SECTION II

CRIMINOLOGY, ETHICS, AND THE LEGAL REGULATORY AND PROFESSIONAL ENVIRONMENTS
CHAPTER 3
WHO COMMITS FRAUD AND WHY:
CRIMINOLOGY AND ETHICS

LEARNING OBJECTIVES
After reading this chapter, you should be able to:
3-1 Describe occupational fraud and abuse.
3-2 Compare and contrast theories of crime causation.
3-3 Identify the six situational categories that cause nonshareable problems from Cressey’s research.
3-4 Discuss the essence of organizational crime.
3-5 Give examples of behavioral or other environmental indications of fraud.
3-6 Explain the relationship between an employee’s position and the level of theft (according to Hollinger and Clark’s research).
3-7 Analyze the role of corporate governance mechanisms in fraud prevention.
3-8 Describe corporate governance breakdowns in the facilitation of historical fraudulent acts.
3-9 Identify ethical issues, conflicts of interest, and noncompliance with corporate policies and procedures in the context of a specific case.
3-10 Discuss alternative courses of action in a given scenario within the framework of appropriate ethical conduct.

CRITICAL THINKING EXERCISE

The Killer Apartment
Colin McFee had a Manhattan apartment to die for, an enormously spacious duplex that looked down on Park Avenue from the 18th and 19th floors. He also had a fortune worth killing for. So it wasn’t too surprising when the old man was found to be a victim of foul play. The day of the murder began innocently enough. McFee’s two nephews and his niece were all visiting him from Duluth, and the old millionaire had been so captivated by the charming trio that he impulsively decided to change his will.

The generous millionaire spent the morning signing the new document, which left his entire estate divided equally among the three vacationing relatives. McFee’s faithful maid witnessed the document, ushered the lawyer out, and, with an uneasy glance at the shiny-eyed heirs, retreated to her room.

Nothing happened until shortly after noon. The maid was in her upper floor bedroom watching TV when she heard McFee’s unmistakable voice screaming out in pain. For a few seconds, she was in shock, wondering what her employer’s voice was doing on an old Columbo episode. And then she realized it wasn’t the TV.

The maid went out into the hall and found Nick, the older nephew, standing at the top of a rarely used back staircase. “It came from downstairs,” Nick stammered.

Pushing past Nick, the maid led the way down the narrow stairs. “Mr. McFee!” she shouted, and a moment later caught a spider web across the face. The back staircase went directly down to the east library. The dim, wood-paneled room was empty, except for the corpse on the floor by the bookshelves. Colin McFee, it seemed, had been hacked to death, although there was no weapon in sight.
The three McFee heirs sat with the maid in the center of the lower level, by the main staircase, awaiting the police and rehearsing their stories. “I was in my second floor bedroom,” Nick said, “watching an old murder mystery show. When Uncle Colin screamed, I didn’t do anything for a minute. Then I went out into the hall. That’s where I met up with you.” Nick smiled at the maid, his alibi.

“I was upstairs in the west dining room,” Nora volunteered, “examining the old dumbwaiter. Even though the scream came from downstairs and on the far side of the apartment, I still heard it. I thought it must be robbers, so, I barricaded the dining room door and didn’t come out until I heard you all calling my name.”

Astor McFee, the younger nephew, claimed to have been asleep. “I was reading a magazine right here in this chair and I nodded off. The scream woke me. It took a few seconds to realize that something was wrong. When I heard people talking in the library, I went off in that direction. That’s when I ran into you,” he said, nodding toward Nick and the maid.

When the police arrived, they took everyone’s statement, and then went to the main floor kitchen in search of the murder weapon. They found it in a utensil drawer, a huge butcher knife that had been wiped clean of blood, the same blood type as the victim’s. “This tells us everything we need to know,” the homicide chief said with a grin.

Who killed Colin McFee?

This critical thinking exercise emphasizes the importance of drawing a picture. Without visually representing the crime scene, very different conclusions are reached about who committed this crime. Upon drawing out the crime scene, however, and placing the suspects in their various locales, it becomes clear who killed Colin McFee, or at least who was involved.

CRIMINOLOGY

Bethany holds the position of office manager at a small commercial real estate company. Jackson Stetson, the owner, conducts numerous entertainment events each month to interact with and locate new clientele. In addition, Mr. Stetson prides himself on his support of charitable organizations. In his capacity as a leader, organizer, and board member of several high-profile charities, Jackson has additional charity events each month. In her position, Bethany is a trusted assistant to Mr. Stetson, runs many aspects of the company, and organizes and hosts many of the social events for Mr. Stetson. Bethany has been with the company for many years, and has a company credit card to pay for social events and incidentals associated with the events. The company pays the monthly credit card balance, although Bethany is supposed to save receipts and match those receipts to her company credit cards before seeking Mr. Stetson’s approval for company payment.

Initially, Bethany lost a few receipts, and Mr. Stetson waived the requirement that she provide all receipts. As the business grew, Bethany’s schedule became even crazier, and she had less time for administrative bureaucracy. Mr. Stetson was so happy with her work on his beloved social events that he was willing to overlook her lack of attention to administrative details. The problem was that, over time, Bethany started charging personal expenses on the company-paid credit card. Not only was the company paying Bethany a salary, they paid her grocery bills and household expenses to retailers where she would shop for social event incidentals. Over a twenty-four month-period, Bethany was able to double her $40,000 take-home pay, and the additional income was tax-free!

Criminology is the sociological study of crime and criminals. Understanding the nature, dynamics, and scope of fraud and financial crimes is an important aspect of an entry-level professional’s knowledge base. As noted in Chapter 1, fraudsters often look exactly like us, and most are first-time offenders. As such, to understand the causes of white-collar crime our research needs to focus on perpetrators of fraud, not street crime.²

Before talking about crime, it is prudent to consider why the vast majority of people do not commit crime. A number of theories have been put forth but essentially, people obey laws for the following reasons:

1. fear of punishment
2. desire for rewards
3. to act in a just and moral manner according to society’s standards.
Most civilized societies are dependent upon people doing the right thing. Despite rewards, punishment, and deterrence, the resources required to fully enforce all the laws would be astronomical. Even deterrence is costly to implement and does not guarantee an adequate level of compliance. The bottom line is that a person’s normative values of right and wrong dictate their behavior and determine compliance or noncompliance with the law.3

**Occupational Fraud and Abuse**

*Occupational fraud and abuse* is defined as “the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.”4 By the breadth of this definition, occupational fraud and abuse involves a wide variety of conduct by executives, employees, managers, and principals of organizations, ranging from sophisticated investment swindles to petty theft. Common violations include asset misappropriation, fraudulent statements, corruption, pilferage, petty theft, false overtime, using company property for personal benefit, fictitious payroll, and sick time abuses.

Four common elements to these schemes were first identified by the Association of Certified Fraud Examiners in its 1996 *Report to the Nation on Occupational Fraud and Abuse* (Section 3, p. 3), which stated: “The key is that the activity (1) is clandestine, (2) violates the employee’s fiduciary duties to the organization, (3) is committed for the purpose of direct or indirect financial benefit to the employee, and (4) costs the employing organization assets, revenues, or reserves.”

*Employee* in the context of this definition is any person who receives regular and periodic compensation from an organization for his or her labor. The employee moniker is not restricted to the rank and file, but specifically includes corporate executives, company presidents, top and middle managers, and other workers.

**White-Collar Crime**

The term *white-collar crime* was a designation coined by Edwin H. Sutherland in 1939, when he provided the following definition: crime in the upper, white-collar class, which is composed of respectable, or at least respected, business and professional men. White-collar crime is often used interchangeably with occupational fraud and economic crime. While white-collar crime is consistent with the notion of trust violator and is typically associated with an abuse of power, one difficulty with relying on white-collar crime as a moniker for financial and economic crimes is that many criminal acts such as murder, drug trafficking, burglary, and theft are motivated by money. Furthermore, the definition, though broad, leaves out the possibility of the perpetrator being an organization where the victim is often the government and society (e.g., tax evasion and fixed contract bidding). Nevertheless, the term *white-collar crime* captures the essence of the type of perpetrator that one finds at the heart of occupational fraud and abuse.

**Organizational Crime**

*Organizational crimes* occur when entities, companies, corporations, not-for-profits, nonprofits, and government bodies, otherwise legitimate and law-abiding organizations, are involved in a criminal offense. In addition, individual organizations can be trust violators when the illegal activities of the organization are reviewed and approved by persons with high standing in an organization such as board members, executives, and managers. Federal law allows organizations to be prosecuted in a manner similar to individuals.5 For example, although the Arthur Andersen conviction was later overturned by the U.S. Supreme Court, the organization was convicted of obstruction of justice, a felony offense that prevented them from auditing public companies. Corporate violations may include administrative breaches, such as noncompliance with agency, regulatory, and court requirements; environmental infringements; fraud and financial crimes, such as bribery and illegal kickbacks; labor abuses; manufacturing infractions related to public safety and health; and unfair trade practices.

Organizational crime is more of a problem internationally and often consists of unfair pricing, unfair business practices, and tax evasion. Organizations are governed by a complex set of interactions among boards of directors, audit committees, executives, and managers. In addition, the actions of external stakeholders such as auditors and regulators also impact the governance of organizations. As such, it is often difficult to distinguish between those individuals with responsibility for compliance with particular laws and regulations, and those infractions committed by the organization. In addition, when considerable financial harm has been inflicted on society as a result of corporate wrongdoing, the organization is often an attractive target because of its deep pockets with which to pay fines and restitution.
It is more common for corporations to become embroiled in legal battles that wind up in civil court. Such litigation runs the gamut of forensic litigation advisory services, including damage claims made by plaintiffs and defendants; workplace issues such as lost wages, disability, and wrongful death; assets and business valuations; costs and lost profits associated with construction delays or business interruptions; insurance claims; fraud; anti-trust actions, intellectual property infringement; environmental issues; tax claims; or other disputes. If you open any 10-K or annual report, you will likely find mention of a pending lawsuit in the notes to the financial statements. Furthermore, these filings include only those lawsuits deemed to be “material” as defined by accounting standards. Most corporations are involved in numerous lawsuits considered to be below the auditor’s materiality threshold.

Organized Crime

These crimes are often complex, involving many individuals, organizations, and shell companies, and often cross jurisdictional borders. In this context, fraud examiners and financial forensic professionals often think of terrorist financing, the mob, and drug trafficking. Some of the crimes typically associated with organized crime include money laundering, mail and wire fraud, conspiracy, and racketeering. Money laundering addresses the means by which organized criminals take money from illegal sources and process it so that it looks like it came from legitimate business sources. Conspiracy is a means of prosecuting the individuals involved in the illegal organized activity. RICO (Racketeering Influence and Corrupt Organizations Act) addresses organizations involved in criminal activity. For example, portions of the RICO Act:

- outlaw investing illegal funds in another business
- outlaw acquisition of a business through illegal acts
- outlaw the conduct of business affairs with funds derived from illegal acts.

Torts, Breach of Duty, and Civil Litigation

Black’s Law Dictionary defines “tort” as “a private or civil wrong or injury, other than breach of contract, for which the law will provide a remedy in the form of an action for damages.” When a tort is committed, the party who was injured is entitled to collect compensation for damages from the wrongdoer for that private wrong. The tort of contract interference or tortuous interference with contracts occurs when parties are not allowed the freedom to contract without interference from third parties. While the elements of tortuous interference are complex, a basic definition is that the law affords a remedy when someone intentionally persuades another to break a contract already in existence with a third party.

Another tort—negligence—applies when the conduct of one party did not live up to minimal standards of care. Each person has a duty to act in a reasonable and prudent manner. When individuals or entities fail to live up to this standard, they are considered “negligent.” The legal standard for negligence has five elements:

a. Duty—a duty to act exists between the parties
b. Breach—a determination that the defendant failed to use ordinary or reasonable care in the exercise of that duty
c. Cause In Fact—an actual connection between the defendant’s breach of duty and the plaintiff’s harm can be established
d. Proximate Cause—the defendant must have been the proximate cause or contributed to the injury to the plaintiff
e. Damages—the plaintiff must establish that damages resulted from the defendant’s breach of duty.

In order to win an award for damages, the injured party must generally prove two points:

1. liability—that the other party was liable for all or part of the damages claimed, and
2. damages—that the injured party suffered damages as the results of the actions or lack of actions of the offending party.

Furthermore, the amount of damages must be proven with a reasonable degree of certainty as to the amount claimed, and that the defendant could reasonably foresee the likelihood of damages if they failed to meet their obligations. Thus, generally speaking, the threshold for suing another person in civil court for a tort, breach of contract, or negligence is fairly low. While judges have the ability to issue summary
judgments and dismiss frivolous lawsuits, most judges are more apt to let the parties negotiate a settlement or let the jury decide the case based on the merits of the arguments put forth by the plaintiff and defense.

RESEARCH IN OCCUPATIONAL FRAUD AND ABUSE

Edwin H. Sutherland

Considering its enormous impact, relatively little research has been done on the subject of occupational fraud and abuse. Much of the current literature is based upon the early works of Edwin H. Sutherland (1883–1950), a criminologist at Indiana University. Sutherland was particularly interested in fraud committed by the elite upper-world business executive, either against shareholders or the public. As Gilbert Geis noted, Sutherland said, “General Motors does not have an inferiority complex, United States Steel does not suffer from an unresolved Oedipus problem, and the DuPonts do not desire to return to the womb. The assumption that an offender may have such pathological distortion of the intellect or the emotions seems to me absurd, and if it is absurd regarding the crimes of businessmen, it is equally absurd regarding the crimes of persons in the economic lower classes.”

For the uninitiated, Sutherland is to the world of white-collar criminality what Freud is to psychology. Indeed, it was Sutherland who coined the term white-collar crime in 1939. He intended the definition to mean criminal acts of corporations and individuals acting in their corporate capacity. Since that time, however, the term has come to mean almost any financial or economic crime, from the mailroom to the boardroom.

Many criminologists believe that Sutherland’s most important contribution to criminal literature was elsewhere. Later in his career, he developed the theory of differential association, which is now the most widely accepted theory of criminal behavior in the 20th century. Until Sutherland’s landmark work in the 1930s, most criminologists and sociologists held the view that crime was genetically based, that criminals beget criminal offspring.

While this argument may seem naive today, it was based largely on the observation of non–white-collar offenders—the murderers, rapists, sadists, and hooligans who plagued society. Numerous subsequent studies have indeed established a genetic base for “street” crime, which must be tempered by environmental considerations. (For a thorough explanation of the genetic base for criminality, see Crime and Punishment by Wilson and Herrnstein.) Sutherland was able to explain crime’s environmental considerations through the theory of differential association. The theory’s basic tenet is that crime is learned, much like we learn math, English, or guitar playing.

Sutherland believed this learning of criminal behavior occurred with other persons in a process of communication. Therefore, he reasoned, criminality cannot occur without the assistance of other people. Sutherland further theorized that the learning of criminal activity usually occurred within intimate personal groups. This explains, in his view, how a dysfunctional parent is more likely to produce dysfunctional offspring. Sutherland believed that the learning process involved two specific areas: the techniques to commit the crime; and the attitudes, drives, rationalizations, and motives of the criminal mind. You can see how Sutherland’s differential association theory fits with occupational offenders. Organizations that have dishonest employees will eventually infect a portion of honest ones. It also goes the other way: honest employees will eventually have an influence on some of those who are dishonest.

Donald R. Cressey

One of Sutherland’s brightest students at Indiana University during the 1940s was Donald R. Cressey (1919–1987). Although much of Sutherland’s research concentrated on upper-world criminality, Cressey took his own studies in a different direction. Working on his Ph.D. in criminology, he decided his dissertation would concentrate on embezzlers. To serve as a basis for his research, Cressey interviewed about 200 incarcerated inmates at prisons in the Midwest.

Cressey’s Hypothesis Embezzlers, whom he called “trust violators,” intrigued Cressy. He was especially interested in the circumstances that led them to be overcome by temptation. For that reason, he excluded from his research those employees who took their jobs for the purpose of stealing—a relatively minor number of offenders at that time. Upon completion of his interviews, he developed what still remains as the classic model for the occupational offender. His research was published in Other People’s Money: A Study in the Social Psychology of Embezzlement.
Cressey’s final hypothesis read as follows:

Trusted persons become trust violators when they conceive of themselves as having a financial problem that is nonshareable, are aware this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property.11

Over the years, the hypothesis became known as the fraud triangle (Figure 3-1). One leg of the triangle represents a perceived pressure (or nonshareable financial need). The second leg represents perceived opportunity, and the final leg denotes rationalization.

Nonshareable Financial Pressures The role of perceived nonshareable financial pressures is important. Cressey said, when the trust violators were asked to explain why they refrained from violation of other positions of trust they might have held at previous times, or why they had not violated the subject position at an earlier time, those who had an opinion expressed the equivalent of one or more of the following quotations: (a) “There was no need for it like there was this time.” (b) “The idea never entered my head.” (c) “I thought it was dishonest then, but this time it did not seem dishonest at first.”12 “In all cases of trust violation encountered, the violator considered that a financial problem which confronted him could not be shared with persons who, from a more objective point of view, probably could have aided in the solution of the problem.”13

What is considered nonshareable is, of course, wholly in the eyes of the potential occupational offender, as Cressey noted:

Thus a man could lose considerable money at the racetrack daily, but the loss, even if it construed a problem for the individual, might not constitute a nonshareable problem for him. Another man might define the problem as one that must be kept secret and private. Similarly, a failing bank or business might be considered by one person as presenting problems which must be shared with business associates and members of the community, while another person might conceive these problems as nonshareable.14

In addition to being nonshareable, the problem that drives the fraudster is described as “financial” because these are the types of problems that can generally be solved by the theft of cash or other assets. A person with large gambling debts, for instance, would need cash to pay those debts. Cressey noted, however, that there are some nonfinancial problems that could be solved by misappropriating funds through a violation of trust. For example, a person who embezzles in order to get revenge on her employer for perceived “unfair” treatment uses financial means to solve what is essentially a nonfinancial problem.15

Through his research, Cressey also found that the nonshareable problems encountered by the people he interviewed arose from situations that could be divided into six basic categories:

- violation of ascribed obligations
- problems resulting from personal failure
- business reversals
- physical isolation
- status gaining
- employer-employee relations
All of these situations dealt in some way with status-seeking or status-maintaining activities by the subjects. In other words, the nonshareable problems threatened the status of the subjects, or threatened to prevent them from achieving a higher status than the one they occupied at the time of their violation.

Violations of Ascribed Obligations Violation of ascribed obligations has historically proved to be a strong motivator of financial crimes. Cressy explains in this way:

Financial problems incurred through nonfinancial violations of positions of trust often are considered as nonshareable by trusted persons since they represent a threat to the status which holding the position entails. Most individuals in positions of financial trust, and most employers of such individuals, consider that incumbency in such a position necessarily implies that, in addition to being honest, they should behave in certain ways and should refrain from participation in some other kinds of behavior.

In other words, the mere fact that a person has a trusted position carries with it the implied duty to act in a manner becoming his status. Persons in trusted positions may feel they are expected to avoid conduct such as gambling, drinking, drug use, or other activities that are considered seamy and undignified. When these persons then fall into debt or incur large financial obligations as a result of conduct that is “beneath” them, they feel unable to share the problem with their peers because this would require admitting that they have engaged in the dishonorable conduct that lies at the heart of their financial difficulties. Basically, by admitting that they had lost money through some disreputable act, they would be admitting—at least in their own minds—that they are unworthy to hold their trusted positions.

Problems Resulting from Personal Failure Problems resulting from personal failures, Cressey writes, are those that the trusted person feels he caused through bad judgment and therefore feels personally responsible for. Cressey cites one case in which an attorney lost his life’s savings in a secret business venture. The business had been set up to compete with some of the attorney’s clients, and though he thought his clients probably would have offered him help if they had known what dire straits he was in, he could not bring himself to tell them that he had secretly tried to compete with them. He also was unable to tell his wife that he’d squandered their savings. Instead, he sought to alleviate the problem by embezzling funds to cover his losses.

While some pressing financial problems may be considered as having resulted from “economic conditions,” “fate,” or some other impersonal force, others are considered to have been created by the misguided or poorly planned activities of the individual trusted person. Because he fears a loss of status, the individual is afraid to admit to anyone who could alleviate the situation the fact that he has a problem which is a consequence of his “own bad judgment” or “own fault” or “own stupidity.” In short, pride goeth before the fall.

Business Reversals Business reversals were the third type of situation Cressey identified as leading to the perception of nonshareable financial problems. This category differs from the class of “personal failures” described above because here the trust violators tend to see their problems as arising from conditions beyond their control: inflation, high interest rates, economic downturns, etc. In other words, these problems are not caused by the subject’s own failings, but instead by outside forces.

Cressey quoted the remarks of one businessman who borrowed money from a bank using fictitious collateral:

Case 36. There are very few people who are able to walk away from a failing business. When the bridge is falling, almost everyone will run for a piece of timber. In business there is this eternal optimism that things will get better tomorrow. We get to working on the business, keeping it going, and we get almost mesmerized by it… Most of us don’t know when to quit, when to say, ‘This one has me licked. Here’s one for the opposition.’

It is interesting to note that even in situations where the problem is perceived to be out of the trusted person’s control, the issue of status still plays a big role in that person’s decision to keep the problem a secret. The subject of Case 36 continued, “If I’d have walked away and let them all say, ‘Well, he wasn’t a success as a manager, he was a failure,’ and took a job as a bookkeeper, or gone on the farm, I would have been all right. But I didn’t want to do that.” The desire to maintain the appearance of success was a common theme in the cases involving business reversals.
Physical Isolation The fourth category Cressey identified consisted of problems resulting from physical isolation. In these situations, the trusted person simply has no one to turn to. It’s not that he is afraid to share his problem; it’s that he has no one to share the problem with. He is in a situation where he does not have access to trusted friends or associates who would otherwise be able to help him. Cressey cited the subject of Case 106 in his study, a man who found himself in financial trouble after his wife had died. In her absence, he had no one to go to for help and he wound up trying to solve his problem through an embezzlement scheme.\textsuperscript{23}

Status Gaining The fifth category involves problems relating to status gaining, which is a sort of extreme example of “keeping up with the Joneses” syndrome. In the categories that have been discussed previously, the offenders were generally concerned with maintaining their status (i.e., not admitting to failure, keeping up appearance of trustworthiness), but here the offenders are motivated by a desire to improve their status. The motive for this type of conduct is often referred to as “living beyond one’s means” or “lavish spending,” but Cressey felt that these explanations did not get to the heart of the matter. The question was, what made the desire to improve one’s status nonshareable? He noted,

\textit{The structuring of status ambitions as being nonshareable is not uncommon in our culture, and it again must be emphasized that the structuring of a situation as nonshareable is not alone the cause of trust violation. More specifically, in this type of case a problem appears when the individual realizes that he does not have the financial means necessary for continued association with persons on a desired status level, and this problem becomes nonshareable when he feels that he can neither renounce his aspirations for membership in the desired group nor obtain prestige symbols necessary to such membership.}\textsuperscript{24}

In other words, it is not the desire for a better lifestyle that creates the nonshareable problem (we all want a better lifestyle), rather it is the inability to obtain the finer things through legitimate means, and at the same time, an unwillingness to settle for a lower status that creates the motivation for trust violation.

Employer-Employee Relations Finally, Cressey described problems resulting from employer-employee relationships. The most common, he stated, was an employed person who resents his status within the organization in which he is trusted and at the same time feels he has no choice but to continue working for the organization. The resentment can come from perceived economic inequities, such as pay, or from the feeling of being overworked or underappreciated. Cressey said this problem becomes nonshareable when the individual believes that making suggestions to alleviate his perceived maltreatment will possibly threaten his status in the organization.\textsuperscript{25} There is also a strong motivator for the perceived employee to want to “get even” when he feels ill-treated.

The Importance of Solving the Problem in Secret Given that Cressey’s study was done in the early 1950s, the workforce was obviously different from today. But the employee faced with an immediate, nonshareable financial need hasn’t changed much over the years. That employee is still placed in the position of having to find a way to relieve the pressure that bears down upon him. Simply stealing money, however, is not enough; Cressey found it was crucial that the employee be able to resolve the financial problem in secret. As we have seen, the nonshareable financial problems identified by Cressey all dealt in some way with questions of status; the trust violators were afraid of losing the approval of those around them and so were unable to tell others about the financial problems they encountered. If they could not share the fact that they were under financial pressure, it follows that they would not be able to share the fact that they were resorting to illegal means to relieve that pressure. To do so would be to admit the problems existed in the first place.

The interesting thing to note is that it is not the embezzlement itself that creates the need for secrecy in the perpetrator’s mind; it is the circumstances that led to the embezzlement (e.g., a violation of ascribed obligation, a business reversal, etc.). Cressey pointed out,

\textit{In all cases [in the study] there was a distinct feeling that, because of activity prior to the defalcation, the approval of groups important to the trusted person had been lost, or a distinct feeling that present group approval would be lost if certain activity were revealed [the nonshareable financial problem], with the result that the trusted person was effectively isolated from persons who could assist him in solving problems arising from that activity}\textsuperscript{26} (emphasis added).

Perceived Opportunity According to the fraud triangle model, the presence of a nonshareable financial problem by itself will not lead an employee to commit fraud. The key to understanding Cressey’s theory
is to remember that all three elements must be present for a trust violation to occur. The nonshareable financial problem creates the motive for the crime to be committed, but the employee must also perceive that he has an opportunity to commit the crime without being caught. This perceivably constitutes the second element.

In Cressey’s view, there were two components of the perceived opportunity to commit a trust violation: general information and technical skill. General information is simply the knowledge that the employee’s position of trust could be violated. This knowledge might come from hearing of other embezzlements, from seeing dishonest behavior by other employees, or just from generally being aware of the fact that the employee is in a position where he could take advantage of his employer’s faith in him. Technical skill refers to the abilities needed to commit the violation. These are usually the same abilities that the employee needs to have to obtain and keep his position in the first place. Cressey noted that most embezzlers adhere to their occupational routines (and their job skills) in order to perpetrate their crimes.27

In essence, the perpetrator’s job will tend to define the type of fraud he will commit. “Accountants use checks which they have been entrusted to dispose of, sales clerks withhold receipts, bankers manipulate seldom-used accounts or withhold deposits, real estate men use deposits entrusted to them, and so on.”28

Obviously, the general information and technical skill that Cressey identified are not unique to occupational offenders; most, if not all, employees have these same characteristics. But because trusted persons possess this information and skill, when they face a nonshareable financial problem they see it as something that they have the power to correct. They apply their understanding of the possibility for trust violation to the specific crises they are faced with. Cressey observed, “It is the next step which is significant to violation: the application of the general information to the specific situation, and conjointly, the perception of the fact that in addition to having general possibilities for violation, a specific position of trust can be used for the specific purpose of solving a nonshareable problem.”29

Rationalizations The third and final factor in the fraud triangle is the rationalization. Cressey pointed out that the rationalization is not an ex post facto means of justifying a theft that has already occurred. Significantly, the rationalization is a necessary component of the crime before it takes place; in fact, it is a part of the motivation for the crime. Because the embezzler does not view himself as a criminal, he must justify his misdeeds before he ever commits them. The rationalization is necessary so that the perpetrator can make his illegal behavior intelligible to him and maintain his concept of himself as a trusted person.30

After the criminal act has taken place, the rationalization will often be abandoned. This reflects the nature of us all: the first time we do something contrary to our morals, it bothers us. As we repeat the act, it becomes easier. One hallmark of occupational fraud and abuse offenders is that once the line is crossed, the illegal acts become more or less continuous. So an occupational fraudster might begin stealing with the thought that “I’ll pay the money back,” but after the initial theft is successful, she will usually continue to steal past the point where there is any realistic possibility of repaying the stolen funds.

Cressey found that the embezzlers he studied generally rationalized their crimes by viewing them: (1) as essentially noncriminal, (2) as justified, or (3) as part of a general irresponsibility for which they were not completely accountable.31 He also found that the rationalizations used by trust violators tended to be linked to their positions and to the manner in which they committed their violations. He examined this by dividing the subjects of his study into three categories: independent businessmen, long-term violators, and absconders. He discovered that each group had its own types of rationalizations.

Independent Businessmen The independent businessmen in Cressey’s study were persons who were in business for themselves and who converted deposits that had been entrusted to them.32 Perpetrators in this category tended to use one of two common excuses: (1) they were “borrowing” the money they converted, or (2) the funds entrusted to them were really theirs—you can’t steal from yourself. Cressey found the “borrowing” rationalization was the most frequently used. These perpetrators also tended to espouse the idea that “everyone” in business misdirects deposits in some way, which therefore made their own misconduct less wrong than stealing.33 Also, the independent businessmen almost universally felt their illegal actions were predicated by an “unusual situation,” which Cressey perceived to be in reality a nonshareable financial problem.

Long-Term Violators Cressey defined long-term violators as individuals who converted their employer’s funds, or funds belonging to their employer’s clients, by taking relatively small amounts over a period of time.34 Similar to independent businessmen, the long-term violators also generally preferred the “borrowing” rationalization. Other rationalizations of long-term violators were noted, too, but they
almost always were used in connection with the “borrowing” theme: (1) they were embezzling to keep their families from shame, disgrace, or poverty; (2) theirs was a case of “necessity;” their employers were cheating them financially; or (3) their employers were dishonest towards others and deserved to be fleeced. Some even pointed out that it was more difficult to return the funds than to steal them in the first place, and claimed they did not pay back their “borrowings” because they feared that would lead to detection of their thefts. A few in the study actually kept track of their thefts but most only did so at first. Later, as the embezzlements escalated, it is assumed that the offender would rather not know the extent of his “borrowings.”

All of the long-term violators in the study expressed a feeling that they would like to eventually “clean the slate” and repay their debt. This feeling usually arose even before the perpetrators perceived that they might be caught. Cressey pointed out that at this point, whatever fear the perpetrators felt in relation to their crimes was related to losing their social position by the exposure of their nonshareable problem, not the exposure of the theft itself or the possibility of punishment or imprisonment. This is because their rationalizations still prevented them from perceiving their misconduct as criminal. “The trust violator cannot fear the treatment usually accorded criminals until he comes to look upon himself as a criminal.”

Eventually, most of the long-term violators finally realized they were “in too deep.” It is at this point that the embezzler faces a crisis. While maintaining the borrowing rationalization (or other rationalizations, for that matter), the trust violator is able to maintain his self-image as a law-abiding citizen; but when the level of theft escalates to a certain point, the perpetrator is confronted with the idea that he is behaving in a criminal manner. This is contrary to his personal values and the values of the social groups to which he belongs. This conflict creates a great deal of anxiety for the perpetrator. A number of offenders described themselves as extremely nervous and upset, tense, and unhappy.

Without the rationalization that they are borrowing, long-term offenders in the study found it difficult to reconcile converting money, while at the same time seeing themselves as honest and trustworthy. In this situation, they have two options: (1) they can readopt the attitudes of the (law-abiding) social group that they identified with before the thefts began; or (2) they can adopt the attitudes of the new category of persons (criminals) with whom they now identify. From his study, Cressey was able to cite examples of each type of behavior. Those who sought to readopt the attitudes of their law-abiding social groups “may report their behavior to the police or to their employer, quit taking funds or resolve to quit taking funds, speculate or gamble wildly in order to regain the amounts taken, or ‘leave the field’ by absconding or committing suicide.” On the other hand, those who adopt the attitudes of the group of criminals to which they now belong “may become reckless in their defalcations, taking larger amounts than formerly with fewer attempts to avoid detection and with no notion of repayment.”

Absconders The third group of offenders Cressey discussed was absconders—people who take the money and run. Cressey found that the nonshareable problems for absconders usually resulted from physical isolation. He observed that these people, “usually are unmarried or separated from their spouses, live in hotels or boarding houses, have few primary group associations of any sort, and own little property. Only one of the absconders interviewed had held a higher status position of trust, such as an accountant, business executive, or bookkeeper.” Cressey also found that the absconders tended to have lower occupational and socioeconomic status than the members of the other two categories.

Because absconders tended to lack strong social ties, Cressey found that almost any financial problem could be defined as nonshareable for these persons, and also that rationalizations were easily adopted because the persons only had to sever a minimum of social ties when they absconded. The absconders rationalized their conduct by noting that their attempts to live honest lives had been futile (hence their low status). They also adopted an attitude of not caring what happened to themselves, and a belief that they could not help themselves because they were predisposed to criminal behavior. The latter two rationalizations, which were adopted by absconders in Cressey’s study, allowed them to remove almost all personal accountability from their conduct.

In the 1950s, when Cressey gathered this data, embezzlers were considered persons of higher socioeconomic status who took funds over a limited period of time because of some personal problem such as drinking or gambling, while “thieves” were considered persons of lower status who took whatever funds were at hand. Cressey noted,

Since most absconders identify with the lower status group, they look upon themselves as belonging to a special class of thieves rather than trust violators. Just as long-term violators and independent businessmen...
do not at first consider the possibility of absconding with the funds, absconders do not consider the possibility of taking relatively small amounts of money over a period of time.\textsuperscript{33}

\begin{quote}
Conjecture of Events One of the most fundamental observations of the Cressey study was that it took all three elements—perceived nonshareable financial problem, perceived opportunity, and the ability to rationalize—for the trust violation to occur. If any of the three elements were missing, trust violation did not occur.
\end{quote}

\begin{quote}
[a] trust violation takes place when the position of trust is viewed according to culturally provided knowledge about and rationalizations for using the entrusted funds for solving a non-shareable problem, and that the absence of any of these events will preclude violation. The three events make up the conditions under which trust violation occurs and the term “cause” may be applied to their conjecture since trust violation is dependent on that conjecture. Whenever the conjecture of events occurs, trust violation results, and if the conjecture does not take place there is no trust violation.\textsuperscript{34}
\end{quote}

\textbf{Cressey’s Conclusion} Cressey’s classic fraud triangle helps explain the nature of many—but not all—occupational offenders. For example, although academicians have tested his model, it has still not fully found its way into practice in terms of developing fraud prevention programs. Our sense tells us that one model—even Cressey’s—will not fit all situations. Plus, the study is nearly half a century old. There has been considerable social change in the interim. And now, many antifraud professionals believe there is a new breed of occupational offender—those who simply lack a conscience sufficient to overcome temptation. Even Cressey saw the trend later in his life.

After doing this landmark study in embezzlement, Cressey went on to a distinguished academic career, eventually authoring thirteen books and nearly 300 articles on criminology. He rose to the position of Professor Emeritus in Criminology at the University of California, Santa Barbara.

\textit{Joe Wells Remembers Donald Cressey}

It was my honor to know Cressey personally. Indeed, he and I collaborated extensively before he died in 1987, and his influence on my own antifraud theories has been significant. Our families are acquainted; we stayed in each other’s homes; we traveled together; he was my friend. In a way, we made the odd couple—he, the academic, and me, the businessman; he, the theoretical, and me, the practical.

I met him as the result of an assignment in about 1983. A Fortune 500 company hired me on an investigative and consulting matter. They had a rather messy case of a high-level vice president who was put in charge of a large construction project for a new company plant. The $75 million budget for which he was responsible proved to be too much of a temptation. Construction companies wined and dined the vice president, eventually providing him with tempting and illegal bait: drugs and women. He bit.

From there, the vice president succumbed to full kickbacks. By the time the dust settled, he had secretly pocketed about $3.5 million. After completing the internal investigation for the company, assembling the documentation and interviews, I worked with prosecutors at the company’s request to put the perpetrator in prison. Then the company came to me with a very simple question: “Why did he do it?” As a former FBI Agent with hundreds of fraud cases under my belt, I must admit I had not thought much about the motives of occupational offenders. To me, they committed these crimes because they were crooks. But the company—certainly progressive on the antifraud front at the time—wanted me to invest the resources to find out why and how employees go bad, so they could possibly do something to prevent it. This quest took me to the vast libraries of The University of Texas at Austin, which led me to Cressey’s early research. After reading his book, I realized that Cressey had described the embezzlers I had encountered to a “T.” I wanted to meet him.

Finding Cressey was easy enough. I made two phone calls and found that he was still alive, well, and teaching in Santa Barbara. He was in the telephone book, and I called him. Immediately, he agreed to meet me the next time I came to California. That began what became a very close relationship between us that lasted until his untimely death in 1987. It was he who recognized the real value of combining the theorist with the practitioner. Cressey used to proclaim that he learned as much from me as I from him. But then, in addition to his brilliance, he was one of the most gracious people I have ever met. Although we were only together professionally for four years, we covered a lot of ground. Cressey was convinced there was a need for an organization devoted exclusively to fraud detection and deterrence. The Association of Certified Fraud Examiners, started about a year after his death, is in existence in large measure because of Cressey’s vision. Moreover, although Cressey didn’t know it at the time, he created the concept of what eventually became the certified fraud examiner. Cressey theorized that it was time for...
a new type of corporate cop—one trained in detecting and deterring the crime of fraud. Cressey pointed out that the traditional policeman was ill equipped to deal with sophisticated financial crimes, as were traditional accountants. A hybrid professional was needed; someone trained not only in accounting, but also in investigation methods, someone as comfortable interviewing a suspect as reading a balance sheet. Thus, the certified fraud examiner was born.

Dr. Steve Albrecht

Another pioneer researcher in occupational fraud and abuse—and another person instrumental in the creation of the certified fraud examiner program—was Dr. Steve Albrecht of Brigham Young University. Unlike Cressey, Albrecht was educated as an accountant. Albrecht agreed with Cressey’s vision—traditional accountants, he said, were poorly equipped to deal with complex financial crimes.

Albrecht’s research contributions in fraud have been enormous. He and two of his colleagues, Keith Howe and Marshall Romney, conducted an analysis of 212 frauds in the early 1980s under a grant from the Institute of Internal Auditors Research Foundation, leading to their book entitled *Deterring Fraud: The Internal Auditor’s Perspective*. The study’s methodology involved obtaining demographics and background information on the frauds through the use of extensive questionnaires. The participants in the survey were internal auditors of companies that had experienced frauds.

Albrecht and his colleagues believed that, taken as a group, occupational fraud perpetrators are hard to profile and that fraud is difficult to predict. His research included an examination of comprehensive data sources to assemble a complete list of pressure, opportunity, and integrity variables, resulting in a list of fifty possible red flags or indicators of occupational fraud and abuse. These variables fell into two principal categories: perpetrator characteristics and organizational environment. The purpose of the study was to determine which of the red flags were most important to the commission (and therefore to the detection and prevention) of fraud. The red flags ranged from unusually high personal debts, to belief that one’s job is in jeopardy; from no separation of asset custodial procedures, to not adequately checking the potential employee’s background.

The researchers gave participants both sets of twenty-five motivating factors and asked which factors were present in the frauds they had dealt with. Participants were asked to rank these factors on a seven-point scale indicating the degree to which each factor existed in their specific frauds. The ten most highly ranked factors from the list of personal characteristics, based on this study, were:

1. Living beyond their means
2. An overwhelming desire for personal gain
3. High personal debt
4. A close association with customers
5. Feeling pay was not commensurate with responsibility
6. A wheeler-dealer attitude
7. Strong challenge to beat the system
8. Excessive gambling habits
9. Undue family or peer pressure
10. No recognition for job performance

As you can see from the list, these motivators are very similar to the nonshareable financial problems Cressey identified.

The ten most highly ranked factors from the list dealing with organizational environment were:

1. Placing too much trust in key employees
2. Lack of proper procedures for authorization of transactions
3. Inadequate disclosures of personal investments and incomes
4. No separation of authorization of transactions from the custody of related assets
5. Lack of independent checks on performance
6. Inadequate attention to details
7. No separation of custody of assets from the accounting for those assets
# CHAPTER 3 WHO COMMITS FRAUD AND WHY: CRIMINOLOGY AND ETHICS

## TABLE 3-1 Occupational Fraud Red Flags

<table>
<thead>
<tr>
<th>Personal Characteristics</th>
<th>Organizational Environment</th>
</tr>
</thead>
<tbody>
<tr>
<td>2. Severe personal financial losses.</td>
<td>27. A department that does not enforce clear lines of authority and responsibility.</td>
</tr>
<tr>
<td>3. Living beyond one’s means.</td>
<td>28. A department that does not enforce proper procedures for authorization of transactions.</td>
</tr>
<tr>
<td>4. Extensive involvement in speculative investments.</td>
<td>29. A department that lacks adequate documents and records.</td>
</tr>
<tr>
<td>5. Excessive gambling habits.</td>
<td>30. A department that is not frequently reviewed by internal auditors.</td>
</tr>
<tr>
<td>6. Alcohol problems.</td>
<td>31. Lack of independent checks (other than internal auditor).</td>
</tr>
<tr>
<td>7. Drug problems.</td>
<td>32. No separation of custody of assets from the accounting for those assets.</td>
</tr>
<tr>
<td>8. Undue family or peer pressure to succeed.</td>
<td>33. No separation of authorization of transactions from the custody of related assets.</td>
</tr>
<tr>
<td>10. Dissatisfaction or frustration with job.</td>
<td>35. Inadequate physical security in the employee’s department such as locks, safes, fences, gates, guards, etc.</td>
</tr>
<tr>
<td>12. Continuous threats to quit.</td>
<td>37. Failure to maintain accurate personnel records of disciplinary actions.</td>
</tr>
<tr>
<td>15. Close associations with suppliers</td>
<td>40. Inadequate attention to details.</td>
</tr>
<tr>
<td>17. Poor credit rating.</td>
<td>42. Lack of budget review or justification.</td>
</tr>
<tr>
<td>18. Consistent rationalization of poor performance.</td>
<td>43. Placing too much trust in key employees.</td>
</tr>
<tr>
<td>19. Wheeler-dealer attitude.</td>
<td>44. Unrealistic productivity expectations.</td>
</tr>
<tr>
<td>20. Lack of personal stability such as frequent job changes, changes in residence, etc.</td>
<td>45. Pay levels not commensurate with the level of responsibility assigned.</td>
</tr>
<tr>
<td>22. Unreliable communications and reports.</td>
<td>47. Failure to discipline violators of company policy.</td>
</tr>
<tr>
<td>23. Criminal record.</td>
<td>48. Not adequately informing employees about rules of discipline or codes of conduct within the firm.</td>
</tr>
<tr>
<td>24. Defendant in a civil suit (other than divorce).</td>
<td>49. Not requiring employees to complete conflict-of-interest questionnaires.</td>
</tr>
<tr>
<td>25. Not taking vacations of more than two or three days.</td>
<td>50. Not adequately checking background before employment.</td>
</tr>
</tbody>
</table>

8. No separation of duties between accounting functions  
9. Lack of clear lines of authority and responsibility  
10. Department that is not frequently reviewed by internal auditors

All of the factors on this list affect employees’ opportunity to commit fraud without being caught. Opportunity, as you will recall, was the second factor identified in Cressey’s fraud triangle. In many ways, the study by Albrecht et al. supported Cressey’s model. Like Cressey’s study, the Albrecht study suggests there are three factors involved in occupational frauds:

… it appears that three elements must be present for a fraud to be committed: a situational pressure (nonshareable financial pressure), a perceived opportunity to commit and conceal the dishonest act (a way to secretly resolve the dishonest act or the lack of deterrence by management), and some way to rationalize (verbalize) the act as either being inconsistent with one’s personal level of integrity or justifiable.\(^50\)

## The Fraud Scale (Figure 3-2)

To illustrate the concept, Albrecht developed the “Fraud Scale,” which included the components of: situational pressures, perceived opportunities, and personal integrity.\(^51\) When situational pressures and perceived opportunities are high and personal integrity is low, occupational fraud is much more likely to occur than when the opposite is true.\(^52\)
Albrecht described situational pressures as “the immediate problems individuals experience within their environments, the most overwhelming of which are probably high personal debts or financial losses.”53 Opportunities to commit fraud, Albrecht says, may be created by individuals, or by deficient or missing internal controls. Personal integrity “refers to the personal code of ethical behavior each person adopts. While this factor appears to be a straightforward determination of whether the person is honest or dishonest, moral development research indicates that the issue is more complex.”54

In addition to its findings on motivating factors of occupational fraud, the Albrecht study also disclosed several interesting relationships between the perpetrators and the frauds they committed. For example, perpetrators of large frauds used the proceeds to purchase new homes and expensive automobiles, recreation property, and expensive vacations, support extramarital relationships, and make speculative investments. Those committing small frauds did not.55

There were other observations: perpetrators who were interested primarily in “beating the system” committed larger frauds. However, perpetrators who believed their pay was not adequate committed primarily small frauds. Lack of segregation of responsibilities, placing undeserved trust in key employees, imposing unrealistic goals, and operating on a crisis basis were all pressures or weaknesses associated with large frauds. College graduates were less likely to spend the proceeds of their loot to take extravagant vacations, purchase recreational property, support extramarital relationships, and buy expensive automobiles. Finally, those with lower salaries were more likely to have a prior criminal record.56

Richard C. Hollinger and John P. Clark

In 1983, Richard C. Hollinger of Purdue University and John P. Clark of the University of Minnesota published federally funded research involving surveys of nearly 10,000 American workers. In their book, *Theft by Employees*, the two researchers reached a different conclusion than Cressey. They found that employees steal primarily as a result of workplace conditions. They also concluded that the true costs of employee theft are vastly understated: “In sum, when we take into consideration the incalculable social costs . . . the grand total paid for theft in the workplace is no doubt grossly underestimated by the available financial estimates.”57

**Hypotheses of Employee Theft** In reviewing the literature on employee theft, Hollinger and Clark noted that experts had developed five separate but interrelated sets of hypotheses to explain employee theft. The first was that external economic pressures, such as the “nonshareable financial problem” that Cressey described, motivated theft. The second hypothesis was that contemporary employees, specifically young ones, are not as hardworking and honest as those in past generations. The third theory, advocated primarily by those with years of experience in the security and investigative industry, was that every employee could be tempted to steal from his employer. The theory basically assumes that people are greedy and dishonest by nature. The fourth theory was that job dissatisfaction is the primary cause of employee theft, and the fifth was that theft occurs because of the broadly shared formal and informal structure of organizations.

That is, over time, the group norms—good or bad—become the standard of conduct. The sum of their research led Hollinger and Clark to conclude that the fourth hypothesis was correct, that employee deviance is primarily caused by job dissatisfaction.
### Employee Deviance

Employee theft is at one extreme of employee deviance, which can be defined as conduct detrimental to the organization and to the employee. At the other extreme is counterproductive employee behavior such as goldbricking and abuse of sick leave. Hollinger and Clark defined two basic categories of employee deviant behavior: (1) acts by employees against property, and (2) violations of the norms regulating acceptable levels of production. The former includes misuse and theft of company property such as cash or inventory. The latter involves acts of employee deviance that affect productivity.

Hollinger and Clark developed a written questionnaire that was sent to employees in three different sectors: retail, hospital, and manufacturing. The employees were presented with lists of category 1 and category 2 offenses and were asked which offenses they had been involved in, and with what frequency. The researchers eventually received 9,175 valid employee questionnaires, representing about 54 percent of those sampled. Below are the results of the questionnaires. The first table represents category 1 offenses—acts against property. Hollinger and Clark found that approximately one-third of employees in each sector admitted to committing some form of property deviance.

#### Combined Phase I and Phase II Property-Deviance Items and Percentage of Reported Involvement, by Sector

<table>
<thead>
<tr>
<th>Items</th>
<th>Almost daily</th>
<th>About once a week</th>
<th>Four to twelve times a year</th>
<th>One to three times a year</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Retail Sector (N = 3, 567)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Misuse the discount privilege</td>
<td>0.6</td>
<td>2.4</td>
<td>11</td>
<td>14.9</td>
<td>28.9</td>
</tr>
<tr>
<td>Take store merchandise</td>
<td>0.2</td>
<td>0.5</td>
<td>1.3</td>
<td>4.6</td>
<td>6.6</td>
</tr>
<tr>
<td>Get paid for more hours than were worked</td>
<td>0.2</td>
<td>0.4</td>
<td>1.2</td>
<td>4</td>
<td>5.8</td>
</tr>
<tr>
<td>Purposely underring a purchase</td>
<td>0.1</td>
<td>0.3</td>
<td>1.1</td>
<td>1.7</td>
<td>3.2</td>
</tr>
<tr>
<td>Borrow or take money from employer without approval</td>
<td>0.1</td>
<td>0.1</td>
<td>0.5</td>
<td>2</td>
<td>2.7</td>
</tr>
<tr>
<td>Be reimbursed for more money than spent on business expenses</td>
<td>0.1</td>
<td>0.2</td>
<td>0.5</td>
<td>1.3</td>
<td>2.1</td>
</tr>
<tr>
<td>Damage merchandise to buy it on discount</td>
<td>0</td>
<td>0.1</td>
<td>0.2</td>
<td>1</td>
<td>1.3</td>
</tr>
<tr>
<td>Total involved in property deviance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>35.1</td>
</tr>
<tr>
<td><strong>Hospital Sector (N = 4, 111)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Take hospital supplies (e.g., linens, bandages)</td>
<td>0.2</td>
<td>0.8</td>
<td>8.4</td>
<td>17.9</td>
<td>27.3</td>
</tr>
<tr>
<td>Take or use medication intended for patients</td>
<td>0.1</td>
<td>0.3</td>
<td>1.9</td>
<td>5.5</td>
<td>7.8</td>
</tr>
<tr>
<td>Get paid for more hours than were worked</td>
<td>0.2</td>
<td>0.5</td>
<td>1.6</td>
<td>3.8</td>
<td>6.1</td>
</tr>
<tr>
<td>Take hospital equipment or tools</td>
<td>0.1</td>
<td>0.1</td>
<td>0.4</td>
<td>4.1</td>
<td>4.7</td>
</tr>
<tr>
<td>Be reimbursed for more money than spent on business expenses</td>
<td>0.1</td>
<td>0.0</td>
<td>0.2</td>
<td>0.8</td>
<td>1.1</td>
</tr>
<tr>
<td>Total involved in property deviance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>33.3</td>
</tr>
<tr>
<td><strong>Manufacturing Sector (N = 1, 497)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Take raw materials used in production</td>
<td>0.1</td>
<td>0.3</td>
<td>3.5</td>
<td>10.4</td>
<td>14.3</td>
</tr>
<tr>
<td>Get paid for more hours than were worked</td>
<td>0.2</td>
<td>0.5</td>
<td>2.9</td>
<td>5.6</td>
<td>9.2</td>
</tr>
<tr>
<td>Take company tools or equipment</td>
<td>0</td>
<td>0.1</td>
<td>1.1</td>
<td>7.5</td>
<td>8.7</td>
</tr>
<tr>
<td>Be reimbursed for more money than spent on business expenses</td>
<td>0.1</td>
<td>0.6</td>
<td>1.4</td>
<td>5.6</td>
<td>7.7</td>
</tr>
<tr>
<td>Take finished products</td>
<td>0</td>
<td>0</td>
<td>0.4</td>
<td>2.7</td>
<td>3.1</td>
</tr>
<tr>
<td>Take precious metals (e.g., platinum, gold)</td>
<td>0.1</td>
<td>0.1</td>
<td>0.5</td>
<td>1.1</td>
<td>1.8</td>
</tr>
<tr>
<td>Total involved in property deviance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>28.4</td>
</tr>
</tbody>
</table>


Following is a summary of the Hollinger and Clark research with respect to production deviance. Not surprisingly, they found that this form of employee misconduct was two to three times more common than property violations.59
### Combined Phase I and Phase II Production-Diviance Items and Percentage of Reported Involvement, by Sector

<table>
<thead>
<tr>
<th>Items</th>
<th>Involvement</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Almost daily</td>
<td>About once a week</td>
<td>Four to twelve times a year</td>
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<td>Total</td>
<td></td>
</tr>
<tr>
<td><strong>Retail Sector (N = 3, 567)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Take a long lunch or break without approval</td>
<td>6.9</td>
<td>13.3</td>
<td>15.5</td>
<td>20.3</td>
<td>56</td>
<td></td>
</tr>
<tr>
<td>Come to work late or leave early</td>
<td>0.9</td>
<td>3.4</td>
<td>10.8</td>
<td>17.2</td>
<td>32.3</td>
<td></td>
</tr>
<tr>
<td>Use sick leave when not sick</td>
<td>0.1</td>
<td>0.1</td>
<td>3.5</td>
<td>13.4</td>
<td>17.1</td>
<td></td>
</tr>
<tr>
<td>Do slow or sloppy work</td>
<td>0.3</td>
<td>1.5</td>
<td>4.1</td>
<td>9.8</td>
<td>15.7</td>
<td></td>
</tr>
<tr>
<td>Work under the influence of alcohol or drugs</td>
<td>0.5</td>
<td>0.8</td>
<td>1.6</td>
<td>4.6</td>
<td>7.5</td>
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<tr>
<td>Total involved in production deviance</td>
<td></td>
<td></td>
<td></td>
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<td>65.4</td>
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<tr>
<td><strong>Hospital Sector (N = 4, 111)</strong></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Take a long lunch or break without approval</td>
<td>8.5</td>
<td>13.5</td>
<td>17.4</td>
<td>17.8</td>
<td>57.2</td>
<td></td>
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<tr>
<td>Come to work late or leave early</td>
<td>1.0</td>
<td>3.5</td>
<td>9.6</td>
<td>14.9</td>
<td>29</td>
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</tr>
<tr>
<td>Use sick leave when not sick</td>
<td>0.0</td>
<td>0.2</td>
<td>5.7</td>
<td>26.9</td>
<td>32.8</td>
<td></td>
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<tr>
<td>Do slow or sloppy work</td>
<td>0.2</td>
<td>0.8</td>
<td>4.1</td>
<td>5.9</td>
<td>11</td>
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<td>0.3</td>
<td>0.6</td>
<td>2.2</td>
<td>3.2</td>
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<td></td>
<td></td>
<td></td>
<td>69.2</td>
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<td><strong>Manufacturing Sector (N = 1, 497)</strong></td>
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<td>Come to work late or leave early</td>
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<td>Use sick leave when not sick</td>
<td>0.0</td>
<td>0.2</td>
<td>9.6</td>
<td>28.6</td>
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<tr>
<td>Do slow or sloppy work</td>
<td>0.5</td>
<td>1.3</td>
<td>5.7</td>
<td>5.0</td>
<td>12.5</td>
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<td>3.1</td>
<td>7.3</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>82.2</td>
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**Income and Theft**

In order to empirically test whether economics had an effect on the level of theft, the researchers sorted their data by household income under the theory that lower levels of income might produce higher levels of theft. However, they were unable to confirm such a statistical relationship. This would tend to indicate—at least in this study—that absolute income is not a predictor of employee theft.

Despite this finding, Hollinger and Clark were able to identify a statistical relationship between employees’ concern over their financial situation and the level of theft. They presented the employees with a list of eight major concerns, ranging from personal health to education issues to financial problems. They noted the following:

*Being concerned about finances and being under financial pressure are not necessarily the same. However, if a respondent considered his or her finances as one of the most important issues, that concern could be partially due to “nonshareable (sic) economic problems,” or it could also be that current realities are not matching one’s financial aspirations regardless of the income presently being realized.*

The researchers concluded “in each industry, the results are significant, with higher theft individuals more likely to be concerned about their finances, particularly those who ranked finances as the first or second most important issue.”

**Age and Theft**

Hollinger and Clark found in their research a direct correlation between age and the level of theft. “Few other variables . . . have exhibited such a strong relationship to theft as the age of the employee.” The reason, they concluded, was that the younger employee generally has less tenure with his organization and therefore has a lower level of commitment to it than the typical older employee. In addition, there is a long history of connection between youth and many forms of crime. Sociologists have suggested that the central process of control is determined by a person’s “commitment to conformity.” Under this model—assuming employees are all subject to the same deviant motives and opportunities—the probability of deviant involvement depends on the stakes that one has in conformity. Since younger
employees tend to be less committed to the idea of conforming to established social rules and structures, it follows that they would be more likely to engage in illegal conduct that runs contrary to organizational and societal expectations.

The researchers suggested that the policy implications from the commitment to conformity theory are that rather than subjecting employees to draconian security measures,

companies should afford younger workers many of the same rights, fringes, and privileges of the tenured, older employees. In fact, by signaling to the younger employee that he or she is temporary or expendable, the organization inadvertently may be encouraging its own victimization by the very group of employees that is already least committed to the expressed goals and objectives of the owners and managers.\(^\text{65}\)

Although this may indeed affect the level of employee dissatisfaction, its policy implications may not be practical for non-fraud-related reasons.

**Position and Theft** Hollinger and Clark were able to confirm a direct relationship between an employee’s position and the level of the theft, with thefts being highest in jobs with greater access to the things of value in the organization. Although they found obvious connections between opportunity and theft (for example, retail cashiers with daily access to cash had the highest incidence), the researchers believed opportunity to be “…only a secondary factor that constrains the manner in which the deviance is manifested.”\(^\text{64}\) Their research indicated that job satisfaction was the primary motivator of employee theft; the employee’s position only affects the method and amount of the theft after the decision to steal has already been made.

**Job Satisfaction and Deviance** The research of Hollinger and Clark strongly suggests that employees who are dissatisfied with their jobs—across all age groups, but especially younger workers—are the most likely to seek redress through counterproductive or illegal behavior in order to right the perceived inequity. Other writers, notably anthropologist Gerald Mars and researcher David Altheide, have commented on this connection. Mars observed that among both hotel dining room employees and dock workers it was believed that pilferage was not theft, but was “seen as a morally justified addition to wages; indeed, as an entitlement due from exploiting employers.”\(^\text{65}\) Altheide also documented that theft is often perceived by employees as a “way of getting back at the boss or supervisor.”\(^\text{66}\) Jason Ditton documented a pattern in U.S. industries called “wages in kind,” in which employees “situated in structurally disadvantaged parts [of the organization] receive large segments of their wages invisibly.”\(^\text{67}\)

**Organizational Controls and Deviance** Hollinger and Clark were unable to document a strong relationship between control and deviance in their research. They examined five different control mechanisms: company policy, selection of personnel, inventory control, security, and punishment.

Company policy can be an effective control. Hollinger and Clark pointed out that companies with a strong policy against absenteeism have less of a problem with it. As a result, they would expect policies governing employee theft to have the same impact. Similarly, they believed employee education as an organizational policy has a deterrent effect. Hiring persons who will conform to organizational expectations exerts control through selection of personnel. Inventory control is required not only for theft, but for procedures to detect errors, avoid waste, and ensure a proper amount of inventory is maintained. Security controls involve proactive and reactive measures, surveillance, internal investigations, and others. Control through punishment is designed to deter the specific individual, plus those who might be tempted to act illegally.

Hollinger and Clark interviewed numerous employees in an attempt to determine their attitudes toward control. With respect to policy, they concluded, “the issue of theft by employees is a sensitive one in organizations and must be handled with some discretion. A concern for theft must be expressed without creating an atmosphere of distrust and paranoia. If an organization places too much stress on the topic, honest employees may feel unfairly suspected, resulting in lowered morale and higher turnover.”\(^\text{68}\)

Employees in the study also perceived, in general, that computerized inventory records added security and made theft more difficult. With respect to security control, the researchers discovered that the employees regarded the purpose of a security division as taking care of outside—rather than inside—security. Few of the employees were aware that security departments investigate employee theft, and most such departments had a poor image among the workers. With respect to punishment, the employees interviewed felt theft would result in job termination in a worst-case scenario. They perceived that minor thefts would be handled by reprimands only.
Hollinger and Clark concluded that formal organizational controls provide both good and bad news. “The good news is that employee theft does seem to be susceptible to control efforts . . . . Our data also indicate, however, that the impact of organizational controls is neither uniform nor very strong. In sum, formal organizational controls do negatively influence theft prevalence, but these effects must be understood in combination with the other factors influencing this phenomenon.”

**Employee Perception of Control**  The researchers also examined the perception—not necessarily the reality—of employees believing they would be caught if they committed theft. “We find that perceived certainty of detection is inversely related to employee theft for respondents in all three industry sectors—that is, the stronger the perception that theft would be detected, the less the likelihood that the employee would engage in deviant behavior.”

This finding is significant and consistent with other research. It suggests that increasing the perception of detection may be the best way to deter employee theft while increasing the sanctions that are imposed on occupational fraudsters will have a limited effect. Recall that under Cressey’s model, embezzlers are motivated to commit illegal acts because they face some financial problem that they cannot share with others because it would threaten their status. It follows that the greatest threat to the perpetrator would be that he might be caught in the act of stealing because that would bring his nonshareable problem out into the open. The possibility of sanctions is only a secondary concern. The perpetrator engages in the illegal conduct only because he perceives there is an opportunity to fix his financial problem without getting caught. Therefore, if an organization can increase in its employees’ minds the perception that illegal acts will be detected, it can significantly deter occupational fraud. Put simply, occupational fraudsters are not deterred by the threat of sanctions because they do not plan on getting caught.

Control in the workplace, according to Hollinger and Clark, consists of both formal and informal social controls. Formal controls can be described as external pressures that are applied through both positive and negative sanctions; informal controls consist of the internalization by the employee of the group norms of the organization. These researchers, along with a host of others, have concluded that—as a general proposition—informal social controls provide the best deterrent. “These data clearly indicate that the loss of respect among one’s acquaintances was the single most effective variable in predicting future deviant involvement.” Furthermore, “in general, the probability of suffering informal sanction is far more important than fear of formal sanctions in deterring deviant activity.” Again, this supports the notion that the greatest deterrent to the fraudster is the idea that he will be caught, not the threat of punishment by his employer.

**Other Hollinger and Clark Conclusions**  Hollinger and Clark reached several other conclusions based on their work. First, they found that “substantially increasing the internal security presence does not seem to be appropriate, given the prevalence of the problem. In fact, doing so may make things worse.”

Second, they concluded that the same kinds of employees who engage in other workplace deviance are also principally the ones who engage in employee theft. They found persuasive evidence that slow or sloppy workmanship, sick-leave abuses, long coffee breaks, alcohol and drug use at work, coming in late and/or leaving early were more likely to be present in the employee-thief.

Third, the researchers hypothesized that if efforts are made to reduce employee theft without reducing its underlying causes (e.g., employee dissatisfaction, lack of ethics), the result could create a “hydraulic effect.” Therefore, tightening controls over property deviance may create more detrimental acts affecting the productivity of the organization—that is, if we push down employee theft, we may push up goldbricking as a result.

Fourth, they asserted that increased management sensitivity to its employees would reduce all forms of workplace deviance.

Fifth, they concluded special attention should be afforded young employees, as these are the ones statistically the most likely to steal. However, it must be pointed out that although the incidence of theft is higher among younger employees, the losses associated with those thefts are typically lower than losses caused by more senior employees who have greater financial authority.

Hollinger and Clark asserted that management must pay attention to four aspects of policy development: (1) a clear understanding regarding theft behavior, (2) continuous dissemination of positive information reflective of the company’s policies, (3) enforcement of sanctions, and (4) publicizing the sanctions.
The researchers summed up their observations by saying, perhaps the most important overall policy implication that can be drawn... is that theft and workplace deviance are in large part a reflection of how management at all levels of the organization is perceived by the employee. Specifically, if the employee is permitted to conclude that his or her contribution to the workplace is not appreciated or that the organization does not seem to care about the theft of its property, we expect to find greater involvement. In conclusion, a lowered prevalence of employee theft may be one valuable consequence of a management team that is responsive to the current perceptions and attitudes of its workforce.74

ETHICS75

Oreo Linderhoof, Loss Prevention Manager, takes a videotape labeled Store 522 Backroom Surveillance, and carefully places the videotape on top of his desk near the guest chairs. Jim Thomas, Store Manager for retail location 522, arrives for his interview with Oreo. When Jim arrives, Oreo escorts Jim to his office and almost immediately is interrupted by a call. He asks Jim to please excuse the interruption and heads out of the office. Oreo returns fifteen minutes later and Jim “spills his guts.” He confesses to the theft of inventory, signs a written statement and is taken from headquarters in handcuffs by the local police.

The rest of the story...

Oreo knows that Jim Thomas is stealing high value inventory from the store but he doesn’t know how. Based on examination of daily inventory counts correlated with scheduling over weeks, Oreo has concluded that Jim is the only person with the opportunity to have committed the theft. Despite surprise inventory counts, store surveillance and other loss prevention techniques, Oreo cannot figure out how Jim is perpetrating the theft. Surveillance suggests that the inventory is not leaving through the front door and that Jim does not have an accomplice. Cash register analysis suggests that Jim is not taking cash through voids and refunds, a method that would also leave the inventory short.

Oreo hatches a scheme to catch Jim...

Oreo calls Jim at the store and schedules an interview at corporate headquarters. Store employees being called to corporate headquarters is never a good sign, and Oreo is hoping that this visit will make Jim nervous. In advance, Oreo instructs the receptionist to call him as soon as he and Jim are in his office. After excusing himself, Oreo goes to the break room, gets a cup of coffee, and then visits with several fellow employees. Essentially, he wants Jim to see the videotape labeled Store 522 Backroom Surveillance, and as noted above, his scheme works. As soon as Jim sees the videotape, he believes that he has been caught “red-handed.” The issue: the videotape was blank; there was no backroom video surveillance. Oreo, being one of the best professionals in his field, caught his man.

Question: Was Oreo’s scheme to obtain Jim’s confession ethical?

Ethics, trust, and responsibility are at the heart of fraud examination and financial forensics, and the above scenario highlights some of the dilemmas faced by professionals confronting persons perpetrating financial crimes. Ethics is defined as the branch of philosophy dealing with values relating to human conduct, with respect to rightness and wrongness of actions and the goodness and badness of motives and ends. The definition of ethics has certain key elements:

1. Ethics involves questions requiring reflective choice and their consequences to the individual and others (decision problems).
2. Ethics considers the rules and regulations that are in place to guide behavior as well as the consequences for breaking those rules and regulations.
3. Ethics often relies on moral principles to guide choices of right and wrong. (These ethical frameworks are discussed in more detail below).
4. Ethics is concerned with outcomes, the assigned impact associated with making a decision where the impact reflects the underlying values of individuals and organizations.

A discussion of ethics goes hand-in-hand with that of criminology because fraudsters often make poor ethical decisions prior to committing criminal acts. Consider, for example, financial statement fraud: perpetrators frequently find themselves on an ethical slippery slope, using an accounting choice as a tool for earnings management to maximize bonuses and influence the financial markets. When earnings management isn’t enough, the individual finds himself at a point of no return, moving from the slippery slope of earnings...
management to fraudulent financial statements. When does the fraud examiner or forensic accountant face an ethical dilemma? Whenever there are several choices, all outcomes have somewhat negative effects, and the correct choice is not obvious. Such dilemmas arise when many people could be harmed and some may benefit while others will not.

Consider another scenario: is it ethical for a fraud examiner or forensic accountant to lie to a perpetrator during an interview to elicit a confession? Most people agree that lying is wrong. Most also agree that an embezzler should not get away with their crime. If lying is the only way to get a white-collar criminal to confess, is lying ok? The answer isn’t obvious because both choices are imperfect: (1) not lying, but the perpetrator gets away; (2) lying and the perpetrator confesses. In either case, the fraud examiner or forensic professional must choose from a flawed set of options. Closely associated with ethics is the concept of values. Values are the personal and social criteria that influence choice: family, friends, peer groups, nationality, culture, and economic and social classes. Values are learned beginning in childhood and are the conventions upon which choices are evaluated.

Approaches to Ethical Problem Solving

**Is It Legal, or Does the Conduct Violate Known Rules?** The law and rules is one approach to resolving an ethical dilemma. Most codes of conduct and professional associations, for example, require that professions avoid breaking the law. This is a practical approach and a starting point for determining if certain conduct should be avoided. The law, however, is the lowest threshold for ethical decision making.

It may happen that a law might permit an action that is prohibited by a profession’s code of ethics. As an example, for years the American Institute of Certified Public Accountants (AICPA) had rules of ethics that prohibited advertising by its members. The profession believed that dignity and objectivity were enhanced by keeping practitioners out of this aspect of the commercial world. The U.S. Federal Trade Commission and the U.S. Department of Justice, however, disagreed. They decided that the prohibitions against advertising violated the laws barring restraint of trade. The government forced the profession to eliminate its rules against advertising. This example illustrates the triumph of one set of values (the government’s belief that competition through advertising would benefit consumers) over another set (the profession’s belief that dignity should be preserved).

**The Means Versus the Ends** A second approach to ethics suggests that it is ok to “fight fire with fire.” As Sean Connery’s character, Malone, asks Elliott Ness (Kevin Costner) in *The Untouchables*, “What are you prepared to do?… You wanna know how to get Capone? They pull a knife, you pull a gun. He sends one of yours to the hospital; you send one of his to the morgue.” Essentially, this is an outcome-based ethical framework. This has the purpose of justifying actions that otherwise could be considered immoral, unethical, or illegal. The problem with means-ends analyses is that they are often superficial, ending with the needed justification but failing to consider other aspects and consequences of the actions.

**Ethical Principles**

**The Imperative Principle** Ethical principles, on the other hand, refer to the process upon which an ethical decision is analyzed or evaluated. Inherently, values are incorporated into the principles that help guide choice. The imperative principle is one of three ethical principles that provide a framework for ethical decision making, and is based on the work of philosopher Immanuel Kant. Although the following characterization is overly simplistic, Kantian philosophy tends to ignore outcomes by providing directives and rules without exception that are in the best interest of society as a whole. For example, under Kantian imperatives, “lying is always wrong.” A society cannot exist if it is based on lies. Furthermore, society should value telling the truth over lying because society cannot exist if everyone is told to lie all the time (the alternative imperative to never tell a lie).

This unconditional obligation assumes that all people are aware of the rule and all agree to follow the rule. The Kantian imperative is very strict but provides an easy to understand framework for ethical decision making. However, Kant himself recognizes that at times, all general rules must have exceptions. While the Kantian imperative is almost impossible to follow all of the time, in practice, when a person is faced with violating an imperative, it alerts persons that they are faced with an ethical problem. Once the dilemma is identified, then the fraud examiner or forensic accountants can seek out additional consideration for weighing the consequences.
CHAPTER 3 WHO COMMITS FRAUD AND WHY: CRIMINOLOGY AND ETHICS

The Utilitarian Principle

The utilitarian principle, championed by John Stuart Mills, suggests that ethical problems should be solved by weighing the good consequences and the bad consequences. The correct course of action is that which provides the most good or minimizes the bad. Like Kantian imperatives, the consequences to society generally are more important than those to individuals. Mills identifies two forms of utilitarianism, “act” and “rule.” Act utilitarianism suggests that it is the consequences of the act that matter. For example, “honesty (an action) is the policy,” subject to the evaluation of the specific circumstances that might suggest that an alternative action, lying, provides better consequences in this particular situation. The individual making the decision has the power to decide, so their value system drives the evaluation process of possible outcomes (consequences) and the final decision.

In contrast, rule utilitarianism emphasizes the benefits to society of general rules (similar to a Kantian imperative) and suggests that the decision to break a rule is one that requires very careful consideration. Rule utilitarianism requires that society as a whole be able to determine which rules are important and ought to be followed. Rules then are also influenced by history, nationality, culture, social goals, and at some level economics.

The difficulty with utilitarianism is the variation in outcomes. In any situation, almost any act can be justified and the choice is always a product of from where a person (act) or society (rule) came: family, friends, peer groups, nationality, ethnic background, and economic and social classes. Furthermore, it is difficult for everyone to agree on universal principles.

The Generalization Principle

The generalization principle is an attempt to marry Kantian imperatives with utilitarianism, and was proposed by Marcus G. Singer. The generalization argument is as follows:

If all relevantly similar persons acting under relevantly similar circumstances were to act a certain way and the consequences would be undesirable, then no one ought to act in that way without a reason.

More simplistically, the generalization argument poses the following questions as a first assessment:

What if everyone acted that way?

If the outcome is considered undesirable, then that conduct ought to be avoided unless the person has a very good reason. Generalization provides the flexibility needed to address the shortcomings of Kant and the specific direction that seems to be missing from utilitarianism. Of course, the success of the generalization argument is dependent on the specific value assessments of the individual decision makers. Furthermore, generalization is invalid when an argument is either invertible or reiterable. Invertibility occurs when both doing something and not doing something leads to bad consequences. In such a circumstance, no generalization argument can be formulated. Reiterability occurs when arbitrary times, places, persons, or other factors can be inserted into a generalization in such a way as to make the generalization outcome to be nonsensical.

Ethics, Trust, and Responsibility

Although the preceding principles provide a framework for ethical decision making, alternative decisions may result in variations of good and bad consequences. Therefore, the task is a difficult one and the choice must be left to individuals. It is impossible to provide a blueprint for every situation with laws, rules, and exceptions. The bottom line is that civilized societies are based on trust with underlying values and implicit codes of conduct that guide our behavior. The decision process is difficult, and the range of possible outcomes suggests that the right choice is not always obvious. Though doing the right thing can be difficult, as members of society, we have a responsibility to reach for that goal every day, without exception.

ETHICS IN PRACTICE

Ethics and Values as Drivers of Personal Behavior

To be successful, professionals in the specialized field of fraud examination and financial forensics must have an ethical framework for appropriate decision making. Although the preceding material has suggested approaches to solving ethical problems, the fraud and forensic professional needs to strive for the highest degree of ethics. This perspective requires that the individual think about possible difficult situations and develop their own framework for decision making and, to the extent possible, in advance. Next, the
individual needs to make the commitment required to follow their ethical values in all cases except those that have extreme consequences.

In practice, fraud and forensic professionals can start with rules, laws, and Kantian imperatives to identify ethical situations (ethical dilemmas) that require more in-depth evaluation. Once the ethical problems have been identified, the evaluation process begins and professionals can use their own framework for ethical problem solving, including using personal rules and processes for decision making. The fraud and forensic professional is not alone and should solicit the input and opinions of other practicing professionals. In some cases, guidance and advice from professional organizations and associations can assist the individual in making the best decision. After careful consideration of the alternative outcomes and the decision is made, the professional can then move forward to implement that decision. This process will help to ensure that the anticipated goals are realized while also attempting to mitigate any negative consequences.

Students who are considering entering the field of fraud examination and financial forensics must consider decisions that they made in the past. For example, some may have past criminal convictions that might exclude them from entry into the profession. While most offenses should not prevent a prospective student from exploring their options, they should be aware that honesty is the best policy. Get caught in a lie, and your career could be over. Tell the truth and explain the facts and circumstances of a less than perfect past, and at least the individual (applicant) will have created a foundation of trust to repair the damage caused by prior conduct.

Professional Conduct

Professions are set apart by five characteristics:77

1. A specialized body of knowledge.
2. Admission governed by standards and qualifications.
3. Recognition and acceptance by society (a characteristic that inflicts social responsibility back on the profession).
4. Standards of conduct for dealing with the public, other professionals, and clients.
5. An organizational body devoted to the advancement and responsibilities of the profession.

These characteristics inflict responsibility on both the profession and the individual professionals. Normally, such responsibilities are captured in the profession’s code of conduct. For example, Certified Fraud Examiners (CFE), as designated by the Association of Certified Fraud Examiners (ACFE), have the following code of ethics:78

1. A Certified Fraud Examiner shall at all times demonstrate a commitment to professionalism and diligence in the performance of his or her duties.
2. A Certified Fraud Examiner shall not engage in any illegal or unethical conduct, or any activity which would constitute a conflict of interest. (Note that the Certified Fraud Examiner has no exception for cases where they may be unaware that a particular law exists.)
3. A Certified Fraud Examiner shall, at all times, exhibit the highest level of integrity in the performance of all professional assignments, and will accept only assignments for which there is reasonable expectation that the assignment will be completed with professional competence.
4. A Certified Fraud Examiner will comply with lawful orders of the courts, and will testify to matters truthfully and without bias or prejudice.
5. A Certified Fraud Examiner, in conducting examinations, will obtain evidence or other documentation to establish a reasonable basis for any opinion rendered. No opinion shall be expressed regarding the guilt or innocence of any person or party.
6. A Certified Fraud Examiner shall not reveal any confidential information obtained during a professional engagement without proper authorization.
7. A Certified Fraud Examiner shall reveal all material matters discovered during the course of an examination, which, if omitted, could cause a distortion of the facts.
8. A Certified Fraud Examiner shall continually strive to increase the competence and effectiveness of professional services performed under his or her direction.
Ethics at Client Entities: The Foundation for Fraud Prevention and Deterrence

Whereas the prior sections dealt with ethics at the individual and professional level, ethics are an important part of organizational behavior. In fact, ethics is the foundation for fraud prevention both by individuals within an organization and the organization itself.

Tone at the Top and a Culture of Ethical Behavior  Ethics at the organizational level starts with corporate governance. The Board of Directors, the Audit Committee, executives, managers, clerical support, and line personnel are the living, breathing embodiment of ethics within the organization. The Board of Directors, Audit Committee, and corporate officers set the “tone at the top.” Tone at the top refers to a culture that is open, honest, and communicates the values of the organization to persons at all levels, both internal and external to the organization. The first step in developing an ethical culture is a code of ethics signed by all personnel. In addition, the company’s position on ethics should be posted in visible places, such as lunchrooms, and communicated across the organization. Employee awareness programs such as periodic ethics training are effective tools, and, of course, leaders lead by example. Employees will take their cues from their managers, managers from executives, and executives from their interaction with board members, audit committee members, and auditors. It is important that individuals in leadership positions not only communicate the value of ethical actions, they must also practice what they preach. In addition, important financial, operational, and compliance information should be disseminated to individuals who need it and can act on it. Furthermore, individuals at the top must be willing to listen to those operating at lower levels of the organization.

Second, the organization should be committed to hiring honest executives, managers, and staff. While most organizations attempt to contact prior employers and resume references, many organizations provide only minimal information about former employees and are remiss to provide any negative feedback for fear of legal retribution. References provided by prospective employees are typically friends and professional acquaintances; so prospective employers should seek out prior supervisors. While costly, organizations should consider background checks on prospective employees. Due to cost constraints, organizations may want to restrict the positions for which background checks are completed. To avoid charges of discrimination, prospective employers need to complete such checks in a consistent manner and in compliance with corporate policy.

Once individuals are hired, they need to be properly supervised. The most common excuse by managers for inadequate supervision is time constraints. While “too much to do, in too little time” is a common complaint in today’s business environment, proper supervision is essential to maintaining good internal controls.

Training is another area that needs adequate attention. Many companies spend a considerable amount of time and resources developing their employees’ technical abilities, but little time or resources are generally spent developing supervisory skills.

Maintain an Environment Dedicated to Fraud Prevention and Deterrence  Once an organization has created the infrastructure to minimize fraud opportunities, the system has to be maintained. Supporting the anti-fraud environment requires continuing education of fraud awareness. The fraud triangle indicates that one of the factors necessary for fraud to occur is rationalization. Failing to maintain a work environment that discourages fraud may enable an employee to justify unethical or illegal actions. Such rationalizations may include the following: an employer’s failure to recognize a job well done, an employee’s overall job dissatisfaction, an employee’s perception that they are inadequately compensated for their work, an employee’s perception that the company owes them, and the misperception that no one is being hurt by their actions.

Another part of a good anti-fraud maintenance program is to provide assistance for employees with problems. In smaller companies, the human resources department may serve this function. In larger companies, there may be specific personnel devoted to assisting employees in exploring their options to solve a problem. This gives the employee the comfort to know that they are not alone, that their problem is “shareable.”

Part of maintaining a strong anti-fraud environment includes appropriate disciplinary procedures, such as prosecuting fraudsters where evidence suggests that such action is warranted. Effective discipline requires a well-defined set of sanctions for inappropriate behavior and strict adherence to those sanctions in order to avoid claims of discriminatory conduct.
One of the most effective anti-fraud deterrents is a hotline to receive anonymous tips from employees, customers, suppliers, vendors, contractors, and others. According to the 2006 ACFE Report to the Nation, tips and accidental discovery (candidates for tip reporting) account for almost 60 percent of fraud detection. Thus, anonymous tip hotlines are a tool that should be in place at all organizations of any size.

In cases where tips are made by employees, especially lower-level employees who report wrongdoing by their supervisors, whistleblower protections should be in place. Unfortunately, even those whistleblower protections that are established by law may not protect employees from subtle, informal retribution, such as exclusion from meetings or not being given important information pertinent to doing their job.

Creating an anti-fraud environment also means minimizing opportunities for fraud. To accomplish this goal, companies need to establish and maintain a good internal control environment; discourage collusion and monitor employee relationships for collusion opportunities; alert vendors and contractors to company policies; monitor employees and, as noted above, create tip hotlines; create expectations that fraudsters will get caught and will be punished; and proactively audit for fraud. Best practices to deter fraud include job rotation, surprise audits and reviews, open-door policies by upper-level management, and periodic testing of internal controls. Actively creating an anti-fraud environment means considering the following questions before fraud occurs:

What?
- What could go wrong?
- What assets are most susceptible?

Who?
- Who has the opportunity to commit fraud?
- Who has partial opportunity and who might they collude with to commit fraud?

How?
- How could fraud be committed—asset misappropriation and financial statement fraud?
- How effective is the internal control environment—policies and procedures?
- How susceptible is the company to management override?

When (timing)?
- When is fraud most likely to occur?

Where?
- Where would the fraud occur?
- Where would red flags (symptoms) manifest themselves?

Why?
- Why might fraud occur? i.e., pressures (nonshareable problems) created internally such as performance bonus plans
- Why might certain employees be driven to commit fraud? i.e., pressures (nonshareable problems) observed in certain employees (e.g., gambling problems, debt, drug or alcohol abuse, or marital issues)

The who, what, where, when, how, and why are questions fraud examiners and forensic professionals often investigate once fraud is discovered. Those same attributes need to be considered, proactively, as companies develop their anti-fraud environment.

React to Early Warning Signs The last aspect of a good antifraud environment requires that the organization react appropriately to symptoms of fraud, red flags, badges of fraud, and other early warning signals. Dr. Steve Albrecht references six types of anomalies that should be investigated at the earliest point of recognition: accounting anomalies, weak internal controls, analytical anomalies, lifestyles symptoms, behavior symptoms, and tips from potential informants. These issues will be more formally explored in later chapters, but some of these anomalies are listed below.
CHAPTER 3 WHO COMMITS FRAUD AND WHY: CRIMINOLOGY AND ETHICS

Accounting Anomalies

Irregular, unusual, and missing source documents
Excessive voids and refunds
Faulty journal entries and journal entries with missing documentation
Missing cash or assets (with coincidental reduction in the G/L with a credit)
Unusual account debits that are frequently used to conceal at fraud
Inaccuracies in ledgers
Underlying account detail does not equal balance
Underlying account detail does not reconcile to the general ledger
Subsidiary ledgers with missing support
Two sets of books and records
False ledger entries or alterations
Back-dated and post-dated documents and transactions
False invoices
False applications
False financial statements elements
Invoice numbers that do not make sense
Failure to keep and maintain records
Concealment of records
Refusal to make records available
Unexplained variances between tax returns and underlying books and records
False interview statements
Interference with an audit, examination, and investigation
Failure to follow advice of attorneys and accountants
Less than full disclosure (e.g., masking the true financial impact)
Taxpayer knowledge
Testimony of employees and other witnesses
Destruction of books and records
Inappropriate transfer of assets
Patterns inconsistent over time
Attempts to bribe the auditor, examiner, or investigator

Weak Internal Controls

Lack of segregation of duties
Lack of physical safeguards for valuable assets (e.g., intellectual property)
Lack of independent checks and balances
Lack of proper authorization
Lack of proper supervision
Lack of proper documents and records (e.g., missing originals)
Observations of management overriding existing controls
Inadequate accounting and information systems
Related parties transactions

Analytical Anomalies

Unexplained inventory and cash shortages
Deviations from quality specifications (e.g., warranty liability down)
Excess scrap
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Excess voids
Excess purchases compared to revenue levels
Ratios that don’t make sense
Nonfinancial numbers that do not correlate with account balances and other numbers presented in the financial statements
Excessive late charges in accounts payable, notes payable, and company credit cards
Strange financial relationships
  e.g., Revenues up; inventory down; A/R up; cash flows down
  e.g., Increased inventory; A/P down
  e.g., Increased volume; increased costs per unit
  e.g., Increased inventory; decreased inventory holding costs
  e.g., A/R up; bad debts down

*Lifestyles Symptoms*

New luxury cars
Pricey clothes
New or high-priced house
Expensive jewelry
High-end recreational toys, such as boats, vacation homes, motor homes

*Behavior Symptoms*

Can’t look people in the eye
Embarrassment with friends, family
Irritable and suspicious
Defensive
Argumentative
Unusually belligerent in stating opinions
Needs to see a counselor, psychiatrist, etc.
Complains of being unable to sleep
Drinks too much
Using illegal, illicit drugs
Can’t relax

*Potential Informants*

Employees
Customers
Suppliers
Family
Friends

**Five-Step Approach to Fraud Prevention, Deterrence, and Detection**

1. Know the exposures (brainstorming, risk assessment, audit planning).
2. Translate exposure into likely symptoms.
3. Always be on the lookout for symptoms.
4. Build audit and data-mining programs to look for symptoms.
5. Pursue these issues to their logical conclusion and ground decisions in the evidence (evidence-based decision-making).
CHAPTER 3 WHO COMITS FRAUD AND WHY: CRIMINOLOGY AND ETHICS

REVIEW QUESTIONS

3-1 Describe occupational fraud and abuse.
3-2 Compare and contrast Cressey’s and Albrecht’s theories of crime causation.
3-3 Identify from Cressey’s research the six situational categories that cause nonshareable problems.
3-4 Discuss the essence of organizational crime.
3-5 Give examples of behavioral indications of fraud.
3-6 Explain the relationship between an employee’s position and the level of theft (according to Hollinger and Clark’s research).
3-7 Analyze the role of corporate governance mechanisms in fraud prevention.
3-8 Describe corporate governance breakdowns in the facilitation of Enron’s fraudulent acts.
3-9 Identify ethical issues, conflicts of interest, and noncompliance with corporate policies and procedures in the Enron case.
3-10 Discuss alternative courses of action in the Enron case within the framework of appropriate ethical conduct.

ENDNOTES

1. Source unknown
2. See Albrecht’s Fraud Examination and the ACFE’s Fraud Examiners Manual. Fraud statistics can be found in the ACFE’s 2004 Report to the Nation.
3. Adapted from the ACFE’s Fraud Examiners Manual, Section 1.21.
7. Ibid., 377.
8. Ibid., 383.
12. Ibid., 33.
13. Ibid., 34.
14. Ibid., 34.
15. Ibid., 35.
16. Ibid., 36.
17. Ibid., 36.
18. Ibid., 42.
19. Ibid., 42.
21. Cressey, 47.
22. Ibid., 48.
23. Ibid., 52–53.
24. Ibid., 54.
25. Ibid., 57.
26. Ibid., 66.
27. Ibid., 84.
28. Ibid., 84.
29. Ibid., 85.
30. Ibid., 94–95.
31. Ibid., 93.
32. Ibid., 101–102.
33. Ibid., 102.
34. Ibid., 102.
35. Ibid., 120–121.
36. Ibid., 121.
37. Ibid., 122.
38. Ibid., 121.
39. Ibid., 122.
40. Ibid., 128.
41. Ibid., 129.
42. Ibid., 128–129.
43. Ibid., 133.
44. Ibid., 139.
46. Although such red flags may be present in many occupational fraud cases, one must reemphasize Albrecht’s caution that the perpetrators are hard to profile, and fraud is difficult to predict. To underscore this point, Albrecht’s research does not address—and no current research has been done to determine—whether nonoffenders have many of the same characteristics. If so, then the list may not be discriminating enough to be useful. In short, although one should be mindful of potential red flags, they should not receive undue attention absent other compelling circumstances.
47. Ibid., 13–14.
48. Ibid., 32.
49. Ibid., 39
50. Ibid., 5.
51. Ibid., 6.
52. Ibid., 5.
53. Ibid., 5.
54. Ibid., 6.
55. Ibid., 42.
56. Ibid., 15.
58. Ibid., 42.
59. Hollinger and Clark, p. 57.
60. Ibid., 57.
61. Ibid., 57.
62. Ibid., 63.
63. Ibid., 68.
64. Ibid., 77.
65. Ibid., 86.
66. Ibid.
67. Ibid.
68. Ibid., 106.
69. Ibid., 117.
70. Ibid., 120.
71. Ibid., 121.
72. Ibid., 144.
73. Ibid., 146.

74. Ethics should be considered pervasive, a common thread, and included in all aspects of the fraud and forensic accounting curricula.
78. Ibid., 4.901.