

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.

- Civil
- Criminal
- Civil
- Criminal
- Criminal
- Civil
- Criminal
- 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.