

## Understanding Fraud: The Basics (Part 1 of 7)

Just as sure as the sun will rise, the day will also see another organization fall victim to embezzlement, another financial report falsely prepared *on purpose*, and yet another public official pocket some hush money. But, why...? The answer is quite simple. There are some fundamental or root causes for why fraud occurs frequently, and unfortunately, those causes are here to stay. As we begin this seven-part series on “Understanding Fraud”, I will provide some insight into why theft, deception and dishonesty *on the job* occur – and what you (yes, *you!*) can do to help minimize or detect it.



## What is it?

Before I dive in too deep, you must first understand that there are numerous types of abuses, scams and schemes. When I speak of fraud, the reference is specifically to abuses in the workplace, or *occupational fraud*. The Association of Certified Fraud Examiners (ACFE), a global fraud education and resource organization, defines occupational fraud as “the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets”.<sup>1</sup> Further, the American Institute of Certified Public Accountants (AICPA) -- the world’s largest advocacy organization for the accounting profession and standard-setter for auditing standards generally accepted in the United States -- defines fraud as “an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in financial statements...”<sup>2</sup>

To put it more simply, I like to think of fraud as knowingly taking things that do not belong to you, or lying about something with the intent to benefit yourself or to harm another person. That being said, let’s get laser-focused on the subject matter at hand.

I’m not talking about this type of fraud...

- Ø Uncle Charlie pretending he has a back injury to stay out of work (worker's compensation fraud)
- Ø Neighbor Nancy filing false tax returns with someone else's social security number (identity theft)
- Ø Your BFF<sup>3</sup> posing as a hot dude who wants to take you on a date (catfish scam)

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### References:

1. ACFE’s *Report to the Nations on Occupational Fraud and Abuse*, 2018 Global Fraud Study (“ACFE Report”)
2. AICPA U.S. Auditing Standards, Glossary of Terms
3. The “BFF” acronym is a commonly used expression, meaning best friends forever.
4. The Fraud Triangle is based on the research and theory of Dr. Donald R. Cressey (1919-1987), world-renowned sociologist and criminologist.
5. According to the *ACFE Report*, out of 2,690 occupational fraud cases investigated during the period January 2016 through October 2017, over \$7 billion in revenue was directly lost by corporations.

I *am* talking about this type of fraud...

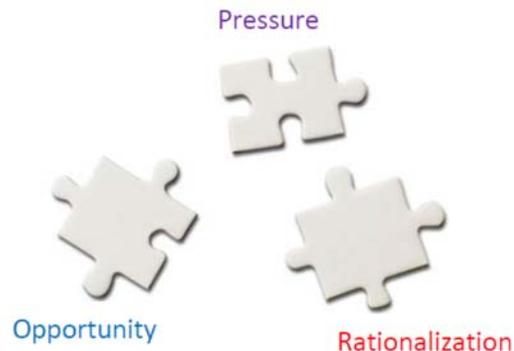
- ✓ Sister Susie pilfering the church's offerings to live lavishly (misappropriation)
- ✓ Eddie Executive inflating company earnings to obtain a bank loan (financial reporting)
- ✓ Manny Mayor taking bribes to ensure a company wins contracts with the city (corruption)

In this series, I will shed light on the main reasons fraud is perpetrated, discuss fraud prevention and detection techniques, and provide insight on steps to take if you stumble upon suspicious activity.

## **The Fraud Triangle**

If you have ever participated in any class or taken a course on fraud, waste and abuse, it is likely that you were introduced to the concept of the Fraud Triangle<sup>4</sup>. The ACFE has used this idea as the backbone of the fraud fighting industry for over two decades. It asserts that there are three main causes for fraud:

- 1) Pressure or Incentive
- 2) Opportunity
- 3) Rationalization



These concepts are introduced in this article, and will be explored in-depth in the next three editions of this series.

### *Pressure/Incentive*

A serious injury, new baby, cancer diagnosis, drug addiction, gambling problem, lost job, or new executive position...when any one or combination of events like these suddenly surfaces into a person's life, a perceived pressure arises, usually financial in nature. The unexpected change in circumstances and resulting anxiety will eventually lead to the affected individual seeking compensating resources elsewhere, either honestly or dishonestly. Thus, fraud is ripe to occur when an individual caves to the financial or performance pressure that is looming. His or her incentive to commit a crime becomes linked to the need or desire to finance a problem or lifestyle change, or to abide by an organization's haughty fiscal standards.

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### *Opportunity*

An organization's nonexistent or ineffective internal controls can manifest through lackadaisical management review procedures, employees with unmonitored access to sensitive information or assets, limited staffing resources, and many other ways. The opportunity for fraud to occur exists when these conditions are present, and particularly when there is a change in how existing processes and procedures are executed, or by whom. Pocketing cash collections, forging company checks, or "cooking the books" is more likely to occur when an employee is under pressure, in the right position, *and* cognizant of a loophole. However, one should be mindful that fraud can also occur in an environment where good controls exist. That is to say, fraud can be mitigated, but not eliminated...

### *Rationalization*

Integrated with a deceiver's motive for committing fraud is his (or her) rationalization for why the act is necessary or justified. He may be dwelling on being over-worked and under-paid, may feel a need to get even with an unfair boss, or may genuinely believe his family is entitled to a better life. Although these conditions may have existed before, the culmination of new life events helps in pushing the perpetrator over the proverbial ledge of the law. Because, you see, he had *no other choice*...that's what he believes. This validation makes the criminal act morally acceptable in said perpetrator's mind.

Just like oxygen, heat, and fuel are the components needed to ignite a fire; all three elements of the fraud triangle are essential to incite fraud. Your accounts payable supervisor, who has recently developed an affinity for trips to Las Vegas, is less likely to engage in a check-writing scheme to replenish his life's savings lost during a compulsive betting binge, if he knows that his manager scrutinizes *every...single...vendor* payment prior to disbursement. In this example, pressure and rationalization are present, but opportunity is narrow. Thus, a fraudulent act is prone to be averted...i.e. *no fire!*



Nonetheless, on any given day, I can find a published story about a scam that did succeed...by someone, at some organization, in some location around the globe. If our beloved Benjamin Franklin were alive today, I believe he would update his famous phrase to say...the only things certain in life are death, taxes, *and fraud!* If gambling suited my fancy, I would wager the next Powerball jackpot that fraud was occurring as I typed this article. It is occurring right now as you are reading it. It will continue to occur long after you and I wither into eternity, because the recipe for fraud...a pinch of *pressure*, an ounce of *opportunity*, and a ration of *rationalization*...is a timeless classic.

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but not eliminated...”*

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## So, What Now...?

Now that I have put the fear of fraud in your head, you can relax...*a little*. Yes, fraud is a daily occurrence, but that doesn't mean *your* organization is riddled with it, or that it is happening every single day in your shop.<sup>5</sup> It does, however, behoove you and your governing board, your leadership team, your co-workers, employees, contractors and suppliers to be in tune with the risks, circumstances, internal changes, and external factors that trigger felonious infractions. Be at the ready with a game plan when you see the red flags and indicators of something awry. The more you know, the stronger you are able to stand as the victor, and not the victim, in the fight against fraud.



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