you are paying an excessive amount or receiving inferior service or products
    - Easy for service provider to overcharge, perform work not needed, provide inferior service, or charge for work not performed

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Failure to Discipline Fraud Perpetrators

- Recidivism
- Termination only
- Prosecution
- Worker mobility

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Table 2.2 John Doe's Employment and Fraud History

TABLE 2.2 JOHN DOE'S EMPLOYMENT AND FRAUD HISTORY

OCCUPATION	JOB LENGTH	AMOUNT EMBEZZLED
Insurance sales	10 months	$200
Office manager	2 years	1,000
Bookkeeper	1 year	30,000
Accountant	2 years	20,000
Accountant	2 years	30,000
Controller & CFO	6 years	1,363,700
Manager	Still employed	?

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Lack of Access to Information or Asymmetrical Information

- Many frauds are allowed to be perpetrated because victims don't have access to information possessed by the perpetrators.
- These are cases of asymmetrical information: that is, one party has information about products or situations and the other party does not.
  - This is especially prevalent in many of the large management frauds that have been perpetrated against stockholders, investors, and debt holders.
  - Certain employee frauds are also allowed to be perpetrated because only offenders have access to information.

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Ignorance, Apathy, or Incapacity

- Older people, individuals with language difficulty, and other "vulnerable" people are often fraud victims because perpetrators know that such individuals may not have the capacity or the knowledge to detect their illegal acts.
- Various consumer frauds such as prime bank fraud, pyramid scams, Internet fraud, phone scams, chain letters, modeling agencies, telemarketing fraud, and Nigerian scams are all crimes of persuasion that try to get victims to unknowingly invest money.

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Figure 2.5 Nigerian Scam Letter

Lagos, Nigeria.

Dear Sir,

Confidential Business Proposal

Having consulted with my colleagues and based on the information gathered from the Nigerian Chambers Of Commerce And Industry, I have the privilege to request your assistance to transfer the sum of $47,500,000.00 (forty seven million, five hundred thousand United States dollars) into your accounts. The above sum resulted from an over-invoiced contract, executed, commissioned and paid for about five years (5) ago by a foreign contractor. This action was however intentional and since then the fund has been in a suspense account at The Central Bank Of Nigeria Apex Bank.

We are now ready to transfer the fund overseas and that is where you come in. It is important to inform you that as civil servants, we are forbidden to operate a foreign account; that is why we require your assistance. The total sum will be shared as follows: 70 for us, 25 for you and 5 for local and international expenses incidental to the transfer.

The transfer is risk free on both sides. I am an accountant with the Nigerian National Petroleum Corporation (NNPC). If you find this proposal acceptable, we shall require the following documents:

a. your bankers name, telephone, account and fax numbers.
b. your private telephone and fax numbers for confidentiality and easy communication.
c. your letter-headed paper stamped and signed.

Alternatively we will furnish you with the text of what to type into your letter-headed paper, along with a breakdown explaining, comprehensively what we require of you. The business will take us thirty (30) working days to accomplish.

Please reply urgently.

Best regards

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Lack of an Audit Trail

- Organizations go to great lengths to create documents that will provide an audit trail so that transactions can be reconstructed and understood.
- Many frauds, however, involve cash payments or manipulation of records that cannot be followed.
  - Smart fraud perpetrators understand that their frauds must be concealed.
  - They also know that such concealment must usually involve manipulation of financial records.
  - When faced with a decision about which financial record to manipulate, perpetrators almost always manipulate the income statement because they understand that the audit trail will quickly be erased.

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The Element of Rationalization

- Most fraud perpetrators are first-time offenders who would not commit other crimes.
- In some way, they must rationalize away the dishonesty of their acts.
- Common rationalizations used by fraud perpetrators include the following:
  - The organization owes me.
  - I am only borrowing the money and 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—my integrity or my reputation.

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Fraud Recruitment

- The majority of frauds—especially financial statement frauds—are collusive, meaning that the act involves more than one perpetrator.
- In some cases one person, after he or she has become involved in fraud as a result of the fraud triangle, influences another individual to participate in the fraud.
- Power is used in different ways to recruit people to participate in fraud.

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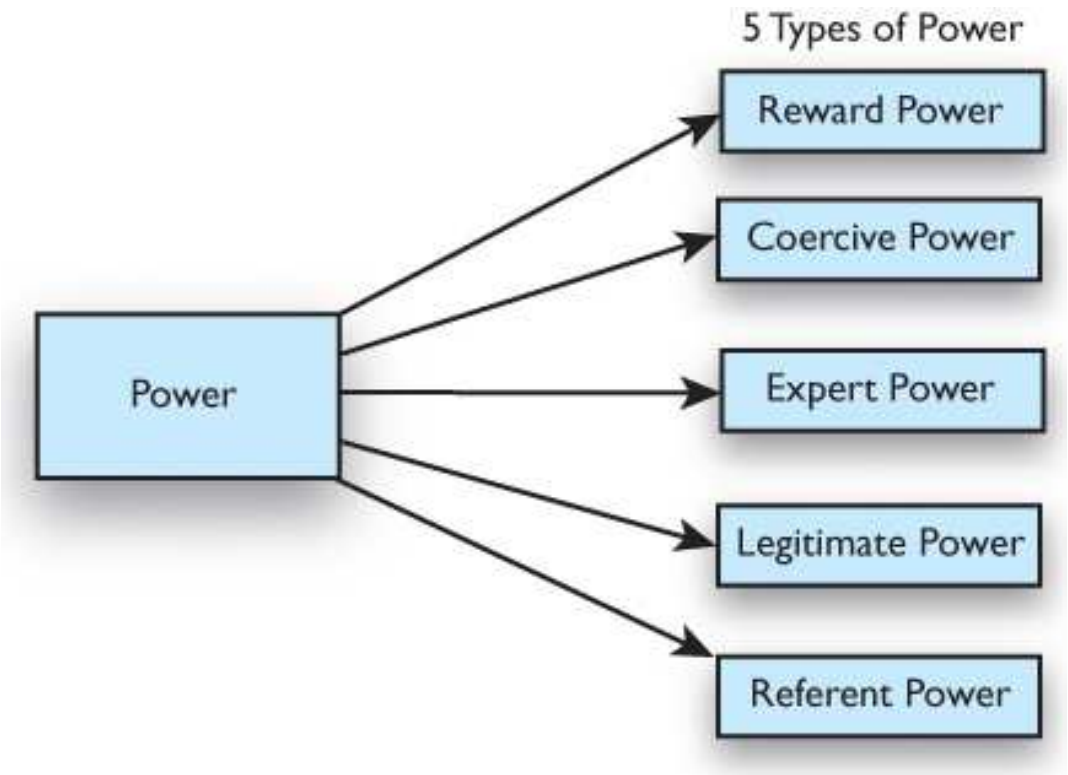
Figure 2.6 Five Types Of Power



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Power

- Reward power
  - The ability of a fraud perpetrator to convince a potential victim that he or she will receive a certain benefit through participation in the fraud scheme
- Coercive power
  - The ability of the fraud perpetrator to make an individual perceive punishment if he or she does not participate in the fraud
- Perceived expert power
  - The ability of the fraud perpetrator to influence another person because of expertise or knowledge
- Legitimate power
  - The ability of the fraud perpetrator to convince a potential perpetrator that he or she truly has power over him or her
- Referent power
  - The ability of the perpetrator to relate to the potential co-conspirator

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Figure 2.7 How Power Is Used to Recruit Others into Frauds

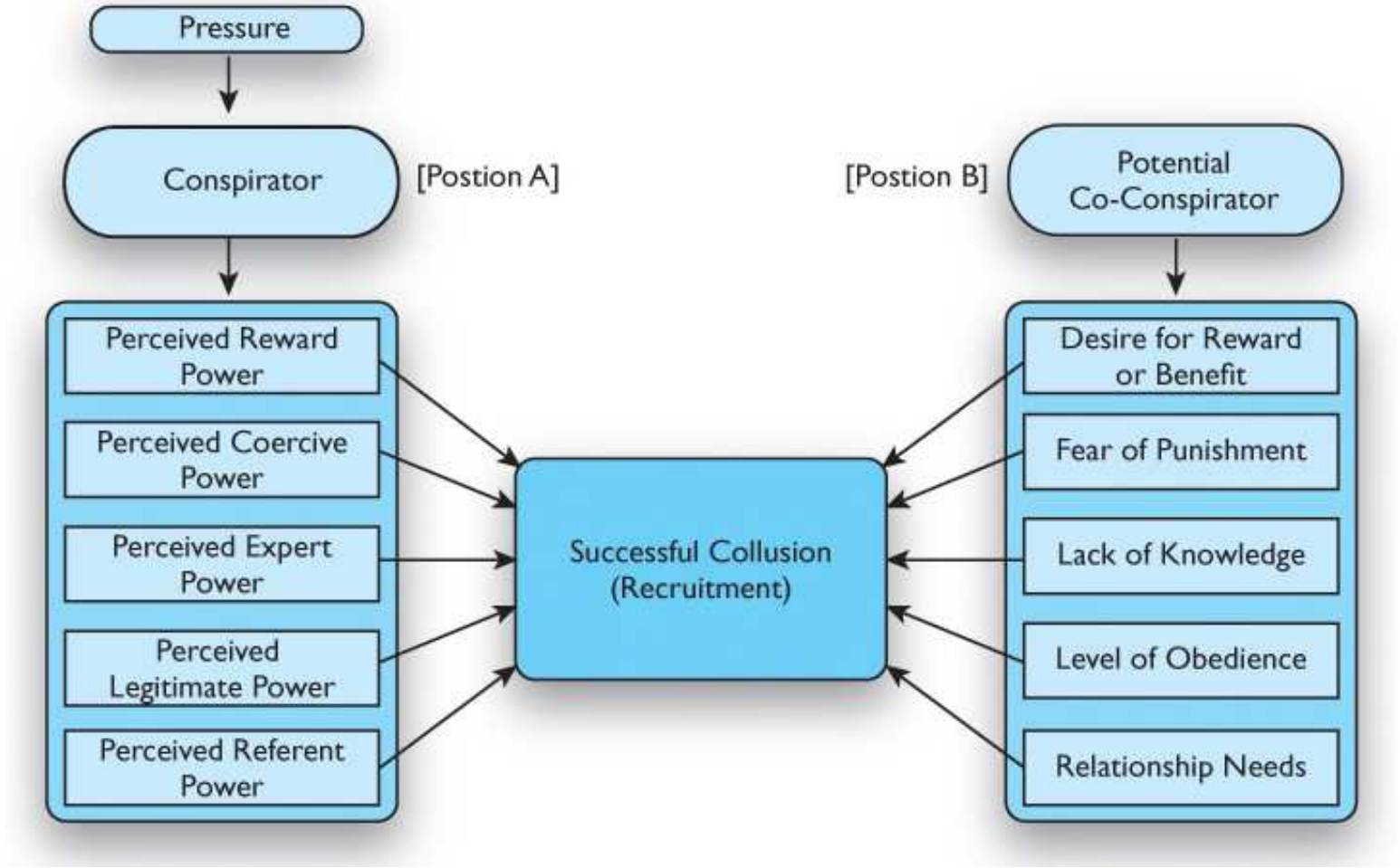

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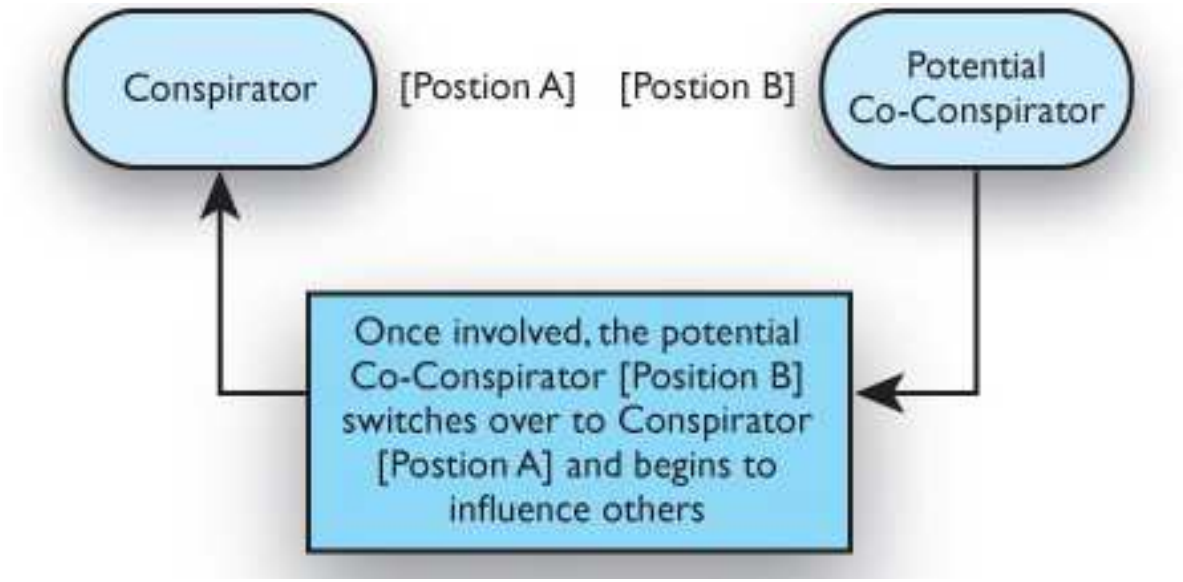
Figure 2.8 How Others Are Recruited into Fraud Schemes



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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.

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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/stores/2003/10/02/60 minutes/main576328.shtml>, accessed on May 22, 2004.

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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 severally 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

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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

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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.

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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.

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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.

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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.

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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.

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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.

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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.

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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.

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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.*

<u>Internet Assignment</u>

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:

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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.

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