

Civil Law	The body of law that provides remedies for violations of private rights. It deals with the rights of individuals.
Customer Fraud	Occurs when customers either do not pay for goods purchased, they pay too little, or they get something for nothing.
Employee Embezzlement	The most common type of employee fraud, where employees deceive their employers by taking company assets. It can be either direct or indirect.
Evidential Matter	The underlying data and all corroborating information available about a fraud.
Financial Statements	Reports such as the balance sheet, income statement, and statement of cash flows that summarise the financial status and results of operations of a business equity.
Fraud	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.
Investment Scams	Occur when fraudulent and usually worthless investments are sold to unsuspecting investors.
Jurisdiction	The limit or territory over which an organisation has authority.
Management Fraud	Involves top management's deceptive manipulation of financial statements.
Miscellaneous Fraud	A fraud that may have been committed for reasons other than financial gain and does not include employee embezzlement, vendor fraud, investment scams, and other consumer frauds.
Net Income	An overall measure of the performance of a company; equal to revenues minus expenses for a period.
Perpetrators	Persons who commit a fraud.
Profit Margin	Net income divided by total revenues; also known as return on sales, profit margin percentage, profit margin ratio, and operating performance ratio.
Revenue	Increases in a company's resources from the sale of goods or services.
Statute	A law or regulation; a law enacted by the legislative branch of a government.
Vendor Fraud	Is extremely common in the United States, and comes in two common forms: (1) fraud perpetrated by vendors acting alone and (2) fraud perpetrated through collusion between buyers and vendors.
Victims	A person or organisation deceived by the perpetrator.

**SERIOUSNESS OF THE FRAUD PROBLEM**

It is impossible to know what percentage of fraud perpetrators are caught.

Many frauds that are detected are quietly handled by the victims and never made public. In many cases of employee fraud, companies merely hide the frauds and quietly terminate or transfer perpetrators rather than make the frauds public.

Companies and individuals who have been defrauded are often more concerned about the embarrassment of making frauds public, and the costs of investigating fraud, than they are about seeking justice and punishing fraud perpetrators.

The four basic sources of fraud statistics include:

- government agencies
- researchers
- insurance companies
- victims of fraud

The Association of Certified Fraud Examiners (ACFE) conducted a study in 2012 that estimated that organisations lose roughly 5 percent off their annual revenues to fraud.

Because fraud affects how much we pay for goods and services, each of us pays not only a portion of the fraud bill but also for the detection and investigation of fraud.

Losses incurred from fraud reduce a firm's income on a dollar-for-dollar basis. This means that for every \$1 of fraud, the net income of the firm is reduced by \$1.

**WHAT IS FRAUD?**

*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. which is *false*,
4. and *intentionally* or *recklessly* so,
5. which is *believed*
6. and *acted upon* by the victim
7. to the victim's *damage*

Fraud is different from unintentional errors.

One of the most common types of fraud today is a scam that lures investment funds from victims and then pays those victims a premium or interest from money that is paid by subsequent investors. This fraud is known as a Ponzi scheme, named after Charles Ponzi.

**TYPES OF FRAUD**

The most common way to classify the various types of fraud is to simply divide frauds into those that are committed *against* organisations and those that are committed *on behalf* of organisations.

In employee fraud, the victim of the fraud is the employee's employer.

With financial statement fraud, executives usually commit fraud "on behalf" of an organisation, usually to make the company's reported financial results look better than they actually are.

The ACFE defines *occupational fraud* as "the use of one's occupation for personnel enrichment through the deliberate misuse or misapplication of the employing organisation's resources or assets".

Occupational fraud results from lunch break abuses to high-tech schemes.

TYPE OF FRAUD	PERPETRATOR	VICTIM	EXPLANATION
Employee embezzlement	Employees of an organization	The employer	Employees use their positions to take or divert assets belonging to their employer. This is the most common type of fraud.
Vendor fraud	Vendors of an organization	The organization to which the vendors sell goods or services	Vendors either overbill or provide lower quality or fewer goods than agreed.
Customer fraud	Customers of an organization	The organization which sells to the customers	Customers don't pay, pay too little, or get too much from the organization through deception.
Management fraud (Financial statement fraud)	Management of a company	Shareholders and/or debt-holders and regulators (taxing authorities, etc.)	Management manipulates the financial statements to make the company look better (or worse in the case of tax fraud) than it is. This is the most expensive type of fraud.
Investment scams and other consumer frauds	Fraud perpetrators—all kinds	Unwary investors	These types of frauds are committed on the Internet and in person and obtain the confidence of individuals to get them to invest money in worthless schemes.
Other (Miscellaneous) types of fraud	All kinds—depends on the situation	All kinds—depends on the situation	Anytime anyone takes advantage of the confidence of another person to deceive him or her.

**EMPLOYEE EMBEZZLEMENT**

Employee embezzlement is the most common type of occupational fraud.

In this type of fraud, employees deceive their employers by taking company assets.

Embezzlement can be either direct or indirect.

Direct fraud occurs when an employee steals company cash, inventory, tools, supplies, or other assets. It also occurs when employees establish dummy companies and have their employers pay for goods that are not actually delivered.

Indirect employee fraud occurs when employees take bribes or kickbacks from vendors, customers, or other outside the company to allow for lower sales prices, higher purchase prices, nondelivery of goods, or the delivery of inferior goods.

### VENDOR FRAUD

Vendor fraud is extremely common in the United States, and comes in two common forms: (1) fraud perpetrated by vendors acting alone and (2) fraud perpetrated through collusion between buyers and vendors.

Vendor fraud usually results in either an overcharge for purchased goods, the shipment of inferior goods, or the nonshipment of goods even though payment is made.

### CUSTOMER FRAUD

When customer fraud takes place, customers either do not pay for goods purchased, they pay too little, or they get something for nothing.

### MANAGEMENT FRAUD

Management fraud, *often called financial statement fraud*, is 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 involves top management's deceptive manipulation of financial statements.

### INVESTMENT SCAMS AND OTHER CONSUMER FRAUDS

Closely related to management fraud are investment scams.

In these scams, fraudulent and usually worthless investments are sold to unsuspecting investors. The FBI has suggested that the following are some of the most common consumer fraud schemes:

- Ponzi schemes
- Telemarketing fraud
- Nigerian letter of money scams
- Identity theft
- Advance fee scams
- Redemption/strawman/bond fraud
- Letter of credit fraud
- Internet Fraud

### **CRIMINAL AND CIVIL PROSECUTION OF FRAUD**

When people commit fraud, they can be prosecuted criminally and/or civilly.

To succeed in a criminal or civil prosecution, it is usually necessary to show that the perpetrator acted with *intent* to defraud the victim.

This is best accomplished gathering *evidential matter* – the underlying data and all corroborating information available.

### CRIMINAL LAW

The branch of law that deals with offenses of a public nature.

Criminal laws generally deal with offenses against society as a whole.

They are prosecuted either federally or by a state for violating a statute that prohibits some type of activity.

**CIVIL LAW**

The body of law that provides remedies for violations of private rights.

Civil law deals with rights of individuals.

Civil claims begin when one party files a complaint against another, usually for the purpose of gaining financial restitution.

The purpose of a civil lawsuit is to gain compensation for harm an individual or organisation believes has done wrong to them.

Fraud examiners and accountants are often used as experts in fraud cases to compute and testify to the amount of damages and to the nature of the fraud.

**TABLE 1.3 DISTINCTIONS BETWEEN CIVIL AND CRIMINAL CASES**

	CRIMINAL CASE	CIVIL CASE
Purpose	To right a wrong	To obtain a remedy
Consequences	Jail and/or fines	Restitution and damage payments
Burden of Proof	"Beyond a reasonable doubt"	"Preponderance of evidence"
Jury	Jury must have 12 people	May consist of fewer than 12 persons
Initiation	Determination by a grand jury that sufficient evidence exists to indict	Filing of a claim by a plaintiff
Verdict	Unanimous verdict	Parties may stipulate to a less than unanimous verdict
Claims	Only one claim at a time	Various claims may be joined in one action



Accounting System	An organisation of policies and procedures for recording economic transactions.
Audit Trail	Documents and records that can be used to trace transactions.
Coercive Power	The ability of a fraud perpetrator to make an individual perceive punishment if he or she does not participate in the fraud.
Control Activities	The policies and procedures that help ensure management directives are carried out.
Control Environment	Sets the tone of an organisation, influencing the control consciousness of its people.
Documents & Records	Documentary evidence of all transactions that create an audit trail.
Dual Custody	Requires two individuals to work together at the same risk.
Expert Power	The ability of the fraud perpetrator to influence another person because of expertise or knowledge.
Independent Checks	Periodically monitoring the work or activities of others.
Labeling	Teaching employees behaviours that are and are not appropriate within the organisation.
Legitimate Power	The ability of the fraud perpetrator to convince a potential perpetrator that he or she truly has power over him or her.
Modeling	Setting an example.
Perceived (pressure)	A situation where someone perceives he or she has a need to commit fraud: a constraining influence on the will or mind, as a moral force.
Perceived Opportunity	A situation where someone believes he or she has a favorable or promising combination of circumstances to commit fraud and not be detected.
Physical Safeguards	Used to protect assets from theft by fraud or other means.
Power	The probability that a person can carry out his or her own will despite resistance.
Procedures	Activities that ensure management directives are carried out.
Rationalise	To devise self-satisfying but incorrect reasons for one's behaviour.
Real Pressure	Pressure that is not perceived.
Referent Power	The ability of the perpetrator to relate to the potential co-conspirator.
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.
Segregation of Duties	The division of a task into two parts so that one person does not have complete control of the task.
System of Authorisations	Systems of limits on who can and cannot perform certain functions.

**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.

**THE FRAUD TRIANGLE**

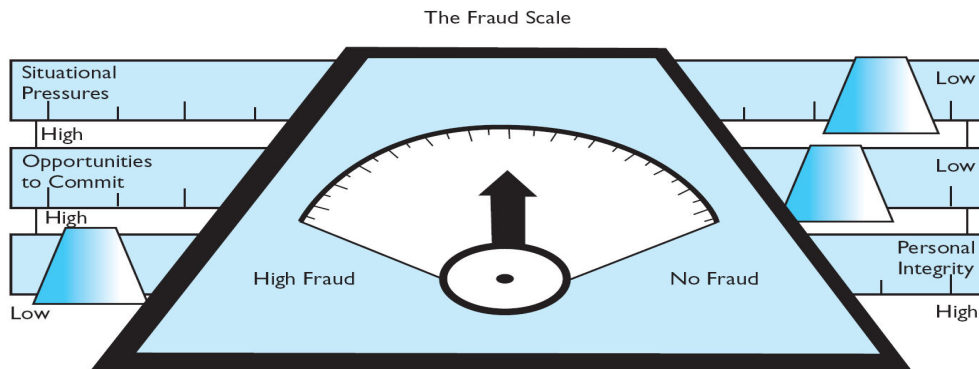
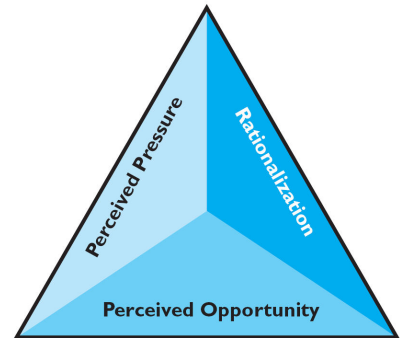
Every fraud perpetrator faces some kind of perceived or real pressure.

Most pressures relate to financial needs, although nonfinancial pressures can also motivate fraud.

Fraud perpetrators need a way to rationalize their actions as acceptable.

The three elements of the fraud triangle are interactive.

People who try to prevent fraud usually only work on one element—opportunity. Because fraud-fighters generally believe that having good internal controls can eliminate opportunities, they focus all or most of their preventative efforts on implementing controls and ensuring adherence to them.

**THE ELEMENT OF PRESSURE**

Most fraud experts believe that the pressures can be divided into four main groups: financial pressures, vices, work-related pressures, and other pressures.

**FINANCIAL PRESSURES**

Approximately 95% of all fraud studies involve either financial or vice-related pressures.

Common real or perceived financial pressures associated with fraud include:

- greed
- living beyond one's means
- inability to pay bills or personal debts
- poor credit
- personal financial losses
- unexpected financial needs

Financial pressures can occur suddenly or be long term.

Financial pressure is the most common type of pressure to commit fraud.

Usually, when management fraud occurs, companies overstate assets on the balance sheet and net income on the income statement.



**VICE PRESSURES**

Closely related to financial pressures are motivations created by vices such as gambling, drugs, alcohol, and expensive extramarital relationships.

Vices are the worst kind of pressures motivating someone to commit fraud.

**WORK-RELATED PRESSURES**

Some people commit fraud to get even with their employer or others.

Factors such as getting little recognition for job performance, having a feeling of job dissatisfaction, fearing losing one's job, being over-looked for a promotion, and feeling underpaid have motivated many frauds.

**OTHER PRESSURES**

Other pressures include spouse Pressures, life pressures, and social pressures.

**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 organisation:

- lack of internal controls that prevent and/or detect fraudulent behaviour
- inability to judge quality of performance
- failure to discipline fraud perpetrators
- lack of access to information or asymmetrical information
- ignorance, apathy, or incapacity
- lack of an audit trail

**INTERNAL CONTROLS THAT PREVENT AND/OR DETECT FRAUDLUENT BEHAVIOUR**

Having an effective internal control framework is probably the most important step an organisation can take to prevent and detect employee fraud.

The organisation that most businesses subscribe to is the Committee of Sponsoring Organisations (COSO).

**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. Effective hiring procedures	2. Properly authorized	2. Proper procedures for authorization
3. Clear organizational structure of proper modeling and labeling	3. Completeness	3. Adequate documents and records
4. Effective internal audit department	4. Proper classification	4. Physical control over assets and records
	5. Proper timing	5. Independent checks on performance
	6. Proper valuation	
	7. Correct summarization	

**INABILITY TO JUDGE THE QUALITY OF PERFORMANCE**

It is easier to judge the quality of a good received rather than a service provided and therefore if you are being overcharged for these services.

You can determine whether or not the quality of a physical good / work meets your specifications and is consistent with the agreed-upon contract. However, it is difficult to do so with a service.

**FAILURE TO DISCIPLINE FRAUD PERPETRATORS**

Fraud perpetrators who are not prosecuted or disciplined have the second highest rate of recidivism.

An individual who commits fraud and is not punished or merely terminated suffers no significant penalty or embarrassment and often resumes the fraudulent behaviour in another setting.

Because of the expenses and time involved in prosecuting, many organisations merely dismiss dishonest employees, hoping to rid themselves of the problem.

Although the fraud perpetrator is removed from the business, this sends a signal to others in the organisation that they will not suffer significant consequences if fraud is committed.

**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: 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.

**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.

Frauds called *pigeon drops* are specifically designed to take advantage of elderly victims.

Many scams prey on elderly or uneducated victims.

**LACK OF AN AUDIT TRAIL**

Many frauds involve cash payments or manipulation of records that cannot be followed.

When faced with a decision about which financial record to manipulate, perpetrators almost always manipulate the income statement because they understand that audit trail will quickly be erased.

**THE ELEMENT OF RATIONALISATION**

Common rationalisations include:

- I deserve more
- I am only borrowing the money and will pay it back
- Nobody will get hurt
- It's for a good purpose
- I pay more than my fair share of taxes
- The government wastes money