

ANSWERS TO EXERCISES

Chapter 1

Review Questions

1-1 (Learning objective 1-1) What is fraud examination?

Answer: Fraud examination is a process for resolving allegations of fraud from inception to disposition. Fraud examinations involve not only financial analysis, but also interviewing witnesses, taking statements, writing reports, testifying to findings, and assisting in the prevention and detection of fraud.

1-2 (Learning objective 1-2) What is the fraud theory approach?

Answer: The fraud theory approach is the methodology used for resolving allegations of fraud by developing a worst-case scenario of what could have occurred, then attempting to confirm or refute that theory.

1-3 (Learning objective 1-3) Occupational fraud and abuse includes any personal enrichment that results from misuse or misapplication of the employing organization's resources or assets. There are four key elements to this activity. What are they?

Answer: The four key elements to occupational fraud abuse are that it (1) is clandestine, (2) violates the employee's fiduciary duties to the organization, (3) is committed for the purpose of direct or indirect financial benefit to the employee, and (4) costs the employing organization assets, revenues, or reserves.

1-4 (Learning objective 1-4) Under the common law, fraud generally consists of four elements, all of which must be present. List them.

Answer: The four legal elements of fraud are (1) a material false statement, (2) knowledge that the statement was false when it was uttered, (3) reliance on the false statement by the victim, and (4) damages as a result.

1-5 (Learning objectives 1-4 and 1-5) What is the difference between occupational fraud and occupational abuse? Give examples.

Answer: Occupational fraud tends to be more costly and less common than abuse. Occupational fraud consists of such actions as asset misappropriations, corruption, and fraudulent financial statements. Occupational abuse consists of petty offenses such as taking extended lunch periods or breaks, showing up late for work or leaving early, and doing slow or sloppy work.

1-6 (Learning objective 1-7) Edwin H. Sutherland, a criminologist, coined the phrase “white-collar crime.” What did he mean by this term? How has the meaning of this phrase changed over time?

Answer: Sutherland coined the term “white-collar crime” to describe criminal acts of corporations and individuals acting in their corporate capacity (e.g., crime in the executive suite). Over time, the term has come to encompass almost any financial or economic crime, from the mailroom to the boardroom.

1-7 (Learning objective 1-7) Sutherland developed what is known as the “theory of differential association.” What is the principal tenet of his theory?

Answer: The theory of differential association’s principal tenet is that crime is learned. Sutherland believed that this learning typically occurred in intimate personal groups.

1-8 (Learning objective 1-8) Cressey interviewed nearly 200 embezzlers in order to develop his theory on the causation of fraud. As a result of his research, what was Cressey’s final - hypothesis?

Answer: “Trusted persons become trust violators when they conceive of themselves as having a financial problem which is non-shareable, are aware this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted property.”

1-9 (Learning objective 1-9) Cressey believed that non-shareable problems provided the motivation for employees to commit occupational fraud. What did he mean by “non-shareable”?

Answer: Cressey meant that the problems, at least in the eyes of the potential offenders, must be kept secret from others, so as to avoid embarrassment or, more importantly, a loss of status.

1-10 (Learning objective 1-9) Cressey divided the non-shareable problems of the subjects in his research into six different subtypes. What are they?

Answer: The subtypes are (1) violation of ascribed obligations, (2) problems resulting from personal failure, (3) business reversals, (4) physical isolation, (5) status gaining, and (6) employer–employee relations.

1-11 (Learning objective 1-11) Albrecht concluded that there were three factors that led to occupational fraud. What are they?

Answer: Albrecht's list is very similar to the fraud triangle. The three factors he identified are (1) situational pressures, (2) opportunities, and (3) personal integrity.

1-12 (Learning objective 1-12) What factor did Hollinger and Clark identify as the primary cause of employee deviance?

Answer: The research of Hollinger and Clark strongly suggests that job dissatisfaction among employees—across all age groups but especially younger workers—is the most likely cause of counterproductive or illegal behavior in the workplace.

1-13 (Learning objective 1-13) The 2011 Global Fraud Survey covered a number of factors that are related to occupational fraud. List these factors.

Answer: The 2011 Global Fraud Survey gathered data on occupational fraud and abuse relating to (1) the cost of fraud and abuse, (2) position, gender, tenure, and criminal history of the perpetrator, (3) size of the victim organization, (4) actions taken against occupational fraudsters by their victims, (5) methods by which occupational frauds were detected, (6) commonness of schemes, and (7) costs associated with various schemes.

Discussion Issues

1-1 (Learning objective 1-1) How does “fraud examination” differ from “forensic accounting”?

Answer: Fraud examination is a process used to resolve allegations of fraud from inception to disposition. Forensic accounting is any accounting work done in anticipation of litigation.

1-2 (Learning objective 1-2) There are several steps involved in the fraud theory approach. What are they?

Answer: The fraud theory approach involves analyzing the available evidence, developing a theory of what fraud could have occurred based on a worst-case scenario, testing the theory, revising it or amending it as necessary, then proving the theory through additional investigative work.

1-3 (Learning objectives 1-3 through 1-6) How does occupational fraud and abuse differ from other kinds of fraud? Give examples of other fraud types.

Answer: Typically, any crime that uses deceit as its principal modus operandi is considered fraud. Occupational fraud involves those frauds that are committed against organizations by individuals who work for those organizations. Other fraud types include but are not limited to: insurance frauds committed by customers and policyholders, Internet frauds and scams perpetrated by individuals, frauds against governmental organizations committed by companies

and individuals, frauds against banks committed by outsiders, and credit card frauds perpetrated against businesses.

1-4 (Learning objectives 1-7 and 1-8) How does the study of criminology relate to the detection or deterrence of fraud? How does it differ from the study of accounting or auditing?

Answer: Criminals commit frauds. Accounting relates to the classification of assets, liabilities, income, expenses, and equity. Auditing involves the verification of books and records. While accounting and auditing give us information on how fraud is committed, the study of criminology helps us understand why fraud is committed. The simple fact is that books don't commit fraud, people do. Understanding both how and why fraud is committed helps us better detect and deter it.

1-5 (Learning objective 1-7) Sutherland's contribution to criminology, in addition to giving us the term "white-collar crime," involved developing the theory of differential association. What are the implications of this theory with respect to occupational fraud?

Answer: Sutherland's main point was that the tendency to commit crime is learned, not inherited. He believed that criminals learned both the techniques of committing crimes and the value systems of criminals in small, intimate groups. This explains, in part, why prisoners frequently return to crime after they are let out of confinement. While behind bars, they talk to other inmates and learn the specifics of how to better commit their crimes. They also are taught the unique values that "street" criminals hold, such as "getting something for nothing" and "society owes me a good living."

Occupational fraudsters, on the other hand, learn their techniques by working with books, records, inventory, and other assets. They frequently hear about other employees who were not successful in their crimes. Rather than being discouraged by someone being caught, the potential criminal often learns a different lesson: that the method the other person used to commit fraud was faulty and that a different one must be devised in order to succeed. They also learn the value systems that some businesses have: Profit is everything, and the end justifies the means. Such values obviously send the wrong message.

1-6 (Learning objective 1-8) Cressey's "fraud triangle" states that three factors—non-shareable financial need, perceived opportunity, and rationalization—are present in cases of occupational fraud. Which of these three factors, if any, is the most important in causing executives, managers, and employees to commit occupational fraud?

Answer: All three are equally important. A fire cannot exist without fuel, oxygen, and heat; a fraud cannot exist without motive, opportunity, and rationalization. If a person has unlimited

motive but no opportunity, he or she cannot commit fraud. If a person has opportunity but doesn't need the money, the fraud is unlikely to occur. Should an individual have both motive and opportunity but cannot salve his or her conscience through rationalization, the crime will most likely not be committed.

1-7 (Learning objectives 1-8 and 1-9) Cressey described a number of non-shareable financial problems that he uncovered during his research. Which of these, if any, apply to modern-day executives who are responsible for large financial statement frauds? In the 50-plus years since Cressey did his study, are the factors he described still valid? Why or why not?

Answer: Three non-shareable financial problems seem to be at the root of today's financial frauds: violation of ascribed obligations, problems resulting from personal failure, and business reversals. Many modern-day businesses begin "cooking the books" when executives realize that they will not be able to meet their financial obligations. Similarly, some executives are too ashamed to admit that they don't have the talent or wherewithal to steer an enterprise through rough economic conditions. And sometimes, business reversals—from loss of a major client or contract, recessions, high costs of capital, and the like—are at the root of these so-called non-shareable financial problems.

One could argue that these factors are as valid today as they were over half a century ago. What motivates people to act changes little over time, although the methods that they use to accomplish their illegal goals (e.g., computer frauds) may.

1-8 (Learning objectives 1-8 through 1-11) Albrecht, in his research, developed the "fraud scale" and furnished a list of the reasons employees and executives commit occupational fraud. How are Albrecht's conclusions similar to Cressey's? How are they different?

Answer: Cressey's three factors were a non-shareable financial need, perceived opportunity, and rationalization. Albrecht's consisted of financial pressure, perceived opportunity, and personal integrity. One of the factors, perceived opportunity, was named by both researchers. Cressey's non-shareable financial need is similar to Albrecht's financial pressure; however, Cressey's is more specific. Nearly everyone suffers financial pressures of some kind, but most do not turn to fraud in order to alleviate them. The ability to rationalize illegal conduct and personal integrity could be viewed as one and the same. However, personal integrity is difficult to measure, while specific rationalizations are easier to identify.

1-9 (Learning objective 1-13) The ACFE's 2011 Global Fraud Survey found, among other things, that the frauds committed by women had smaller median losses than those by men. What are some possible explanations for this finding?

Answer: The sizes of losses due to occupational fraud are almost always determined by the employee's access to assets. This explains why executives account for the largest losses. Women, because of the so-called "glass ceiling" (where they are not promoted into jobs equal to their male counterparts'), typically occupy lower-level positions.

Chapter 2

Review Questions

2-1 (Learning objective 2-1) How is "skimming" defined?

Answer: Skimming is the theft of cash from a victim organization prior to its entry in the organization's accounting system.

2-2 (Learning objective 2-2) What are the two principal categories of skimming?

Answer: Skimming schemes can be subdivided based on whether they target sales or receivables. The character of the incoming funds has an effect on how the frauds are concealed, and concealment is the crucial element of most occupational fraud schemes.

2-3 (Learning objective 2-3) How do sales skimming schemes leave a victim organization's books in balance, despite the theft of funds?

Answer: When an employee skims money by making off-book sales of merchandise, neither the sales transaction nor the incoming cash is ever recorded. For example, suppose a cash register clerk skims \$500 in receipts from one sale of goods. At the end of the day, his cash drawer will be short by \$500—the amount of money that was stolen. But because the sale was never recorded, the sales records will be understated by \$500. Therefore, the books will remain in balance.

2-4 (Learning objective 2-3) Under what circumstances are incoming checks received through the mail typically stolen?

Answer: Checks are normally stolen when a single employee is in charge of opening the mail and preparing the deposit. The employee simply removes the check from the incoming mail and forges the endorsement of the employer, then endorses it with his or her own name and cashes or deposits it.

2-5 (Learning objective 2-4) How do "understated sales" schemes differ from "unrecorded sales"?

Answer: Unrecorded sales schemes are purely off-book transactions. Understated sales, on the other hand, are posted to the victim organization's books, but for a lower amount than what the

perpetrator collected from the customer. Typically, the perpetrator will understate a sale by recording a lower sales price for a particular item, or by recording the sale of fewer items of merchandise than the customer actually purchased.

2-6 (Learning objective 2-5) How is the cash register manipulated to conceal skimming?

Answer: There are two common methods. The first is to ring “no sale” on the register and omit giving the customer a receipt for the purchase. The second and less common method is for the cashier to alter the tape itself so that it does not show the sale. This is impossible to accomplish with cash registers that also record the transaction electronically.

2-7 (Learning objective 2-6) Give examples of skimming during nonbusiness hours and skimming of off-site sales.

Answer: Certain categories of employees usually commit these schemes. Managers of department stores or employees opening or closing the store have been known to open early or close late and skim all or part of the sales during those periods. Apartment rental employees, parking lot attendants, and independent salespeople are at a higher risk of skimming funds from off-site sales.

2-8 (Learning objective 2-8) What are the six principal methods used to conceal receivables skimming?

Answer: The six concealment techniques identified in this chapter are: lapping, force balancing, stealing customer statements, recording fraudulent write-offs or discounts, debiting the wrong account, and document destruction.

2-9 (Learning objective 2-9) What is “lapping” and how is it used to conceal receivables skimming?

Answer: Lapping is the crediting of one account through the abstraction of money from another account. Lapping customer payments is one of the most common methods of concealing receivables skimming. Suppose a company has three customers, A, B, and C. When A’s payment is received, the fraudster takes it for himself instead of posting it to A’s account. When B’s check arrives, the fraudster posts it as a payment to A’s account. Likewise, when C’s payment is received, the perpetrator applies it to B’s account. This process continues indefinitely until one of three things happens: (1) someone discovers the scheme, (2) restitution is made to the accounts, or (3) some concealing entry is made to adjust the accounts receivable balances.

2-10 (Learning objective 2-10) List four types of false entries a fraudster can make in the victim organization's books to conceal receivables skimming.

Answer: The fraudster can lap the payments, as discussed in the previous question. He can also engage in force balancing by posting a payment to a customer's account even though the payment was stolen. A third false entry that can be made is to fraudulently write off a customer's account as uncollectible. A fourth technique is to credit the targeted account with a fraudulent "discount" in the amount of the stolen funds. Also, some fraudsters conceal receivables skimming by debiting existing or fictitious accounts receivable.

Discussion Issues

2-1 (Learning objective 2-3) Sales skimming is called an "off-book" fraud. Why?

Answer: Simply because the fraud occurs outside the books and records. There is no direct audit trail to uncover; the proof of the fraud must be determined by indirect methods, such as ratio analysis or other comparisons.

2-2 (Learning objective 2-3) In the case study of Brian Lee, the plastic surgeon, what kind of skimming scheme did he commit?

Answer: Dr. Lee committed a sales (revenue) skimming scheme. In this fraud, Dr. Lee's clinic was a partnership with several other doctors, and all of the revenue derived from his services was supposed to go to the partnership. Because of a lack of controls and periodic reconciliations by the clinic, Dr. Lee simply instructed his patients to pay him directly. His scheme was uncovered by accident, as are many frauds.

2-3 (Learning objectives 2-5 and 2-12) If you suspected skimming of sales at the cash register, what is one of the first things you would check?

Answer: The cash register tape is one of the first things you should check. In a typical cash register skimming scheme, the crooked employee will ring up "no sale" on the register when a sale is made and pocket the money. The customer is not given a receipt. If you notice an excessive amount of "no sales" entered on the cash register, it could mean that the drawer is being opened and no money is being put in.

2-4 (Learning objective 2-3) Assume a client who owns a small apartment complex in a different city than where he lives has discovered that the apartment manager has been skimming rental receipts, which are usually paid by check. The manager endorsed the checks with the apartment rental stamp, then endorsed her own name and deposited the proceeds into her own checking

account. Because of the size of the operation, hiring a separate employee to keep the books is not practical. How could a scheme like this be prevented in the future?

Answer: Two simple, separate control measures might help prevent such future occurrences.

Although it might not be practical for the owner to reconcile the rental receipts himself since he lives in a different city, he could obtain a restrictive endorsement stamps that states "for deposit only." Second, the owner could have rental payments directed to a bank lockbox, where they would be less likely to be stolen.

2-5 (Learning objectives 2-8 and 2-11) What is the most effective control to prevent receivables skimming?

Answer: In almost all cases of receivables skimming, the person handling the cash and the person keeping the books are one and the same. An employee who opens incoming mail or handles cash should not be permitted to post the transactions.

2-6 (Learning objectives 2-3 and 2-7) In many cases involving skimming, employees steal checks from the incoming mail. What are some of the controls that can prevent such occurrences?

Answer: Here are some of the basic controls over incoming checks:

- The person opening the mail should be independent of the cashier, accounts receivable clerk, or employees who are authorized to initiate or post journal entries.*
- Unopened mail should not be delivered to employees having access to accounting records.*
- The employee who opens the mail should (1) place restrictive endorsements on the incoming checks; (2) prepare a list of checks received; (3) forward all remittances to the person responsible for preparing and making the bank deposit; and (4) forward the list of checks to a person who can check to see if it agrees with the bank deposit.*

2-7 (Learning objectives 2-7 and 2-11) In the case study of Stefan Winkler, who was the chief financial officer for a beverage company in Florida, how did he conceal his skimming scheme? How could the scheme have been prevented or discovered?

Answer: Winkler's scheme is a classic example of too much trust placed in one employee. The beverage company received money from two different sources: route deposits (cash sales) and office deposits (accounts receivable). The route salespeople prepared their own deposit slips showing the cash and currency collected. The office personnel listed and accounted for the checks received through the mail. Winkler removed currency from the route deposits and replaced it with a check for the same amount from office deposits. Although office personnel

listed the checks, they did not prepare the deposit slips—Winkler did that. As a result, he would ensure that the bank deposits agreed with the amount of money going into the bank.

To cover his tracks with the credit customers, Winkler would lap payments made by one customer to cover thefts from another customer. He would also give unauthorized discounts to credit customers. When Winkler was fired for other reasons, he made a general ledger adjustment of over \$300,000 in a vain attempt to cover the shortages.

There were many clues: The internal control deficiencies were glaring. All of the cash made a stop at Winkler's desk on its way to the bank. Had there been adequate division of responsibilities, Winkler's scheme would have been much more difficult to accomplish. There were excessive false discounts to customers. The cost of sales would have been out of line with sales. And, like so many other fraudsters, Winkler lived beyond his means. Had his fellow employees been properly educated about fraud, they would have easily seen the fact that Winkler was driving a \$75,000 car as a red flag. Also, had they been to his home, they would have noticed that their chief financial officer lived in an excessively expensive residence.