Chapter 2
Who Commits Fraud and Why

I, Dennis Greer, am making this statement on my own, without threat or promises, as to my activities in regard to the activity of kiting between Bank A and Bank B. As of May 19XX, I was having extreme emotional and financial difficulties. For religious reasons, I was required without notice to move out of where I was living, and I had no place to go. Also, my grandmother—the only family member I was close to—was dying. I had to live out of my car for 3 1/2 weeks. At the end of this time, my grandmother died. She lived in Ohio. I went to the funeral and I returned with a $1,000 inheritance. I used this money to secure an apartment. The entire sum was used up for the first month's rent, deposit, and the application fee. From that time, mid-June, until the first part of August, I was supporting myself on my minimum-wage job at the nursery. I had no furniture or a bed. I was barely making it. I was feeling very distraught over the loss of my grandmother and problems my parents and brother were having. I felt all alone. The first part of August arrived and my rent was due. I did not have the full amount to pay it. This same week, I opened a checking account at Bank B. I intended to close my Bank A account because of a lack of ATMs, branches, and misunderstanding. As I said, my rent was due and I did not know how to meet it. On an impulse, I wrote the apartment manager a check for the amount due. I did not have the funds to cover it. I thought I could borrow it, but I could not. During the time I was trying to come up with the money, I wrote a check from my Bank B account to cover the rent check and put it into Bank A. I did not know it was illegal. I knew it was unethical, but I thought since the checks were made out to me that it wasn't illegal. This went on for about a week—back and forth between banks. I thought I could get the money to cover this debt but I never did. My grandmother's estate had been quite large, and I expected more money, but it was not to happen. After a week of nothing being said to me by the banks, I began to make other purchases via this method. I needed something to sleep on and a blanket and other items for the apartment. I bought a sleeper sofa, a desk, a modular shelf/bookcase, dishes, and also paid off my other outstanding debts—college loans, dentist bill, and credit. I was acting foolishly. No one had questioned me at the banks about any of this. I usually made deposits at different branches to try to avoid suspicion, but when I was in my own branches, no one said a thing. I thought maybe what I was doing wasn't wrong after all. So I decided to purchase a new car, stereo, and a new computer to use at home for work. Still, I did not have a problem making deposits at the banks. But, I was feeling very guilty. I knew I needed to start downsizing the "debt" and clear it up. I began to look for a better-paying job. Finally, last week I got a call from Bank B while I was at work: They had discovered a problem with my account. I realized then that the banks *had found out. Later that day, I got another call from Bank A. They told me that what I had been doing was illegal and a felony. I was in shock. I didn't know it was that bad. I realize now how wrong what I did was. From the start, I knew it was unethical, but I didn't know it was indeed a crime until now. I have had to do a lot of thinking, praying, and talking to those close to me about this. I am truly sorry for what I have done, and I don't EVER plan to do it again. All I want now is to make amends with the banks. I do not have the money to pay back either bank right now. I realize this hurts them. I want to try to set this right, whether I go to prison or not. I am prepared to work however long it takes to pay the banks back in full with reasonable interest from a garnishment of my wages from now until the full amount is paid and settled. I committed this act because I was feeling desperate. I was emotionally a wreck and physically tired. I felt I didn't have a choice but to do what I did or return to living in my car. I know now that what I did was wrong, and I am very sorry for it. I am attempting to seek psychological counseling to help me deal with and resolve why I did this. I feel I have a lot to offer society, once I am able to clean up my own life and get it straightened out. I pray the bank employees and officers will forgive me on a personal level for the hardship my actions have caused them, and I want to make full restitution. I have done wrong, and I must now face the consequences. This statement has been made in my own words, by myself, without threat or promise, and written by my own hand.*

Dennis Greer

The names of the perpetrator and the banks have been changed in this case. However, this is a true confession written by a person who committed the fraud of kiting—using the "float time" between banks to give the impression that he had money in his accounts.

In Chapter 1, we talked about what fraud is; the seriousness of the problem; different types of frauds, including customer frauds like Greer's; how much fraud costs organizations; and the difference between civil and criminal law. In this chapter, we discuss who commits frauds and why they commit fraud. To prevent, detect, and investigate fraud, you must understand what motivates fraudulent behavior and why otherwise honest people behave unethically.

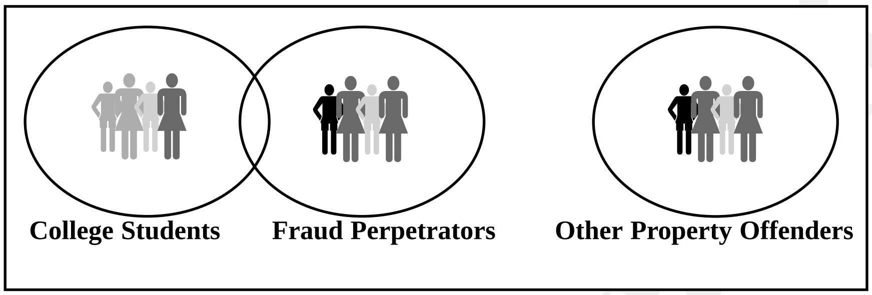
WHO COMMITS FRAUD

Past research has shown that anyone can commit fraud.[1] Fraud perpetrators usually cannot be distinguished from other people by demographic or psychological characteristics. Most fraud perpetrators have profiles that look like those of other honest people.

Several years ago, the author was involved in a study of the characteristics of fraud perpetrators. In this study, fraud perpetrators were compared with prisoners incarcerated for property offenses and a noncriminal sample of college students. The personal backgrounds and psychological profiles of the three groups were compared, and the results indicated that incarcerated fraud perpetrators are very different from other incarcerated prisoners. When compared to other criminals, they are less likely to be caught, turned in, arrested, convicted, and incarcerated. They are also less likely to serve long sentences. In addition, fraud perpetrators are considerably older. Although only 2 percent of the property offenders are female, 30 percent of fraud perpetrators are women. Fraud perpetrators are better educated, more religious, less likely to have criminal records, less likely to have abused alcohol, and considerably less likely to have used drugs. They are also in better psychological health. They enjoy more optimism, self-esteem, self-sufficiency, achievement, motivation, and family harmony than other property offenders. Fraud perpetrators also demonstrate more social conformity, self-control, kindness, and empathy than other property offenders.[2]

When fraud perpetrators were compared with college students, they differed only slightly. Fraud perpetrators suffer more psychic pain and are more dishonest, more independent, more sexually mature, more socially deviant, and more empathetic than college students. However, fraud perpetrators are much more similar to college students than they are to property offenders. Figure 2.1 illustrates the differences among the three groups.

Figure 2.1
Profiles of Fraud Perpetrators



It is important to understand the characteristics of fraud perpetrators because they appear to be much like people who have traits that organizations look for in hiring employees, seeking out customers and clients, and selecting vendors. This knowledge helps us to understand two things (1) most employees, customers, vendors, and business associates and partners fit the profile of fraud perpetrators and are probably capable of committing fraud and (2) it is impossible to predict in advance which employees, vendors, clients, and customers will become dishonest. In fact, when fraud does occur, the most common reaction by those around the fraud is denial. Victims can't believe that individuals who look and behave much like them and who are usually well trusted can behave dishonestly.

WHY PEOPLE COMMIT FRAUD

Although there are thousands of ways to perpetrate fraud, Dennis Greer's fraud in the chapter opening vignette illustrates three key elements common to all of them. His fraud includes (1) a perceived pressure, (2) a perceived opportunity, and (3) some way to rationalize the fraud as acceptable. These three elements make up what we call the fraud triangle.

After moving into an apartment, Greer could not pay the second month's rent. Faced with having to choose between dishonesty or living in his car, he chose to be dishonest. Every fraud perpetrator faces some kind of *perceived pressure.* Most pressures involve a financial need, although nonfinancial pressures (such as the need to report results better than actual performance, frustration with work, or even a challenge to beat the system) can also motivate fraud. In Greer's case, he had a real pressure, not a perceived one. We may look at fraud perpetrators and say "they didn't have a real pressure." But it doesn't matter what we think—it is only what is in the fraud perpetrator's mind that matters. Later in this chapter we will discuss the different kinds of pressures that trigger fraudsters.

Greer found a way to commit fraud by repeatedly writing bad checks to give the impression that he was depositing real money in his accounts. He didn't need access to cash, to use force, or even to confront his victims physically. Rather, he simply wrote checks to himself in the privacy of his own apartment and deposited them in two different banks. His weapons of crime were a pen and checks from the financial institutions. Whether or not Greer could actually get away with the crime didn't matter. What mattered was that Greer believed he could conceal the fraud—in other words, he had a *perceived opportunity.*

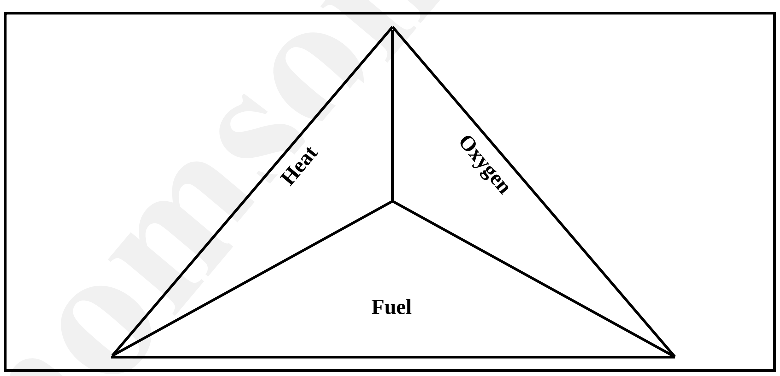
Fraud perpetrators need a way to *rationalize* their actions as acceptable. Greer's rationalizations are twofold (1) he didn't believe what he was doing was illegal, although he recognized it might be unethical and (2) he believed he would get an inheritance and be able to pay the money back. In his mind, he was only *borrowing,* and, although his method of borrowing was *perhaps* unethical, he would repay the debt. After all, almost everyone borrows money.

Perceived pressure, perceived opportunity, and rationalization are common to every fraud. Whether the fraud is one that benefits the perpetrators directly, such as employee fraud, or one that benefits the perpetrator's organization, such as management fraud, the three elements are always present. In the case of management fraud, for example, the pressure may be the need to make earnings look better to meet debt covenants, the opportunities may be a weak audit committee or weak internal controls, and the rationalization may be that "we'll only cook the books until we can get over this temporary hump."

Fraud resembles fire in many ways. For a fire to occur, three elements are necessary (1) oxygen, (2) fuel, and (3) heat. These three elements make up the "fire triangle," as shown in Figure 2.2. When all three elements come together, there is fire.

Firefighters know that a fire can be extinguished by eliminating any one of the three elements. Oxygen is often eliminated by smothering, by using chemicals, or by causing explosions, as is the case in oil well fires. Heat is most commonly eliminated by pouring water on fires. Fuel is removed by building fire lines or fire breaks or by shutting off the source of the fuel.

Figure 2.2
The Fire Triangle



As with the elements in the fire triangle, the three elements in the fraud triangle are also interactive (Figure 2.3). With fire, the more flammable the fuel, the less oxygen and heat it takes to ignite. Similarly, the purer the oxygen, the less flammable the fuel needs to be to ignite. With fraud, the greater the perceived opportunity or the more intense the 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. The scale shown in Figure 2.4 illustrates the relationship between the three elements.

As we show in later chapters, people who try to prevent fraud usually work on only one of the three elements of the fraud triangle—opportunity. Because fraud-fighters generally believe that opportunities can be eliminated by having good internal controls, they focus all or most of their preventive efforts on implementing controls and ensuring adherence to them. Rarely do they focus on the pressures motivating fraud or on the rationalizations of perpetrators.

Figure 2.3
The Fraud Triangle

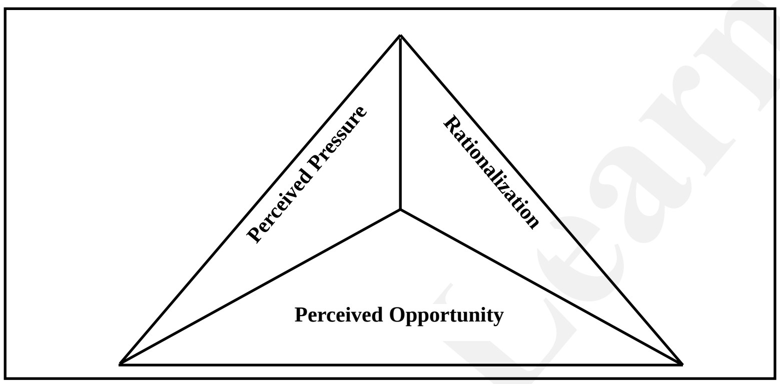
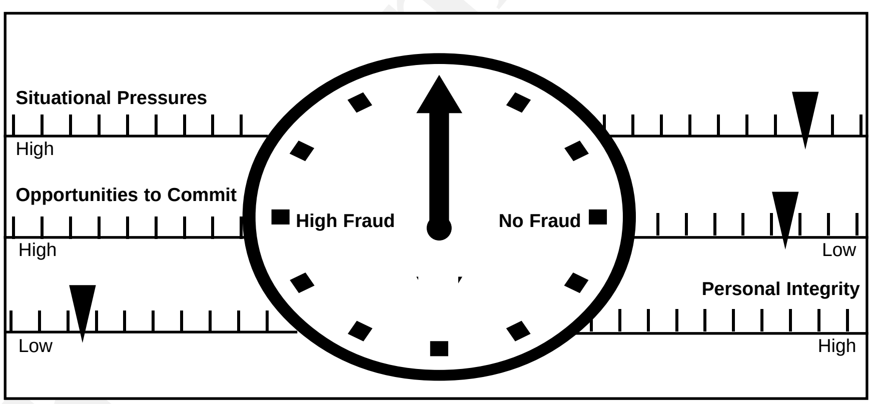


Figure 2.4
The Fraud Scale



It is interesting to note that almost every study of honesty reveals that levels of honesty are decreasing.[3] Given the interactive nature of the elements in the fraud triangle, society's retreat from this value presents a scary future for companies combatting fraud. Less honesty makes it easier to rationalize, thus requiring less perceived opportunity and/or pressure for fraud to occur.

Rationalizations and varying levels of honesty, as well as fraud opportunities, are discussed later in this chapter. We now turn our attention to the pressures that motivate individuals to commit fraud.

THE FIRST ELEMENT: PRESSURE

Fraud is perpetrated to benefit oneself or to benefit an organization, or both. Employee fraud, in which individuals embezzle from their employers, usually benefits the perpetrator. Management fraud, in which an organization's officers deceive investors and creditors (usually by manipulating financial statements), is most often perpetrated to benefit an organization and its officers. In this section we will discuss the different pressures that motivate individuals to perpetrate fraud on their own behalf. Most experts on fraud believe these pressures can be divided into four types (1) financial pressures, (2) vices, (3) work-related pressures, and (4) other pressures.

Financial Pressures

Studies conducted by the author show that approximately 95 percent of all frauds involve either financial or vice-related pressures.[4] What were Greer's financial pressures? He was living in his car, he didn't have furniture or other necessities, and he was broke. Here are the six most common financial pressures associated with fraud that benefits perpetrators directly:

1. Greed.
2. Living beyond one's means.
3. High bills or personal debt.
4. Poor credit.
5. Personal financial losses.
6. Unexpected financial needs.

This list is not exhaustive, and these pressures are not mutually exclusive. However, each pressure in this list has been associated with numerous frauds. We know of individuals who committed fraud because they were destitute. We know of perpetrators who were living lifestyles far beyond that of their peers. When one perpetrator was caught embezzling over $1.3 million from his employer, investigators discovered that he spent the money on monogrammed shirts and gold cuff links, two Mercedes Benz cars, an expensive suburban home, a beachfront condominium, furs, rings, and other jewelry for his wife, a new car for his father-in-law, and a country club membership. Most people would say he didn't have real financial pressures. But to him, the pressures from his desire to acquire these luxuries were enough to motivate him to commit fraud.

Financial pressures can occur suddenly or can be long-term. Unfortunately, very few fraud perpetrators inform others when they are having financial problems. As an example, consider Susan Jones. Susan had worked at the same company for over 32 years. Her integrity had never been questioned. At age 63, she became a grandmother—and immediately thereafter, a spendaholic. She bought everything she could get her hands on for her two grandchildren. She even became addicted to the Home Shopping Network, a cable TV channel. During the three years prior to her retirement, Susan stole over $650,000 from her employer. When caught, she was sentenced and served one year in prison. She also deeded everything she and her husband owned to her former employer in an attempt to pay the employer back. By giving her employer her home, her retirement account, and her cars, she repaid approximately $400,000 of the $650,000 she stole. She also entered into a restitution agreement to pay back the remaining $250,000 she still owed. And, because she hadn't paid income taxes on the $250,000 of fraudulent "income," the IRS required her to make monthly tax payments after she got out of prison. In the Adelphia case, it was the personal financial problems of John Regas (personal debt of $66 million), including the need to meet margin calls and fund poorly performing closely-held companies, that led to his alleged frauds.

The fact that someone has been an "honest" employee for a long time (32 years in Susan's example) appears to make no difference when severe financial pressures occur or an individual perceives that such pressures exist. One study found that whereas approximately 30 percent of frauds are perpetrated by employees during their first three years of employment, 70 percent are committed by employees with 4-35 years of experience. The age group with the highest rate of fraud is between the ages of 35 and 44.[5]

Financial pressure is the most common pressure that drives people to commit fraud. Usually when management fraud occurs, companies overstate assets on the balance sheet and revenues and income on the income statement. They usually feel pressured to do so because of a poor cash position, receivables that aren't collectible, a loss of customers, obsolete inventory, a declining market, or restrictive loan covenants that the company is violating. Regina Vacuum's management committed massive financial statement fraud. The main pressure that drove them to fraud was that their vacuum cleaners were defective—parts melted—and thousands were being returned. The large number of returns reduced revenues significantly and created such income pressures that management intentionally understated sales returns and overstated sales.[6]

Vice

Closely related to financial pressures are "vices"—addictions such as gambling, drugs, and alcohol—and expensive extramarital relationships. As an example of how these vice problems motivate a person to commit fraud, consider one individual's confession of how gambling led to his dishonest acts:

> *As I sat on the stool in front of the blackjack table I knew I was in trouble. I had just gambled away my children's college fund. I stumbled to my hotel room, hoping to wake up and realize this evening was nothing more than a nightmare. While driving back to San Jose from Reno Sunday morning, I could not face the embarrassment of telling my wife. I had to come up with the money. I was sure that if I had only $500, I could win the money back. But how could I get $500? A short time later at work, an accounts payable clerk came to my office seeking assistance with a problem. The clerk was matching invoices with purchase*

orders. He had found an invoice for $3,200 that did not match the purchase order. Immediately, I realized how I could get the $500 "loan." My company was a fast-growing microchip producer whose internal controls were quite good on paper but were often not followed. The company had a policy of paying, without secondary approval, any invoice of $500 or less. I decided to set up a dummy company that would issue invoices to my employer for amounts up to $500. I was confident my winnings from these "borrowings" would not only allow me to replace the college fund, but would also allow repayment of the "loan." I couldn't believe how easy it was to "borrow" the money. The first check showed up in a P.O. box I had opened a few days earlier. I called my wife with the bad news. Together with the controller, I would have to fly to Los Angeles over the weekend to meet with lawyers over a company matter. Within minutes, I was on my way to Reno. Upon arrival, I went straight to the craps tables. By 4:00 A.M., I was not only out of money but was in the hole over $600. I was concerned about the losses, but not as worried as before. I would just submit more fictitious bills to the company. Over the next few months, my fraud progressed to the point where I had set up two more dummy companies and insisted that accounts payable clerks not verify any invoice of less than $750. No one questioned my changing the policy because I had worked for the company for over 14 years and was a "trusted" employee. After one year, I had replaced the college fund and purchased a new automobile; I had stolen over $75,000. I was caught when the internal auditors matched addresses of vendors and found that my three dummy vendors all had the same P.O. Box.

Vices are the worst kind of pressure—out-of-control lifestyles are frequently cited as the trigger that drives previously honest people to commit fraud. We know of female employees who embezzled because their children were on drugs and they couldn't stand to see them go through withdrawal pains. We also know of "successful" managers who, in addition to embezzling from their companies, burglarized homes and engaged in other types of theft to support their drug habits. To understand the addictive nature of these vices, consider the following confessions from reformed gamblers:

- "Gambling was the ultimate experience for me—better than sex, better than any drug. I had withdrawal tortures just like a heroin junkie."
- "I degraded myself in every way possible. I embezzled from my own company; I conned my six-year-old out of his allowance."
- "Once I was hooked, any wager would do. I would take odds on how many cars would pass over a bridge in the space of 10 minutes."
- "I stole vacation money from the family sugar jar. I spent every waking hour thinking about getting to the track."
- "After I woke up from an appendectomy, I sneaked out of the hospital, cashed a bogus check, and headed for my bookie. I was still bleeding from the operation."
- "I'll never forget coming home from work at night, looking through the window at my family waiting for me, and then leaving to place a couple more bets. I was crying the whole time, but I had simply lost all control."

If someone will steal from his six-year-old child or sneak out of a hospital still bleeding from an operation to feed his addiction, he will certainly steal from his employer or commit other types of fraud. The number of embezzlers who trace their motivation for embezzlement to alcohol, gambling, and expensive extramarital relationships is high. However, the number who steal for drugs may even be higher. Consider these confessions of former addicted drug users:

- "I began living with a man who was a heavy drug user. We had a child, but the relationship didn't last. By the time it ended, I was high on drugs and alcohol so much of the time I could barely manage to make it to work every day."
- "I was the branch manager of a large bank. But secretly I was shooting up in my office all day and stealing money from my employer to finance it."
- "One day my daughter stretched out her little arms in front of me. She had made dots with a red pen on each of the creases in her arms. 'I want to be just like my Daddy,' she said proudly."
- "My wife and I literally whooped for joy at the sight of our newborn son. A seven-pound baby with big eyes and rosy cheeks—normal and healthy looking. But we both knew the moment we had been dreading was now just hours away. The baby would be going through withdrawal. We didn't want him to suffer because of our awful habit. And we had to keep the doctors from finding out he had drugs in his system, or he would be taken from us and placed in foster care. We felt we had no choice. When the nurses left the room, I cradled our baby in my arms and slipped a thin piece of heroin under his tongue."
- "I lost my job. I was robbing and stealing every day to support my habit, which cost $500 per day."

Someone who will slip a piece of heroin under a newborn baby's tongue or burglarize homes to support her habit will surely look for ways to embezzle from employers or commit other types of fraud.

Work-Related Pressures

Whereas financial pressures and vices motivate most frauds, some people commit fraud to get even with their employer. Factors such as not enough recognition for job performance, dissatisfaction with the job, fear of losing one's job, being overlooked for a promotion, and feeling underpaid motivate many frauds. Here is an example:

> *I began my career at the XYZ Company as a staff accountant. I am a religious person. In fact, I spent a year volunteering with a nonprofit agency that provided relief to people in need of food and shelter. Because of this experience and because of my six years with the company, I was considered a person of impeccable character and a very trusted employee. The president of XYZ is a workaholic and considers an eight-hour day to be something a part-time employee works. As a result, I spent six years working in my finance position, putting in between 12 and 14 hours per day. During this period, I was paid a salary, with no overtime compensation. Early in my career, the extra hours didn't bother me; I considered them an investment in my future. Soon, I was named manager of the*

purchasing department. After two years in that position, I realized that the 12- to 14-hour days were still an expected way of life at the company. I was becoming bitter about the expectation of overtimes and felt that the company "owed me" for the time I had worked for "nothing." I decided to get my "pay" from the company. Working with a favored vendor, I accepted kickbacks to allow over $1.5 million in overcharges to the company. I figured the $80,000 I received in kickbacks was compensation that I deserved.

Other Pressures

Once in a while, fraud is motivated by other pressures, such as a spouse who insists on an improved lifestyle or a desire to beat the system. One perpetrator, for example, embezzled over $450,000 so that her husband could drive a new car, enjoy a higher lifestyle, and eat steak instead of hamburger. One famous computer consultant who is now retained by major companies to help them deter and detect computer fraud once felt personally challenged to "commit the perfect crime." After purchasing and taking delivery of over $1.5 million in inventory that was paid for by accessing a large company's computer records, he was caught when one of his inventory managers figured out what was going on.

All of us face pressures in our lives. We have legitimate financial needs, we make foolish or speculative investments, we are possessed by addictive vices, we feel overworked and/or underpaid, or we simply want more than we have. We sometimes have a difficult time distinguishing between wants and needs. Indeed, the objective of most people in capitalistic societies is to obtain wealth. We often measure success by how much money or wealth a person has. If you say you have a very successful relative, you probably mean that he or she lives in a big house, has a cabin or a condominium, drives expensive automobiles, and has money to do whatever he wants. But most of us don't put our success ahead of our honesty and integrity.

To some people, however, being successful is more important than being honest. If they were to rank the personal characteristics they value most in their lives, success would rank higher than integrity. Psychologists tell us that most people have a price at which they will be dishonest. Individuals with high integrity and low opportunity need high pressure to be dishonest.

Most of us can think of scenarios in which we, too, might commit fraud. If for example, we were starving, and we worked in an environment where cash was abundant and not accounted for, and we really believed that we would repay the money taken to feed ourselves, we might commit fraud. The U.S. president most famous for his honesty, Abraham Lincoln, once threw a man out of his office, angrily turning down a substantial bribe. When someone asked why he was so angry, he said, "Every man has his price, and he was getting close to mine."[7] One thing is for certain—eliminating pressures in the fraud triangle has an effect similar to removing heat from the fire triangle. Without some kind of pressure, fraud rarely occurs.

THE SECOND ELEMENT: OPPORTUNITY

A perceived opportunity to commit fraud, to conceal it, or to avoid being punished is the second element in the fraud triangle. In this section we discuss opportunity. First, we examine controls that increase opportunities for individuals to commit fraud in organizations. Then, we provide a number of scenarios to illustrate noncontrol issues that should be considered when deciding whether a fraud opportunity is present.

At least six major factors increase opportunities for individuals to commit fraud in organizations. The following list is not exhaustive, but it does show system weaknesses that create opportunity.

1. Lack of or circumvention of 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.
5. Ignorance, apathy, and incapacity.
6. Lack of an audit trail.

Control Factors: Controls That Prevent and Detect Fraud

Having an effective control structure is probably the single most important step organizations can take to prevent and detect employee fraud. There are three components in a company's control structure (1) the control environment, (2) the accounting system, and (3) control procedures or activities. The accounting profession and the Committee of Sponsoring Organizations (COSO) have defined these components; here we discuss only those components that are most effective in deterring fraud.

The Control Environment

The *control environment* is the work atmosphere that an organization establishes for its employees. The most important element in an appropriate control environment is *management's role and example.* There are numerous instances in which management's dishonest or inappropriate behavior was learned and then modeled by employees. In the famous Equity Funding case, management wrote insurance policies on individuals who didn't exist and sold them to other insurance companies. Seeing this dishonest behavior, one employee said to himself, "It doesn't make sense to have all these fictitious people live forever. I'll knock a few of them off and collect death proceeds. My actions won't be any different from those of the management of this company." In another case, employees realized top management was overstating revenues. In response, the employees began overstating expenses on their travel reimbursement forms, billing for hours not worked, and perpetrating other types of fraud.

Proper *modeling* (being an example) and proper *labeling* (communication) are some of the most important elements in effective control environments. When management models unacceptable behavior, the control environment is contaminated. Similarly, if management models a behavior that is inconsistent with good control procedures, the effectiveness of the control system is eroded. When a manager says, "Don't loan keys or share passwords with others," and then shares her password or keys, she sends mixed signals and her inappropriate behavior may eventually be copied by other employees. In other words, "actions speak louder than words." Management's example is the most critical element of the control environment when it comes to preventing fraud. Inappropriate behavior by management encourages others to justify overriding and ignoring control procedures.

The second critical element in the control environment is *management's communication.* Communicating what is and is not appropriate is crucial. Just as parents who are trying to teach their children to be honest must communicate often and openly with them, so must organizations clearly label what is and is not acceptable. Codes of conduct, orientation meetings, training, supervisor/employee discussions, and other types of communication that distinguish between acceptable and unacceptable behavior should be routine activities.

To be an effective deterrent to fraud, communication must be consistent. Messages that change based on circumstances and situations serve not only to confuse employees but also to encourage rationalizations. One reason so many frauds occur in "crash" projects is that the regular control procedures are not followed. Inconsistent messages relating to procedures and controls abound. Strikes, mergers, bankruptcies, and other dramatic events often result in inconsistent communication and increase fraud.

The third critical element in creating the proper control structure is *appropriate hiring.* Research shows that nearly 30 percent of all people in the United States are dishonest, another 30 percent are situationally honest (honest where it pays to be honest and dishonest where it pays to be dishonest), and 40 percent are honest all the time.[8] Although most organizations are convinced that their employees, customers, and vendors are among the 40 percent who are honest, this usually isn't the case.

When dishonest individuals are hired, even the best controls will not prevent fraud. For example, a bank has tellers, managers, loan officers, and others who have daily access to cash and can steal. Because it is impossible to deter all bank fraud, banks hope that personal integrity, together with preventive and detective controls and the fear of punishment, will deter theft.

As an example of the consequences of poor hiring, consider the case of a famous country singer who was raped a few years ago. The singer checked into a well-known hotel. A few hours after her arrival, there was a knock on her door, accompanied by the words "Room Service." She hadn't ordered anything but thought that maybe, because she was famous, the hotel was bringing her a basket of fruit or some complimentary wine. When she opened the door, a hotel custodian burst into her room and raped her. She later sued the hotel for $2.5 million and won. The basis of her lawsuit was that locks on the door were inadequate, and the hotel had inadequate hiring procedures because the custodian had previous arrest records and had been fired from previous jobs because of rape.[9]

If an organization does not screen job applicants carefully and hires dishonest individuals, it will be victimized by fraud, regardless of how good its controls are. To understand how sound hiring practices help prevent fraud and other problems, consider a company that decided to take extra precautions in its hiring practices. They first trained all persons associated with hiring decisions to be expert interviewers and secondly required them to thoroughly check three background references for each prospective employee. Because of these extra precautions, over 800 applicants (13 percent of the applicant pool) who would have been hired were disqualified. These applicants had undisclosed problems, such as falsified employment information, previous arrest records, uncontrollable tempers, alcoholism, drug addiction, and a pattern of being fired from previous jobs.

The effects of poor hiring practices are illustrated in the following excerpt from an article in *Business Week Online:*

> *These days, it's tempting to hire the first person who seems capable of doing a job. But do you know what lurks behind that spiffy resume? The Association of Certified Fraud Examiners estimates that employee fraud costs small companies an average of $120,000 per incident. It's a good idea to check the backgrounds of all applicants. At the very least, you'll be certain the person has the credentials they claim. . . . Three years ago managers hired a security expert to conduct background checks on employees and potential hires, examining credit and criminal backgrounds and verifying education and experience. Good thing they did—the company was on the verge of hiring a director of finance who turned out to have neither the MBA nor any of the experience he said he had.*[10]

The fourth fraud-deterring element of the control environment is a *clear organizational structure.* When everyone in the organization knows exactly who has responsibility for each business activity, fraud is less likely to be committed. Such structures make it easier to track missing assets and harder to embezzle without being caught. Strict accountability for job performance is critical for a good control environment.

As an example of how failure to assign proper custody resulted in a fraud, consider the case of "Jane Doe:"

> *I was one of eight tellers in a medium-sized bank. Because we all had access to money orders and bank checks, I stole 16 money orders. I didn't use them for two weeks to see if anyone would notice them missing. Then, I used one for $300. After nothing being said during the next two weeks, I used seven more.*

In this case, someone independent from the teller should have had responsibility for reconciling money orders on a daily basis.

The fifth element of the control environment is an *effective internal audit department, combined with security or loss prevention programs.* Although most studies have found that internal auditors detect only about 20 percent of all employee frauds (others are detected through tips, by alert employees, or accidentally), the mere presence of internal auditors provides a significant deterrent effect.[11] Internal auditors provide independent checks and cause potential perpetrators to question whether they can act and not be caught. A visible and effective security function, in conjunction with an appropriate loss prevention program, helps ensure that fraud is properly investigated and that control weaknesses and violations are appropriately punished.

Taken together, the five elements are (1) proper management modeling, (2) good communication or labeling, (3) effective hiring procedures, (4) clear organizational structure and assigned responsibilities, and (5) an effective internal audit department and security function. These create an atmosphere in which fraud opportunities are decreased because employees see that fraud is neither acceptable nor tolerated. Relaxing any one of these elements increases opportunities for committing fraud.

The new Corporate Responsibility Act (Sarbanes-Oxley Act) has, as one of its goals, to get management and boards of public companies to accept more responsibility for the control environment in their organizations.

The Accounting System

The second component of the control structure is a good *accounting system.* Every fraud is comprised of three elements (1) the theft, in which assets are taken, (2) concealment, which is the attempt to hide the fraud from others, and (3) conversion, in which the perpetrator spends the money or converts the stolen assets to cash and then spends the money. An effective accounting system provides an *audit trail* that allows frauds to be discovered and makes concealment difficult. Unlike bank robbery, in which there is usually no effort to conceal the theft, concealment is a distinguishing element of fraud.

Frauds are often concealed in the accounting records. Accounting records are based on transaction documents, either paper or electronic. To cover up a fraud, paper or electronic documentation must be altered or misplaced. Frauds can be discovered in the accounting records by examining transaction entries that have no support or by probing financial statement amounts that are not reasonable. Without a good accounting system, distinguishing between actual fraud and unintentional errors is often difficult. A good accounting system ensures that recorded transactions are (1) valid, (2) properly authorized, (3) complete, (4) properly classified, (5) reported in the proper period, (6) properly valued, and (7) summarized correctly.

Control Activities (Procedures)

The third component of the control structure is good *control activities* (or procedures). *Individuals* who own their own businesses and are the sole "employee" probably do not need many control procedures. Although these people may have ample opportunity to defraud their own business, they have no incentive to do so. They wouldn't steal from themselves, and they would never want to treat customers poorly. However, organizations that involve many employees must have control procedures so that the actions of employees are congruent with the goals of management and the owners. In addition, with control procedures, opportunities to commit and/or conceal frauds are eliminated or minimized. No matter what the business is, whether it is the business of operating a financial institution, a grocery store, a Fortune 500 company, or the business of investing personal assets, there are five primary control procedures or activities:

1. Segregation of duties or dual custody.
2. System of authorizations.
3. Independent checks.
4. Physical safeguards.
5. Documents and records.

Although there are thousands of control activities used by businesses, they are basically all variations of these five basic procedures. Good fraud detection and prevention efforts involve matching the most effective control procedures with the various risks of fraud. As an illustration of how control procedures can be used to achieve goal congruence and prevent fraud, consider the following situation:

> *Mark was a seventh grader. At the annual parent-teacher conferences, Mark's parents discovered that he was getting straight As in all of his classes except one—a German class in which he was getting an F. When Mark's parents later asked him about the class, he said, "I hate the teacher. She is a jerk and I refuse to work for her." After discussions with the teacher and Mark, Mark's parents decided to implement three controls, so that his actions would be consistent with*

> *the desires of his parents. First, Mark's parents printed up some simple forms (documents) for the teacher to check off each day. These pieces of paper contained two simple statements (1) Mark (was) (was not) prepared for class today and (2) Mark (was) (was not) responsible in class today. The teacher would circle the appropriate response to each phrase, initial the paper, and send it home with Mark. By insisting on reading the note each night, Mark's parents were performing an independent check on his performance. In addition, his rollerblades were taken away until his grade improved. Taking away his right to play street hockey on his rollerblades was a variation of an authorization control. (He lost his authorized use.) When Mark's parents invoked the three controls of (1) documents, (2) independent checks, and (3) taking away an authorized activity, his behavior performance in German changed to become more in line with the goals of his parents. By the end of the term, his grade in German changed from an F to a B.*

Segregation of Duties and Dual Custody. *Activities* can usually be better controlled by invoking either segregation of duties or dual-custody control. Segregation of duties involves dividing a task into two parts, so that one person does not have complete control of the task. Dual custody requires two individuals to work together at the same task. Either way, it takes two people to do one job. This control, like most preventive controls, is most often used when cash is involved. For example, the opening of incoming cash in a business is usually done by two people or by segregating duties. The accounting for, and the handling of, cash are separated so that one person does not have access to both. Fred R.'s example shows the ease with which fraud can be perpetrated when accounting for and custody of assets are not separated.

> *Fred R. worked for a medium-size homebuilder. He was in charge of writing checks as well as reconciling bank statements. Over a period of time, Fred stole over $400,000 by manipulating the check register and forcing the bank reconciliation to balance. If, for example, his employer owed a subcontractor $15,000, Fred would write the check for $15,000 and write $20,000 on the check stub. Then, using the next check, he would write himself a check for $5,000 and mark the check stub "voided." When the bank statement was returned, he would destroy the checks written to himself and force the reconciliation.*

Fred's fraud could easily have been caught, if not prevented, if someone besides Fred was either reconciling the bank statements or writing the checks. There are at least three critical functions that even small business owners should either set up as segregated duties or always do themselves (1) writing checks, (2) making bank deposits, and (3) reconciling bank statements.

Because two individuals are involved, dual custody or segregation of duties is usually the most expensive of all controls. Labor costs are high, and hiring two people to complete one job is a luxury that most businesses don't believe they can afford. This control always involves a trade-off between higher labor cost and less opportunity for error and fraud. Besides being expensive, good dual custody is often difficult to enforce. When two individuals are working on the same task, they shouldn't take their eyes or their minds off the task to answer telephones, use the restroom, respond to a question, or even sneeze. A fraud that was perpetrated in a supposed "dual-custody environment" is the case of Roger M., who made the following confession:

> *In January 20XX, I took the amount of $3,062 in cash, which was contained in a disposable night drop bag. I concealed my actions by putting it inside a night drop envelope that I processed on the same day. I have no real excuse for taking money. I saw an easy way of taking the money, and I took advantage of it.*
>
> *Circumstances that made it seem easy to take the money without being caught or observed were that I was situated on the customer side of the merchant vault, which obscured the view of my dual-custody partner. I have reimbursed the bank today (January 27, 20XX) the amount of $3,062.*

System of Authorizations. The second internal control procedure is a proper system of authorizations. Authorization control procedures take many forms. Passwords authorize individuals to use computers and to access certain databases. Signature cards authorize individuals to enter safe deposit boxes, to cash checks, and to perform other functions at financial institutions. Spending limits authorize individuals to spend only what is in their budget or approved level.

When people are not authorized to perform an activity, the opportunity to commit fraud is reduced. For example, when individuals are not authorized to enter safe deposit boxes, they cannot enter and steal the contents of someone else's box. When individuals are not authorized to approve purchases, they cannot order items for personal use and have their companies pay for the goods. As the following case shows, the failure to enforce authorization controls makes the perpetration of fraud quite simple.

> *Mary and Ron had been customers of a certain bank for many years. Because Ron owned a jewelry store, they maintained a safe deposit box at the bank to store certain inventory. Most employees of the bank knew them well because of their frequent visits to make deposits and conduct other business. What was unknown to the bank employees was that Mary and Ron were having marital difficulties, which ended in a bitter divorce. After the divorce, they canceled their joint safe deposit box. Ron came in to the bank a short time later and opened a new safe deposit box, with his daughter as cosigner. Because Mary was bitter about the divorce settlement, she entered the bank one day and told the safe deposit custodian (who had been away on vacation when she and Ron closed their box) that she had lost her key and needed to have the box drilled. Because the custodian knew Mary and didn't know the old box had been closed and a new one opened, Mary arranged to force open the box. Without any problems, the box was drilled and Mary emptied the contents. When Ron tried to open the box a few days later, he discovered what had happened. Because Mary was not a signer on the account at the time the box was forced open, the bank was completely liable and settled out of court with the jeweler for $200,000. This fraud was allowed to be perpetrated because the authorization control of matching signatures to a signature card was not performed.*

Independent Checks. The theory behind independent checks is that if people know their work or activities are monitored by others, the opportunity to commit and conceal a fraud is reduced. There are many varieties of independent checks. The Office of the Controller of the Currency (OCC) requires that every bank employee in the United States take one week's vacation (five consecutive days) each year. While employees are gone, others are supposed to perform their work. If an employee's work piles up while he or she is out for the week, this "mandatory vacation" control is not working as it should and the opportunity to commit fraud is not eliminated.

Periodic job rotations, cash counts or certifications, supervisor reviews, employee hot-lines, and the use of auditors are other forms of independent checks. One large department store in Europe has a complete extra staff of employees for its chain of department stores. This staff goes to a store and works while everyone who is employed there goes on vacation for a month. While they are gone, the transient staff operates the store. One purpose of this program is to provide complete, independent checks on the activities of store employees. If someone who is committing fraud is forced to leave for a month, the illegal activity is often discovered.

To illustrate the creative use of independent checks, consider the case of a Baskin-Robbins ice cream store in Washington, D.C.

> *Upon entering this 31-flavors establishment, the customer is greeted by a smiling cashier. Two large signs hang on the wall behind the cashier. One sign reads, "If you have problems with service, please call the manager at this telephone number." The other reads, "If you get a star on your sales receipt, you receive a free sundae."*

In an ice cream store or any other retail establishment, one of the easiest ways to perpetrate fraud is to accept cash from customers and either not ring it into the cash register or ring it in as a lesser amount. If the store happens to sell ice cream, cones can be made a little smaller during the day to cover for the extra ice cream used in sales that are not entered into the cash register. The purpose of the Baskin-Robbins signs is to encourage customers to receive and examine their sales receipts. In order for customers to be able to look for a star, sales receipts must be issued. If the cashier charges $2 for an ice cream cone and rings only $1 into the cash register, sooner or later a customer will report the embezzlement.

Physical Safeguards. Physical safeguards protect assets from theft by fraud or other means. Physical safeguards, such as vaults, safes, fences, locks, and keys, take away opportunities to commit fraud by making it difficult for people to access assets. Money locked in a vault, for example, cannot be stolen unless someone gains unauthorized access or unless someone who has access violates the trust. Physical controls also protect inventory by storing it in locked cages or warehouses; small assets such as tools or supplies by locking them in cabinets; and cash by locking it in vaults or safes.

Documents and Records. The fifth control procedure involves using documents or records to create a record of transactions and an audit trail. Documents rarely serve as preventive controls, but they do provide excellent detective tools. Banks, for example, prepare kiting-suspect reports as well as reports of employee bank account activity to detect abuse by employees or customers. Most companies require a customer order to initiate a sales transaction. In a sense, the entire accounting system serves as a documentary control. Without documents, no accountability exists. Without accountability, it is much easier to perpetrate fraud and not get caught.

Summary of the Controls That Prevent or Detect Fraud

The control environment, the accounting system, and the many variations of the five control procedures work together to eliminate or reduce the opportunity for employees and others to commit fraud. A good control environment establishes an atmosphere in which proper behavior is modeled and labeled, honest employees are hired, and all employees understand their job responsibilities. The 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. Together, these three components make up the control structure of an organization. Table 2.1 (page 48) summarizes these components and their elements.

Unfortunately, many frauds are perpetrated in environments in which controls that are supposed to be in place are not being followed. Indeed, it is the overriding and ignoring of existing controls, not the lack of controls, that allow most frauds to be perpetrated.

Table 2.1 Internal Control Structure

Control Environment	Accounting System	Control Activities or Procedures
1. Managment philosopy 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 sum-marization	

Noncontrol Factor: Inability to Judge the Quality of Performance

If you pay someone to construct a fence, you can examine the completed job and determine whether or not the quality of work meets your specifications and is consistent with the agreed contract. If, however, you hire a lawyer, a doctor, a dentist, an accountant, an engineer, or an auto mechanic, it is often difficult to know whether you are paying an excessive amount or receiving inferior service or products. With these kinds of contracts, it is easy to overcharge, perform work not needed, provide inferior service, or charge for work not performed. As an example of fraud perpetrated by a professional whose work quality could not be assessed, consider the following excerpt from a *Los Angeles Times* article.

> *A dermatologist who was struck and killed after walking into freeway traffic last week had been under investigation by the state medical board for allegedly faking diagnoses of skin cancer to collect higher fees. Dr. Orville Stone, who once headed the dermatology department at UC Irvine Medical Center, was accused by five former employees of using cancerous patients' skin tissue to fake diag-*

> *noses for hundreds of other patients. . . . Last Friday, the day after the board served a search warrant at his Huntington Beach practice, . . . Stone, 61, walked in front of traffic on the San Bernardino Freeway near Indio, the California Highway Patrol said. "He basically parked his car, walked down to the embankment and walked in front of the path of a truck and was struck by four other cars." The Highway Patrol listed the death as suicide. Former employees accused Stone of hoarding cancerous moles or skin tissue he removed from at least 3 patients. He then would take healthy tissue from patients, diagnose them as having cancer and switch tissues, sending the diseased tissue to a laboratory for analysis. Stone normally charged about $50 to remove non-cancerous skin tissue and about $150 to remove cancerous ones.*[12]

Another example of this noncontrol factor is the case of Sears Automotive in California:

> *Prompted by an increasing number of consumer complaints, the California Department of Consumer Affairs completed a one-year investigation into allegations that Sears Tire and Auto Centers overcharged their customers for auto repair services. The undercover investigation was conducted in two phases. In the first phase, agents took 38 cars known to have defects in the brakes and no other mechanical faults to 27 different Sears Automotive Centers in California during 1991. In 34 of the 38 cases, or 89 percent of the time, agents were told that additional work was necessary, involving additional costs. Their average amount of the overcharge was $223, but in the worst case, which occurred in San Francisco, agents were overcharged $585 to have the front brake pads, front and rear springs, and control-arm bushings replaced. Although a spokesman for Sears denies the allegations and says that Sears will fight any attempt to deprive them of their license to do auto repair work in California, the evidence of fraud is substantial. In one case, Ruth Hernandez, a citizen of Stockton, California, went to Sears to have new tires put on her car. While she was there, the mechanic informed her that she also needed new struts, which would cost an additional $419.95. When Mrs. Hernandez sought a second opinion, she was told her struts were fine. The Sears mechanic later admitted to having made an incorrect diagnosis.*[13]

To understand why a well-established, reputable company such as Sears might commit such a fraud, it is important to know that Sears had quotas for parts, services, and repair sales for each eight-hour shift. Allegedly, mechanics who consistently did not meet their quotas either had their hours reduced or were transferred out of the parts and service department. Apparently, faced with the pressure to cheat or fail, and believing that customers would not know whether the parts and services were actually needed, many service center employees decided to commit fraud.

Noncontrol Factor: Failure to Discipline Fraud Perpetrators

Criminologists generally agree that rapists have the highest rate of repeat offenses (recidivism) of all criminals. The next highest category of repeat offenders is no doubt fraudsters who are neither prosecuted nor disciplined. An individual who commits fraud and is not punished or is merely terminated suffers no significant penalty and often resumes the fraudulent behavior.

Fraud perpetrators often command respect in their jobs, communities, churches, and families. If they are marginally sanctioned or terminated, they rarely inform their families and others of the real reason for their termination or punishment. On the other hand, if they are prosecuted, they usually suffer significant embarrassment when family, friends, and business associates find out about their offenses. Indeed, humiliation is often the strongest factor in deterring future fraud activity.

Because of the expense and time involved in prosecuting, many organizations simply dismiss dishonest employees, hoping to rid themselves of the problem. What these organizations fail to realize is that such action is shortsighted. They may rid themselves of one fraudster, but they have also sent a message to others in the organization that perpetrators will not suffer significant consequences for their actions. Indeed, lack of prosecution gives others "perceived opportunity" that, when combined with pressure and rationalization, can result in additional frauds in the organization. Perceived opportunity is removed when employees understand that perpetrators will be punished according to the law, not merely terminated.

In a society in which workers are mobile and often move from job to job, termination often helps perpetrators build an attractive resume, but it does not deter future fraud. A man we'll call John Doe is a classic example of someone whose termination (he was not otherwise punished) allowed him to get increasingly attractive jobs at increased salary levels. His employment and fraud history for 14 years is shown in Table 2.2.

Table 2.2
Internal Control Structure

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	?

According to one reference who described John Doe's fraud, he was never prosecuted. His victim organizations either felt sorry for him, thought prosecution would be too time-consuming and too expensive, or merely chose to pass the problem on to others. As a result, every succeeding job Doe obtained was better than his previous one until he eventually became a controller and CFO making $130,000 a year. By only terminating him, his victims helped him build a resume and secure increasingly attractive jobs.

Noncontrol Factor: Lack of Access to Information

Many frauds occur because victims don't have access to information possessed by the perpetrators. This is especially prevalent in large management frauds that are perpetrated against stockholders, investors, and debt holders. In the famous ESM fraud case, for example, the same securities were sold to investors several times. Yet, because only ESM possessed those investment records, victims didn't know of the fraudulent sales.[14]

A classic example in which lack of information played a major role in the fraud is the Lincoln Savings and Loan case. On January 6, 1992, Charles Keating and his son, Charles Keating III, were convicted on 73 and 64 counts, respectively, of racketeering and fraud. Charles Keating created sham transactions to make Lincoln Savings look more profitable than it really was in order to please auditors and regulators. He was able to perpetrate the schemes because auditors and regulators were not given complete access to transactions. One transaction, known as the RA Homes sale, was structured as follows:

> *On September 30, 1986, defendants Keating and others caused a subsidiary of Lincoln Savings to engage in a fraudulent sale of approximately 1,300 acres of undeveloped land northwest of Tucson, Arizona, to RA Homes, Inc., at a price of approximately $25 million, consisting of a $5 million cash down payment and a $20 million promissory note, secured only by the undeveloped land. Defendants Keating and others caused Lincoln to record a sham profit of approximately $8.4 million on the sale. RA Homes agreed to purchase the land only after Keating orally (1) promised that Lincoln would reimburse RA Homes for the down payment on the purchase, (2) agreed that the Lincoln subsidiary would retain responsibility for developing and marketing the property, and (3) guaranteed that RA Homes would be able to sell the land at a profit within a year following the purchase.*[15]

Auditors didn't know about the oral commitments, all of which violated accounting standards for recording real estate sales. Subsequent to these oral agreements, in supposedly separate transactions, Keating loaned RA Homes $5 million (to cover the down payment) and then continued to manage, market, and develop the "sold" property. When the real estate agent, who thought he had an exclusive selling arrangement, discovered that the 1,300 acres had supposedly been sold by Charles Keating himself, he contacted Charles Keating for commissions on the sale and was told that no real estate commission was due because the land had just been "parked" with RA Homes. With the higher reported profits of his company, Lincoln Savings and Loan was able to appear profitable and further perpetrate its fraud on investors and others.[16]

Most investment scams and management frauds depend on their ability to withhold information from victims. Individuals can attempt to protect themselves against such scams by insisting on full disclosure, including audited financial statements, a business history, and other information that could reveal the fraudulent nature of such organizations.

Noncontrol Factor: Ignorance, Apathy, and Incapacity

Older people, individuals with language difficulties, and other vulnerable citizens are often victims of fraud because perpetrators know that such individuals may not have the capacity or the knowledge to detect their illegal acts. Vulnerable people are, unfortunately, easier to deceive. For example, consider the following:

> *A nurse with purple hands was charged with embezzling money from patients' rooms at a local hospital. The nurse's hands were purple because invisible dye*

had been put on money planted in a purse used to trap the embezzler. The nurse was on loan from a temporary-help agency. Two sisters reported to hospital security that money was taken from their purses, which were left unattended in their father's room. A check of the staff roster showed that the nurse was alone in the room just before the money was discovered missing. Hospital security put a purse containing dye-covered bills in a room. Later that day, a supervisor reported that the nurse had dye on her hands. When confronted, the nurse first said she accidentally knocked the purse to the floor and her hands were stained while she was replacing the items. After further questioning, however, the nurse admitted to taking the money from the women's purses.

The nurse realized that elderly patients were an easy target for theft. In hospital rooms, where patients are often under the influence of sedating drugs, victims don't always recognize that they have been robbed.

Frauds called *pigeon drops* take specific advantage of elderly victims. In such thefts, perpetrators often pose as bank examiners trying to catch dishonest bankers, or they use some other scheme to get elderly or non-English-speaking customers to withdraw money from banks. When these customers leave the bank with their money, the perpetrators grab the money and flee instead of examining it as promised, knowing the elderly person has no chance to catch them.

Investment scams also take advantage of elderly people. In the AFCO fraud case, a real estate investment scam, elderly victims were persuaded to take out mortgages on their homes. Sales pitches like the following convinced them that it was a good idea:

- Do you know you have a sleeping giant in your home that you are not using?
- Your home is worth $100,000, is completely paid off, and you could get $80,000 out of it with no debt to you.
- If you are willing to borrow and invest $80,000, we'll make the mortgage payments, pay you interest of 10 percent on the money you're making nothing on now, and buy you a new luxury car to drive.

A financially prudent person would recognize that the perpetrators could not possibly pay the 10 percent interest they were promising on the loan, plus the new car, but many of the victims found the offer too good to refuse. As a result, several hundred elderly, retired citizens invested a total of over $39 million in the AFCO scam.

Noncontrol Factor: Lack of an Audit Trail

Organizations go to great lengths to create documents that provide an audit trail so that transactions can be reconstructed and understood at a later time. Many frauds, however, involve cash payments or manipulation of records that cannot be followed. Smart perpetrators understand that their frauds must be concealed. They also know that such concealment usually involves 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. Here is an example:

Joan Rivera was the controller for a small bank. Over a period of four years, she stole more than $100,000 by having a larger bank pay her credit card bills.

She covered her fraud by creating accounting entries like the following:

Advertising Expense	*1,000*	
Cash		*1,000*

Joan used this approach because she knew that at year-end all expense accounts, including advertising expense, would be closed and brought to zero balances. If bank auditors and officials didn't catch the fraud before year-end, the audit trail would be erased and the fraud would be difficult to detect. On the other hand, she knew that if she covered the cash shortage by overstating outstanding checks on the bank reconciliation, the cash shortage would be carried from month to month, creating a "permanent" concealment problem. She also knew, for example, that if she manipulated the inventory, an asset, that inventory shortage would carry over into the next period.

Joan was not caught until she got greedy and started using other fraud methods that were not as easily concealed.

THE THIRD ELEMENT: RATIONALIZATION

So far, we have discussed the first two elements of the fraud triangle (1) perceived pressure and (2) perceived opportunity. The third element is rationalization. To see how rationalization contributes to fraud, let's look at the infamous case of Jim Bakker and Richard Dortch. These men were convicted on 23 counts of wire and mail fraud and one count of conspiracy to commit wire and mail fraud. As a result of their conviction, the perpetrators of one of the largest and most bizarre frauds in U.S. history were sent to jail. In his remarks to the court prior to Jim Bakker's sentencing, prosecutor Jerry Miller summarized this PTL (Praise-the-Lord) fraud with the following comments:

The biggest con man to come through this courtroom, a man corrupted by power and money and the man who would be God at PTL, is a common criminal. The only thing uncommon about him was the method he chose and the vehicle he used to perpetrate his fraud. He was motivated by greed, selfishness, and a lust for power. He is going to be right back at it as soon as he gets the chance. Mr. Bakker was a con man who in the beginning loved people and used things, but he evolved into a man, a ruthless man, who loved things and used people.[17]

How did Jim Bakker, the beloved TV minister of the PTL network, rationalize the committing of such a massive fraud? Here is his story:

PTL had a modest beginning in 1973 when it began operating out of a furniture showroom in Charlotte, North Carolina. By October 1975, it had purchased a 25-acre estate in Charlotte, North Carolina, and had constructed Heritage Village, a broadcast network of approximately 70 television stations in the United States, Canada, and Mexico on which the PTL ministry's show was aired. PTL's corporate charter stated that the religious purposes of the organization were (1) establishing and maintaining a church and engaging in all types of religious activity, including evangelism, religious instruction, and publishing and distributing Bibles, (2) engaging in other religious publication, (3) missionary *work, both domestic and foreign, and (4) establishing and operating Bible schools and Bible training centers. Over the following 11 years, PTL built a multimillion-dollar empire that consisted of PTL and a 2,300 acre Heritage USA tourist center valued at $172 million. Specific activities of the organization included Heritage Church with a weekly attendance of over 3,000; Upper Room prayer services where counselors ministered to people; Prison Ministry, with a volunteer staff of over 4,000; Fort Hope, a missionary outreach house for homeless men; Passion Play, a portrayal of the life of Christ in an outdoor amphitheater; a dinner theater; a day care center; Heritage Academy; a summer day camp; the Billy Graham Home; workshops; and a Christmas nativity scene that had been visited by over 500,000 people.*

PTL also had a wide range of activities that were ultimately deemed by the IRS to be commercial. In one such venture, PTL viewers were given an opportunity to become lifetime partners in a hotel for $1,000 each. Bakker promised that only 25,000 lifetime partnership interests would be sold and that partners could use the hotel free each year for four days and three nights. In the end, however, 68,412 such partnerships were sold. Through this and similar solicitations, Jim Bakker's PTL had amassed gross receipts of over $600 million, much of which had been used to support the extravagant lifestyle of Bakker and other officers of PTL. Time and time again, Bakker misled worshippers, investors, and his faithful followers by misusing contributions, overselling investments, evading taxes, and living an extravagant lifestyle.[18]

How could a minister perpetrate such a large and vicious fraud in the name of religion? Most people believe that Jim Bakker's ministry was initially sincere, inspired by a real desire to help others and to teach the word of God. He believed that what he was doing was for a good purpose and rationalized that any money he received would directly or indirectly help others. He even recognized at one time that money might be corrupting him and his empire. In 1985, he said, "I was going to say to listeners, 'Please stop giving.' But, I just couldn't say that."[19] What started out as a sincere ministry was corrupted by money. Jim Bakker stated on a television program, "I have never asked for a penny for myself. . . . God has always taken care of me." His rationalizations increased to the point that one trial attorney, in her closing argument, stated, "You can't lie to people to send you money—it's that simple. What unfolded before you over the past month was a tale of corruption—immense corruption. . . . What was revealed here was that Mr. Bakker was a world-class master of lies and half-truths."[20]

Jim Bakker rationalized his dishonest acts by convincing himself that the PTL network had a good purpose and that he was helping others. In a similar way, folklore has it that Robin Hood defended his dishonest acts by arguing that he "stole from the rich and gave to the poor."

Nearly every fraud involves rationalization. Most perpetrators are first-time offenders who would not commit other crimes. Rationalizing helps them hide from the dishonesty of their acts. Here are some common rationalizations used by fraudsters:

- The organization owes it to 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—my integrity or my reputation. (If I don't embezzle to cover my inability to pay, people will know I can't meet my obligations and that will be embarrassing because I'm a professional.)

Certainly, there are countless other rationalizations. These, however, are representative and serve as an adequate basis to discuss the role rationalization plays in fraud.

It is important to recognize that there are very few, if any, people who do not rationalize. We rationalize being overweight. We rationalize not exercising enough. We rationalize spending more than we should. Most of us rationalize being dishonest. Here are two examples:

> *A wife works hard, saves her money, and buys a new dress. When she puts it on for the first time, she asks her husband, "How do you like my new dress?" Realizing that the wife worked hard for the money and that she must really like the dress or she wouldn't have purchased it, the husband says, "Oh, it's beautiful," even though he really doesn't like it. Why did the husband lie? He probably rationalized in his mind that the consequence of telling the truth was more severe than the consequence of lying. "After all, if she likes it, I'd better like it, too," he reasons.*
>
> *Unfortunately, not wanting to hurt his wife's feelings resulted in lying, which is dishonest. In fact, the husband will pay for his dishonesty. His wife will continue to wear the dress because she believes her husband likes it. What the husband could have said is, "Honey, you are a beautiful woman and that is one reason I married you. I like most of the clothes you buy and wear, but this dress is not my favorite."*
>
> *You go to your mother-in-law's for dinner. For dessert, she bakes a cherry pie. Even though you don't like pie, you lie and say, "This pie is delicious." Why did you lie? Because you rationalized that you didn't want to hurt your mother-in-law's feelings and that, in fact, it would make her feel good if you complimented her cooking. As in the dress example, you will pay for your dishonesty because your mother-in-law, believing you like her cherry pie, will serve it again the next time you visit. Dishonesty could have been avoided by remaining silent or by saying, "Mom, you are an excellent cook, and I really like most of the food you cook. However, cherry pie is not my favorite."*

We rationalize dishonesty by our desire to make other people feel good. The same sort of rationalization often enables fraud to be perpetrated. Sometimes it's lying to oneself. Sometimes it's lying to others. For example, the following rationalization allows us to break the law: You get in your car and start down the freeway. You see a sign that says, "65 miles per hour." What do you do? Most likely you will go faster than 65, justifying your speeding by using one or more of the following rationalizations:

- Nobody drives 65. Everyone else speeds.
- My car was made to go faster.

- Sixty-five miles per hour is a stupid law. Going faster is still safe.
- I must keep up with the traffic or I'll cause an accident.
- It's all right to get one or two speeding tickets.
- I'm late.
- The speed limit is really 72 or 73.

Is it OK to break the law and speed just because "everyone else is doing it"? What if everyone else were committing fraud? If so, would that make it right for you to commit fraud?

Take income tax evasion. Many people underpay taxes with the following rationalizations:

- I pay more than my fair share of taxes.
- The rich don't pay enough taxes.
- The government wastes money.
- I "work" for my money.

To understand the extent of income tax fraud, consider that, in 1988, for the first time, the IRS required taxpayers who claimed dependents to list social security numbers for their dependents. In 1987, 77 million dependents were claimed on federal tax returns. In 1988, the number of dependents claimed dropped to 70 million. Fully one-tenth of the dependents claimed—7 million dependents—"disappeared." The IRS determined that in 1987 and probably in previous years, over 60,000 households had claimed four or more dependents who didn't exist, and several million had claimed one or more who didn't exist.[21]

Claiming dependents who don't exist is one of the easiest-to-catch income tax frauds. Yet, rationalizations were strong enough to drive millions of citizens to blatantly cheat on their tax returns.

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 their actions, they do not see themselves as criminals. Their victims, on the other hand, tend to take an entirely different view!

SUMMARY

In concluding this chapter, we examine a famous fraud case. Jerry Schneider, at age 21, was the model West Coast business executive, bright and well educated. Schneider differed from this image in only one respect—starting in 1971, he embezzled over $1 million from Pacific Telephone Company. Here is the story of his fraud.

> *Jerry Schneider's fraud had its genesis at a warm, open-air evening party where he and some friends had gathered for drinks, socializing, and small talk. Schneider was the young president of his own electronics corporation. This night, the talk was of organized crime and whether or not it could be profitable. "All these press stories of the big-time killings, and the crooks who build palaces down in Florida*

and out here on the coast, aagh. . . ," said a cynical male voice, "they're cooked up for the movies."

Schneider recognized the speaker as a young scriptwriter whose last outline—a crime story set among the Jewish mafia—had been turned down. "Not so," he said. "Some of them clean up. Some of them walk away clean, with a huge pot. You only hear of the ones that don't. The others become respectable millionaires."

A lawyer asked, "You believe in the perfect crime, do you?"

"Yes, if what you mean is the crime that doesn't get detected. But I'm sure there are crooks clever enough to figure ways to beat the system."

Long after everyone had left the party, Jerry Schneider was still thinking about whether or not there was a perfect crime. He had a great knowledge of computers and he thought maybe he could use his knowledge to perpetrate the perfect crime. Finally, about 2:00 A.M. he felt sick about the whole idea.

No one knows why Schneider later changed his mind. An investigator with the district attorney's office in Los Angeles believes it was because Jerry got possession of a stolen computer code book from Pacific Telephone Company. Schneider accessed the company's computer from the outside. Exactly how he did it was not fully revealed at his trial. He used a touch-tone telephone to place large orders with Pacific's supply division, inserting the orders into the company's computer. He then programmed Pacific Telephone's computers to pay for the merchandise. After he received the merchandise, he sold it on the open market.

Schneider was caught when an embittered employee noticed that much of the stuff Schneider was selling was Pacific's. The employee leaked to the police a hint about how Schneider had acquired the material. An investigation revealed that huge amounts of equipment were missing from Pacific's dispatch warehouse. Invoices showed that the equipment had been ordered and authorized for dispatch. The goods had then been packaged and put out on the loading bays ready for collection. Schneider had collected the goods himself, always early in the morning. To avoid the scrutiny of a gate guard and a tally clerk, who would have required bills of lading, Schneider left home at two and three in the morning night after night, in a pickup truck painted to look like a company transport.

Schneider merely drove in among the assorted wagons and freight piles. He had somehow acquired keys, and documents issued by the computer gave him access to the yard. The inexperienced night security guards not only let him through but even offered him cups of coffee and cigarettes as he and his men loaded the equipment.

Schneider started to have fears about what he was doing—the morality of it and the cheating it involved. He had intended the theft to be just a brilliant near-scientific feat. Jerry began to realize that the effort of the crime was greater than the reward. In Schneider's words, "It got so that I was afraid of my ex-employees, men I knew were aware of what I was up to because they'd seen the stuff come in, day after day, and go out again as our stuff. I began to feel hunted. Scared." The crime left him short of sleep, exhausted, and feeling guilty. In addition, the value of the stolen material passing into his possession was rising dramatically.[22]

Schneider robbed Pacific Telephone of nearly $1 million worth of equipment. His crime is interesting because his rationalization was "to see if the perfect crime could be committed." In fact, he probably couldn't have rationalized committing the crime for any other reason. When he was asked whether he considered himself an honest man, Schneider responded with a firm "yes." When he was asked whether, if he saw a wallet on the sidewalk, he would pocket it or try to return it to the owner, his answer was that he was like everyone else—he'd try to return it if it was at all possible. However, when he was asked whether, if he saw $10,000 lying in an open cash box in a supermarket and nobody was watching him, if he would take the money, he answered, "Sure, I would. If the company was careless enough to leave the money there, it deserved to have the money taken."[23]

Schneider's pressures were greed, retaliation (it was revealed at his trial that he hated Pacific Telephone Company), and a compulsion to prove his superiority. Schneider is a man with strong self-discipline. He is a strict vegetarian who does a lot of physical exercise. He works hard, and is brilliant and successful at whatever he undertakes. There is little doubt that he could be a valued and even trusted executive at most corporations. His tremendous knowledge of computers allowed him opportunities to get keys and passwords.

Schneider's "perfect crime" failed. It would have never happened, however, had he not acted on a personal challenge and rationalized that he was only playing a game—a game of intellectual chess with a faceless company. For several years after he was caught, Jerry Schneider worked as a security fraud consultant.

END NOTES

1. See, for example, W. S. Albrecht, D. Cherrington, R. Payne, A. Roe, and M. Romney, *How to Detect and Prevent Business Fraud,* Prentice-Hall, 1981.
2. See "Red-Flagging the White-Collar Criminal," *Management Accounting*, by Marshall B. Romney, W. Steve Albrecht, and David J. Cherrington, March 1980, pp. 51-57.
3. For example, several studies on retail theft over time by Richard C. Hollinger (University of Florida) and others have shown that a higher percentage of employees were dishonest in later years than in earlier years. Other studies have found similar results.
4. See *How to Detect and Prevent Business Fraud*, op. cit.
5. This was a proprietary study performed for one of the author's fraud clients.
6. *http://www.better-investing.org*
7. From speech by Lynn Turner, former chief accountant of U.S. Securities and Exchange Commission, given at the 39th Annual Corporate Counsel Institute, Northwestern University School of Law, October 12, 2000.
8. Richard C. Hollinger. 1989. *Dishonesty in the Workplace: A Manager's Guide to Preventing Employee Theft.* Park Ridge, Ill.: London House Press, pp. 1-5.
9. *http://www.biography.com/features/sweethearts/cframes.html*
10. Alison Stein Wellner, "Background Checks," *Business Week Online,* Aug. 14, 2000.
11. For example, see *2002 Report to the Nations: Occupational Fraud and Abuse,* Association of Certified Fraud Examiners, Austin, Texas, pp. 11.

12. "Doctor Listed as Suicide Was Target of Fraud Investigation," *Los Angeles Times,* Dec. 10, 1992, p. A3.
13. Kevin Kelly, "How Did Sears Blow the Gasket? Some Say the Retailer's Push for Profits Sparked Its Auto-Repair Woes," *Business Week,* June 29, 1992, p. 38; and Tung Yin, "Sears Is Accused of Billing Fraud at Auto Centers," *Wall Street Journal,* June 12, 1992, Western Ed., p. B1.
14. From the video, "Cooking the Books," Association of Certified Fraud Examiners, Austin, Texas.
15. From the personal notes of the author, who testified as an expert witness before a June 1990 grand jury, U.S. District Court for the Central District of California.
16. From the personal notes of the author, who testified as an expert witness before a June 1990 grand jury, U.S. District Court for the Central District of California.
17. *Anatomy of a Fraud: Inside the Finances of the PTL Ministries,* by G. Tidwell and J. McKee, John Wiley & Sons, March 1993.
18. Facts about the PTL case were taken from "PTL: Where Were the Auditors?" a working paper by Gary L. Tidwell, Associate Professor of Business Administration, School of Business and Economics, College of Charleston, Charleston, South Carolina.
19. Ibid.
20. Ibid.
21. *http://www.house.gov/ways_means/socsec/106Cong/5-11-00/5-llhost.htm*
22. From an unpublished interview with Jerry Schneider by Donn Parker of the Stanford Research Institute. Author Steve Albrecht was privileged to read Donn's files in his office. To read about the case, go to *http://www.arts/uwaterloo/ca/acct/ccag/chapter 2/chpt2sect1topic6.htm.*
23. Ibid.