

Introduction

In the world of commerce, organizations incur costs to produce and sell their products or services. These costs run the gamut: labor, taxes, advertising, occupancy, raw materials, research and development—and, yes, fraud and abuse. The latter cost, however, is fundamentally different from the former: The true expense of fraud and abuse is hidden, even if it is reflected in the profit and loss figures.

For example, suppose the advertising expense of a company is \$1.2 million. But unknown to the company, its marketing manager is in collusion with an outside ad agency and has accepted \$300,000 in kickbacks to steer business to that firm. That means the true advertising expense is overstated by at least the amount of the kickback—if not more. The result, of course, is that \$300,000 comes directly off the bottom line, out of the pockets of the investors and the workforce.

DEFINING OCCUPATIONAL FRAUD AND ABUSE

The example just given is clear-cut, but much about occupational fraud and abuse is not so well defined, as we will see. Indeed, there is widespread disagreement on what exactly constitutes these offenses.

For purposes of this book, “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.”¹

By the breadth of the definition, it 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 and petty theft, false overtime, using company property for personal benefit, and payroll and sick time abuses. As the first *Report to the Nation on Occupational Fraud and Abuse*, set forth in 1996, states, “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.”²

“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 term is not restricted to the rank and file, but specifically includes corporate executives, company presidents, top and middle managers, and other workers.

Defining Fraud

In the broadest sense, fraud can encompass any crime for gain that uses deception as its principal modus operandus. There are but three ways to illegally relieve a victim of his money: force, trickery, or larceny. All those offenses that employ trickery are frauds. Since deception is the linchpin of fraud, we will include *Webster's* synonyms: “‘Deceive’ implies imposing a false idea or belief that causes ignorance, bewilderment or helplessness; ‘mislead’ implies a leading astray that may or may not be intentional; ‘delude’ implies deceiving so thoroughly as to obscure the truth; ‘beguile’ stresses the use of charm and persuasion in deceiving.”

All deceptions, however, are not frauds. To meet the legal definition of a fraud, there must be damage, usually in terms of money, to the victim. Under the common law there are four general elements, all of which must be present for a fraud to exist:

1. A material false statement
2. Knowledge that the statement was false when it was uttered
3. Reliance on the false statement by the victim
4. Damages as a result

The legal definition is the same whether the offense is criminal or civil; the difference is that criminal cases must meet a higher burden of proof.

Let us assume an employee did not deceive anyone, but stole valuable computer chips while no one was looking and resold them to a competitor. Has he committed fraud? Has he committed theft? The answer, of course, is that it depends. Employees have a recognized fiduciary relationship with their employers under the law.

The term “fiduciary,” according to *Black's Law Dictionary*, is of Roman origin and means

a person holding a character analogous to a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires. A person is said to act in a 'fiduciary capacity' when the business which he transacts, or the money or property which he handles, is not for his own benefit, but for another person, as to whom he stands in a relation implying and necessitating great confidence and trust on the one part and a high degree of good faith on the other part.

So, in our example, the employee has not only stolen the chips—in so doing, he has violated his fiduciary capacity. That makes him an embezzler.

To “embezzle” means willfully to take, or convert to one's own use, another's money or property of which the wrongdoer acquired possession lawfully, by reason of some office or employment or position of trust. The elements of “embezzlement” are that there must be a relationship such as that of employment or agency between the owner of the money and the defendant, the money alluded to have been embezzled must have come into the possession of defendant by virtue of that relationship and there must be an intentional and fraudulent appropriation or conversion of the money.³

In other words, embezzlement is a special type of fraud.

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“Conversion,” in the legal sense, is

an unauthorized assumption and exercise of the right of ownership over goods or personal chattels belonging to another; to the alteration of their condition or the exclusion of the owner's rights. An unauthorized act which deprives an owner of his property permanently or for an indefinite time. Unauthorized and wrongful exercise of dominion and control over another's personal property, to the exclusion of or inconsistent with the rights of owner.⁴

So by stealing the chips, the employee also engages in conversion of the company's property.

The legal term for stealing is “larceny,” which is

felonious stealing, taking and carrying, leading, riding, or driving away with another's personal property, with the intent to convert it or to deprive the owner thereof. The unlawful taking and carrying away of property of another with the intent to appropriate it to a use inconsistent with the latter's rights. The essential elements of a “larceny” are an actual or constructive taking away of the goods or property of another without the consent and against the will of the owner and with a felonious intent. Obtaining possession of property by fraud, trick or device with preconceived design or intent to appropriate, convert, or steal is “larceny.”⁵

As a matter of law, the employee in question could be charged with a wide range of criminal and civil conduct: fraud, embezzlement, obtaining money under false pretenses, or larceny. As a practical matter, he probably will be charged with only one offense, commonly larceny.

“Larceny by fraud or deception” means that

a person has purposely obtained the property of another by deception. A person deceives if he purposely: (1) creates or reinforces a false impression, including false impressions as to law, value, intention or other state of mind; but deception as to a person's intention from the act alone that he did not subsequently perform the promise; or (2) prevents another from acquiring information which would affect his judgment of a transaction; or (3) fails to correct a false impression which the deceiver previously created or reinforced, or which the deceiver knows to be influencing another to whom he stands in a fiduciary or confidential relationship; or (4) fails to disclose a known lien, adverse claim, or other legal impediment to the enjoyment of property which he transfers or encumbers in consideration for the property obtained, whether such impediment is or is not valid, or is or is not a matter of official record.⁶

The fraudulent aspect of occupational frauds, then, deals with the employee's fiduciary duties to the organization. If those duties are violated, that action may be considered fraud in one of its many forms. Under the definition of occupational fraud and abuse in this book, the activity must be clandestine. *Black's* defines “clandestine” as “secret, hidden, concealed; usually for some illegal or illicit purpose.”⁷

Defining Abuse

A litany of abusive practices plagues organizations. Here are a few of the more common examples of how employees “cost” their employers. As any employer knows, it is hardly out of the ordinary for employees to:

- Use employee discounts to purchase goods for friends and relatives.
- Take products belonging to the organization.
- Get paid for more hours than worked.
- Collect more money than due on expense reimbursements.
- Take a long lunch or break without approval.
- Come to work late or leave early.
- Use sick leave when not sick.
- Do slow or sloppy work.
- Work under the influence of alcohol or drugs.

Over the years abuse has taken on a largely amphoteric meaning; *Webster's* definition of abuse might surprise you. From the Latin word *abusus*—to consume—it means: “1. a deceitful act, deception; 2. a corrupt practice or custom; 3. improper use or treatment, misuse. . . .” To deceive is “to be false; to fail to fulfill; to cheat; to cause to accept as true or valid what is false or invalid.”⁸

Given the commonality of the language describing both fraud and abuse, what are the key differences? An example illustrates: Suppose a teller was employed by a bank and stole \$100 from her cash drawer. We would define that broadly as fraud. But if she earns \$500 a week and falsely calls in sick one day, we might call that abuse—even though each has the exact same economic impact to the company—in this case, \$100.

And, of course, each offense requires a dishonest intent on the part of the employee to victimize the company. Look at the way each typically is handled within an organization, though: In the case of the embezzlement, the employee gets fired; there is also the remotest of probabilities that she will be prosecuted. In the case in which the employee misuses her sick time, she *perhaps* gets reprimanded, or her pay is docked for the day.

But we also can change the “abuse” example slightly. Let us say the employee works for a governmental agency instead of in the private sector. Sick leave abuse—in its strictest interpretation—could be a fraud against the government. After all, the employee has made a false statement for financial gain (to keep from getting docked). Government agencies can and have prosecuted flagrant instances. Misuse of public money—in any form—can end up being a serious matter, and the prosecutive thresholds can be surprisingly low.

Here is one real example. In 1972, I was a rookie FBI agent assigned to El Paso, Texas. That division covered the Fort Bliss military reservation, a sprawling desert complex. There were rumors that civilian employees of the military commissary were stealing inventory and selling it out the back door. The rumors turned out to be true, albeit slightly overstated. But we did not know that at the time.

So around Thanksgiving, the FBI spent a day surveying the commissary's back entrance. We had made provisions for all contingencies—lots of personnel, secret vans, long-range cameras—the works. But the day produced only one measly illegal sale out the back door: several frozen turkeys and a large bag of yams. The purchaser of the stolen goods tipped his buddy \$10 for merchandise valued at about \$60. The offense occurred late in the day. We were bored and irritated, and we pounced on the purchaser as he exited the base, following him out the gate in a caravan of unmarked cars with red lights. The poor guy was shaking so badly that he wet his pants. I guess he knew better than we did what was at stake.

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Because he was in the wrong place at the wrong time and did the wrong thing, our criminal paid dearly: He pled guilty to a charge of petty theft. So did his buddy at the commissary. The employee was fired. But the purchaser, it turned out, was a retired military colonel with a civilian job on the base—a person commonly known as a “double dipper.” He was let go from a high-paying civilian job and now has a criminal record. But most expensively, I heard he lost several hundred thousand dollars in potential government retirement benefits. Would the same person be prosecuted for petty theft today? It depends entirely on the circumstances. But it could and does happen.

The point here is that the term *abuse* often is used to describe a variety of petty crimes and other counterproductive behavior that have become common and even silently condoned in the workplace. The reasons employees engage in these abuses are varied and highly complex. Do abusive employees eventually turn into out-and-out thieves and criminals? In some instances, yes. We will describe that later.

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 on 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, against either 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.”⁹

For the noninitiated, 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, myself included, 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. 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 as we learn math, English, or guitar playing.¹⁰

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. In his view, this explains 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. It is clear how Sutherland's differential association theory fits with occupational offenders. In organizations, dishonest employees eventually will infect a portion of honest ones. It also goes the other way: Honest employees eventually will 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). While much of Sutherland's research concentrated on upper-world criminality, Cressey took his own studies in a different direction. Working on his doctorate in criminology, he decided to concentrate on embezzlers. Accordingly, Cressey arranged the necessary permission at prisons in the Midwest and eventually interviewed about 200 incarcerated inmates.

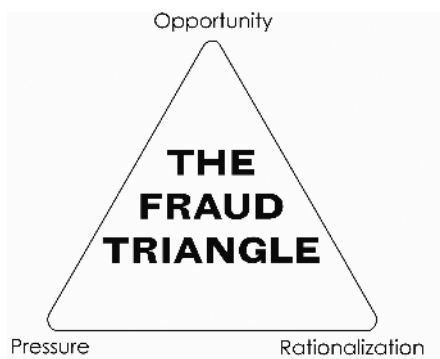
Cressey's Hypothesis

Cressey was intrigued by embezzlers, whom he called "trust violators." 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 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 was: "Trusted persons become trust violators when they conceive of themselves as having a financial problem which is nonsharable, 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 has become better known as the fraud triangle. (See Exhibit 1.1.) One leg of the triangle represents a perceived nonsharable financial need; the second leg is for perceived opportunity; and the final is for rationalization. The role of the nonsharable problem 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

Exhibit 1.1 The Fraud Triangle



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

Nonsharable Problems

What, of course, is considered “nonsharable” is wholly in the eyes of the potential occupational offender, Cressey said. “Thus a man could lose considerable money at the race track daily but the loss, even if it construed a problem for the individual, might not constitute a nonsharable problem for him. Another man might define the problem as one which must be kept secret and private, that is, as one which is nonsharable. 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 nonsharable.”¹⁴

Cressey divided these “nonsharable” problems into six basic subtypes:

1. Violation of ascribed obligations
2. Problems resulting from personal failure
3. Business reversals
4. Physical isolation
5. Status gaining
6. Employer–employee relations

Violation of Ascribed Obligations

Violation of ascribed obligations—the specter of being unable to pay one’s debts—has historically proved a strong motivator. “Financial problems incurred through

non-financial violations of positions of trust often are considered as nonsharable 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.”¹⁵ In other words, the mere fact that a person has a trusted position brings with it the implication that he or she can and does properly manage money.

“When persons incur debts or in some other way become financially obligated as a result of violation of the obligations ascribed to the role of trusted person, they frequently consider that these debts must be kept secret, and that meeting them becomes a non-sharable financial problem. In many instances, the insurance of such debts is also considered incompatible with the duties and obligations of other roles which the person might be enacting, such as those of a husband or father, but the concern here is with such debts only as they represent conflict with the person’s role as a trusted person.”¹⁶ Cressey describes a situation we can all appreciate—not being able to pay one’s debts—and then having to admit it to one’s employer, family, or friends.

Problems Resulting from Personal Failure

Problems resulting from personal failures, Cressey writes, can be of several different types. “While some pressing financial problems may be considered as having resulted from ‘economic conditions’ . . . 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.’ ”¹⁷ In short, pride goeth before the fall. If the potential offender has a choice between covering his poor investment choices through a violation of trust and admitting that he is an unsophisticated investor, it is easy to see how some prideful people’s judgment could be clouded.

Business Reversals

Business reversals were the third area Cressey detailed as a part of the nonsharable problem. He saw these as different from personal failures, since many businesspeople consider their financial reverses as coming from conditions beyond their control: inflation, high interest rates, raising capital, and borrowing money. 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 almost get 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.’ ”*¹⁸

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Physical Isolation

The fourth category of nonsharable problems Cressey described is physical isolation, in which the person in financial straits is isolated from the people who can help him.

Status Gaining

The fifth category consists of problems relating to status gaining. Although these are easily passed off as living beyond one's means or spending money lavishly, Cressey was interested more in their behavioral implications. He noted: "The structuring of status ambitions as being nonsharable is not uncommon in our culture, and it again must be emphasized that the structuring of a situation as nonsharable 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 nonsharable when he feels that he can neither renounce his aspirations for membership in the desired group nor obtain prestige symbols necessary to such membership."¹⁹ He observed, then, that a lot of occupational offenders are afflicted with the Keeping Up with the Joneses syndrome.

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. 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 nonsharable when the individual believes that making suggestions to alleviate perceived maltreatment will possibly threaten his or her status in the organization. There is also a strong motivator for the perceived employee to want to "get even" when he or she feels ill treated.

A Personal Experience

One of my best-remembered examples involves a personal experience, and not a pleasant one. Most people—if they admit the truth—will have stolen on the job at some time in their careers. Some of the thefts are major, some minor. Some are uncovered; many never are. With this preamble (and the fact that the statute of limitations has long expired!), I will tell you the story of one employee thief: me.

The incident occurred during college. Like many of you, I didn't work my way through the university just for experience; it was a necessity. One of my part-time jobs was as a salesperson in a men's clothing store, a place I'll call Mr. Zac's. It seems that Mr. Zac had the imagination to name the store after himself, which may give you a clue as to the kind of person he was.

My first day on the job, it became clear by talking to the other employees that they strongly disliked Mr. Zac. It didn't take long to figure out why: He was cheap beyond all reason; he was sore-tempered, paranoid, and seemed to strongly resent having to pay the

employees who were generating his sales. Mr. Zac was especially suspicious of the help stealing. He always eyed the employees warily when they left in the evening, I assume because he thought their clothing and bags were stuffed with his merchandise. So his employees figured out novel ways to steal for no other reason than to get back at Mr. Zac. I was above all that, or so I thought. But then Mr. Zac did something to me personally, and my attitude changed completely.

One day I was upstairs in the storeroom getting merchandise off the top shelf. Since the high reach had pulled my shirttail out, I was standing there tucking it in when Mr. Zac walked by. He didn't say a word. I went back downstairs to work and thought no more of it. But 10 minutes later Mr. Zac called me into his small, cubbyhole office, closed the door, and asked, "What were you tucking in your pants upstairs?" Just my shirt, I replied. "I don't believe you," Mr. Zac said. "Unless you unzip your pants right now and show me, you're fired." At first, of course, it didn't register that he was serious. When it finally did, I was faced with a dilemma: Unzip my pants for the boss, or be late on the rent and face eviction. I chose the former, but as I stood there letting my pants fall down around my knees, my face burned with anger and embarrassment. Never before had I been placed in a position like this—having to undress to prove my innocence.

After seeing for himself that I didn't have any of his precious merchandise on my person, Mr. Zac sent me back to the sales floor. I was a different person, though. No longer was I interested in selling merchandise and being a good employee. I was interested in getting even, and that's what I did. Over the next few months I tried my best to steal him blind—clothing, underwear, outerwear, neckties—you name it. With the help of some of the other employees, we even stole a large display case. He never caught on, and eventually I quit the job. Was I justified in stealing from Mr. Zac? Absolutely not. At this age, given the same circumstances, would I do it again? No. But at that particular time, I was young, idealistic, very headstrong, and totally fearless. Criminologists have documented that the reason so many young people lack fear is because they do not yet realize actions can have serious consequences; it never occurred to me that I could have gone to jail for stealing from Mr. Zac.

The impact of job loyalty—or, like Mr. Zac's employees, the lack of it—is an important consideration in the occupational fraud and abuse formula. With changes in the American workforce, we may or may not experience more fraud-related problems. Much has been written recently concerning the downsizing, outsourcing, and increased employee turnover in business. If the employee of the future is largely a contract worker, much of the incentive of loyalty toward organizations could be lost. Such a trend seems to be under way, but its real fraud impact has not been determined. However, fraud is only one cost of doing business. If the outsourcing of corporate America does indeed cause more occupational fraud and abuse, the benefits of restructuring may be seen as outweighing the cost of more crime, at least in the short term. In the long run, it is difficult to justify how employees stealing from organizations can be beneficial to anyone. That was Cressey's theory, too.

Sociological Factors

Since Cressey's study was done in the early 1950s, the workforce was obviously different from today's. But the employee faced with an immediate, nonsharable financial need

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has not changed much over the years. Cressey pointed out that for the trust violator, it is necessary that he believe his financial situation can be resolved in secret. Cressey said:

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 nonsharable 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.

Although the clear conception of a financial problem as nonsharable does not invariably result in trust violation, it does establish in trusted persons a desire for a specific kind of solution to their problems. The results desired in the cases encountered were uniform: the solution or partial solution of the problem by the use of funds which can be obtained in an independent, relatively secret, safe, and sure method in keeping with the 'rationalizations' available to the person at the time.²⁰

Cressey pointed out that many of his subjects in the study mentioned the importance of resolving the problem secretly.

Cressey also discovered, by talking to his trust violators, that they did not see their positions as a point of possible abuse until after they were confronted with the nonsharable financial problem. They used words such as “it occurred to me” or “it dawned on me” that the entrusted moneys could be used to cure their vexing situations. In Cressey’s view, the trust violator must have two prerequisites: general information and technical skill. With respect to general information, the fiduciary capacity of an employee in and of itself implies that, since it is a position of trust (read: no one is checking), it can be violated.

Cressey said that in addition to general information, the trust violator must have the technical skills required to pull off the fraud in secret. He 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 nonsharable problem. . . . The statement that trusted persons must be cognizant of the fact that the entrusted funds can be used secretly to solve the nonsharable problem is based upon observations of such applications of general information to specific situations.²¹

Cressey believed that based on observations, it was difficult to distinguish which came first: the need for the funds, or the realization that they could be secretly used. In other words, did the person have a “legitimate” need for the funds before figuring out how to get his or her hands on them secretly? Or did the person see secret access to funds and find a justification to use them?

Next, Cressey delved into the inner workings of the offenders’ minds: How were they able to convince themselves that stealing was okay? He found they were able to excuse their actions to themselves by viewing their crimes in one of three ways:

1. As noncriminal
2. As justified
3. As part of a situation that the offenders do not control

These methods he generalized as “rationalizations.” In his studies, Cressey discovered that “in cases of trust violation encountered, significant rationalizations were always present before the criminal act took place, or at least at the time it took place, and, in fact, after the act had taken place the rationalization often was abandoned.”²² That is, of course, because of 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.

One of the simplest ways to justify unacceptable conduct and avoid guilt feelings is to invent a good reason for embezzling—one sanctioned in the social group as a greater good. Thus, the trust violator’s self-image, should she be discovered, must be explainable to herself and others around her.

Offender Types

For further analysis, Cressey divided the subjects into three groups:

1. Independent businessmen
2. Long-term violators
3. Absconders

He discovered that each group had its own types of rationalizations.

INDEPENDENT BUSINESSMEN

Businessmen, for example, used one of two common excuses: (1) They were “borrowing” the money that they converted, or (2) the funds entrusted to them were really theirs—you cannot steal from yourself. Cressey found the “borrowing” rationalization was the most frequently used. Many independent businessmen also expressed the belief that their practices were the rule of the day for other businesses. Nearly universally, the business owners felt their illegal actions were predicated by an “unusual situation,” which Cressey perceived to be in reality an unsharable financial problem.

LONG-TERM VIOLATORS

The long-term violators Cressey studied also generally preferred the “borrowing” rationalization. Other rationalizations of long-term violators were described, too:

1. They were embezzling to keep their families from shame, disgrace, or poverty.
2. There was a case of “necessity”; their employers were cheating them financially.
3. Their employers were dishonest toward 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” out of fear of detection. A few in the study actually kept track of their thefts, but most did so only at first. Later, as the embezzlements escalate, it is assumed that offenders would

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rather not know the extent of their “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.

Cressey noted that many of the offenders finally realized they were “in too deep.” This realization forces violators to think of the possible consequences of their actions. Cressey said the fear generated from being in over one’s head is not caused by the thought of going to jail—after all, offenders do not generally consider their conduct illegal. As Cressey observed, “The trust violator cannot fear the treatment usually accorded criminals until he comes to look upon himself as a criminal.”²³

But at some point, Cressey noted, the offenders start becoming apprehensive about the possible social connotations and, later, the criminal possibilities. A number of offenders described themselves as extremely nervous and upset, tense, and unhappy. Cressey felt that 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. If this is the situation, Cressey says that “as a result, [the offender] either (a) readopts the attitudes of the groups with which he identified before he violated the trust, or (b) he adopts the attitudes of the new category of persons (offenders) with whom he now identifies.”²⁴

ABSCONDERS

The third group of offenders Cressey discussed was “absconders”—people who take the money and run. He was able to work this group into his theory of a nonsharable financial need by describing their behavior as “isolated.” He observed:

*While among persons who abscond with entrusted funds, as among other violators, almost any problem situation may be defined as nonsharable, the problems which are nonsharable for absconders are almost always of that nature, at least in part because the person is physically isolated from other persons with whom he can share his problems. Individuals who abscond with the funds or goods entrusted to them usually are unmarried or separated from their spouses, live in hotels or rooming 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.*²⁵

Cressey says that although absconders recognize their behavior as criminal, they justify their actions by claiming their behavior is caused by outside influences beyond their control. Absconders also frequently express a don’t-care attitude. Moreover, they are more likely to claim their own personal “defects” led to their criminality.

In the 1950s, when Cressey gathered this data, embezzlers were considered

*persons of higher socioeconomic status who took money over periods of time . . . while “thieves” are persons of lower status who take whatever funds are at hand. 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.*²⁶

One of the most fundamental observations of the Cressey study was that it took all three elements—perceived motive, perceived opportunity, and the ability to rationalize—for the trust violation to occur.

Cressey concluded that

[a] trust violation takes place when the position of trust is viewed by the trusted person according to culturally provided knowledge about and rationalizations for using the entrusted funds for solving a nonsharable 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.²⁷

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 over half a century old. There has been considerable social change in the interim. And today many antifraud professionals believe there is a new breed of occupational offender—one who simply lacks 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 13 books and nearly 300 articles on criminology matters. He rose to the position of Professor Emeritus in Criminology at the University of California, Santa Barbara.

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. It 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 guy 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

Introduction

resources to find out why and how employees go bad, so that it might 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. He agreed to meet me the next time I came to California. That began what became a very close relationship between us which 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 together professionally for only 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*.

It happened like this. Don, his wife, Elaine, my wife, Judy, and I were returning from a fraud conference in Australia when we stopped over in Fiji for two days. As he and I were sitting on the beach talking, Cressey theorized that it was time for a new type of "corporate cop"—one trained in detecting and deterring the crime of the future: fraud. Cressey pointed out that the traditional policeman was ill-equipped to deal with sophisticated financial crimes, as were the traditional accountants. It was just one of many ideas he had discussed that day, but that one stuck.

Dr. W. Steve Albrecht

Not too long thereafter, I met another pioneer researcher in occupational fraud and abuse, Dr. Steve Albrecht of Brigham Young University. Unlike Cressey, Albrecht was educated as an accountant. We discussed, among other things, Cressey's vision. Albrecht agreed with Cressey—traditional accountants, he said, were ill-equipped to deal with complex financial crimes. Eventually my colleagues and I decided that this new kind of "corporate cop" would have training in four disciplines: accounting, law, investigation, and criminology. And that new corporate cop is now the certified fraud examiner (CFE).

The Albrecht Study

Steve was helpful in commencing the CFE program, and his 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 *Detering Fraud: The Internal Auditor's Perspective*. The study's methodology involved obtaining demographics and background information on the frauds through the extensive use of questionnaires. The participants in the survey were internal auditors of companies who had experienced frauds.

The study covered several areas, one of the most interesting of which concentrated on the motivations of the perpetrators of occupational frauds and abuses. They classified these motivators as one of nine different types:

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 pressure²⁸

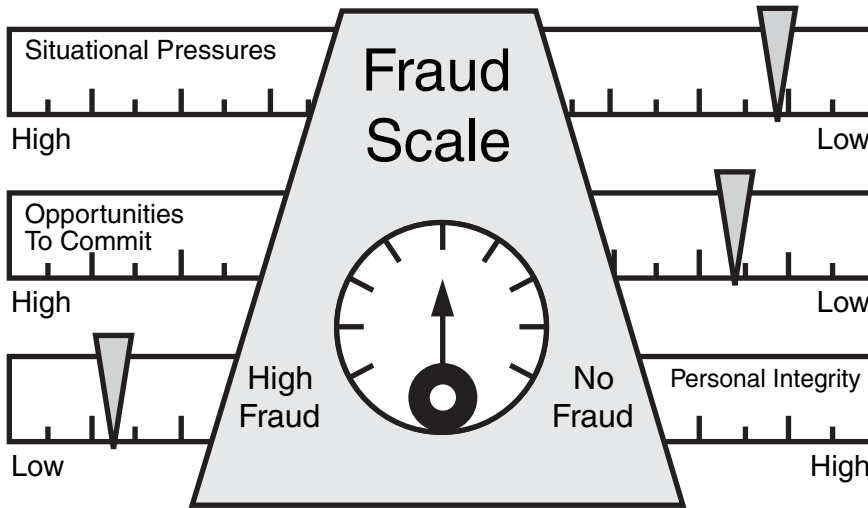
As can be seen from the list, these motivators are very similar to the nonsharable financial problems Cressey discussed. The study by Albrecht et al. also disclosed several interesting relationships between the perpetrators and the frauds they committed. For example, perpetrators of large frauds used the proceeds to purchase new homes and expensive automobiles, recreation property, and expensive vacations, to support extramarital relationships, and to make speculative investments. Those committing small frauds did not.

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.²⁹

Like Cressey’s study, the Albrecht study suggests there are three factors involved in occupational frauds: “a situational pressure (nonsharable 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.”

The Fraud Scale

To explain the concept, Albrecht developed the “Fraud Scale,” shown in Exhibit 1.2, which included the components of situational pressures, perceived opportunities, and personal integrity.³⁰ 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.³¹

Exhibit 1.2 The Fraud Scale

Source: Albrecht, Howe, and Romney, *Deterring Fraud: The Internal Auditor's Perspective*, p. 6 (Altamonte Springs: The Institute of Internal Auditors Research Foundation, 1983.)

The authors describe situational pressures as “the immediate problems individuals experience within their environments, the most overwhelming of which are probably high personal debts or financial losses.”³² Opportunities to commit fraud, Albrecht et al. say, may be created by deficient or missing internal controls—those of the employee or the company. 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.”³³

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 examined comprehensive data sources to assemble a complete list of pressure, opportunity, and integrity variables, resulting in a list of 82 possible red flags or indicators of occupational fraud and abuse. 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.³⁴

Although such red flags may be present in many occupational fraud cases, Albrecht and associates caution that the perpetrators are hard to profile and fraud is difficult to predict. To underscore this point, their research does not address—and no current research has been done to determine—if nonoffenders have many of the same characteristics. If so, then the list may not be discriminating enough to be useful. In short, while potential red flags should be noted, they should not receive undue attention absent more compelling circumstances.

Richard C. Hollinger***The Hollinger-Clark Study***

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. Their book, *Theft by Employees*, reached a different conclusion than did the work of Cressey. They concluded that employees steal primarily as a result of workplace conditions and that the true costs of the problem 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.”³⁵

Hypotheses of Employee Theft

In reviewing the literature on employee theft, Hollinger and Clark concluded that experts had developed five separate but interrelated sets of hypotheses of employee theft. The first was external economic pressures, such as the “unsharable financial problem” that Cressey described. 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 can be tempted to steal from an 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, 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 generally concluded that the fourth hypothesis was correct.

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, industrial sabotage, and even wildcat strikes. Hollinger and Clark define two basic categories of employee deviant behavior: acts by employees against property and violations of the norms regulating acceptable levels of production. The latter relates to the impact employee deviance can have on sales.

During the three-year duration of the study, Hollinger and Clark developed a written questionnaire that was sent to employees in three different sectors: retail, hospital, and manufacturing. They eventually received 9,175 valid employee questionnaires, representing about 54 percent of those sampled. The results of the questionnaires follow. Exhibit 1.3 represents property deviance only.³⁶

Exhibit 1.3 Hollinger-Clark Property Deviance

Combined Phase I and Phase II Property Deviance Items and Percentage of Reported Involvement, by Sector					
Items	Involvement				Total
	Almost Daily	About Once a Week	4 to 12 Times a Year	1 to 3 Times a Year	
<i>Retail Sector (N = 3,567)</i>					
Misuse the discount privilege	0.6	2.4	11	14.9	28.9
Take store merchandise	0.2	0.5	1.3	4.6	6.6
Get paid for more hours than were worked	0.2	0.4	1.2	4	5.8
Purposely underrring a purchase	0.1	0.3	1.1	1.7	3.2
Borrow or take money from employer without approval	0.1	0.1	0.5	2	2.7
Be reimbursed for more money than spent on business expenses	0.1	0.2	0.5	1.3	2.1
Damage merchandise to buy it on discount	0	0.1	0.2	1	1.3
Total involved in property deviance					35.1
<i>Hospital Sector (N = 4,111)</i>					
Take hospital supplies (e.g., linens, bandages)	0.2	0.8	8.4	17.9	27.3
Take or use medication intended for patients	0.1	0.3	1.9	5.5	7.8
Get paid for more hours than were worked	0.2	0.5	1.6	3.8	6.1
Take hospital equipment or tools	0.1	0.1	0.4	4.1	4.7
Be reimbursed for more money than spent on business expenses	0.1	0	0.2	0.8	1.1
Total involved in property deviance					33.3
<i>Manufacturing Sector (N = 1,497)</i>					
Take raw materials used in production	0.1	0.3	3.5	10.4	14.3
Get paid for more hours than were worked	0.2	0.5	2.9	5.6	9.2
Take company tools or equipment	0	0.1	1.1	7.5	8.7
Be reimbursed for more money than spent on business expenses	0.1	0.6	1.4	5.6	7.7
Take finished products	0	0	0.4	2.7	3.1
Take precious metals (e.g., platinum, gold)	0.1	0.1	0.5	1.1	1.8
Total involved in property deviance					28.4

Source: Adapted from Richard C. Hollinger and John P. Clark, *Theft by Employees* (Lexington, KY: Lexington Books, 1983), p. 42.

In order to empirically test whether economics had an effect on the level of theft, the researchers also sorted the data by household income, under the theory that the lower the level of income, the greater the degree of thefts. 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. But they were able to confirm that there was a statistical relationship between a person’s “concern” over his or her financial situation and the level of theft.

Exhibit 1.4 provides a summary of the Hollinger and Clark research with respect to production deviance. Not surprisingly, the most common violations were taking too long for lunch or breaks, with more than half of the employees involved in this activity.³⁷

Exhibit 1.4 Hollinger-Clark Production Deviance

Combined Phase I and Phase II Production Deviance Items and Percentage of Reported Involvement, by Sector					
Items	Involvement				Total
	Almost Daily	About Once a Week	4 to 12 Times a Year	1 to 3 Times a Year	
Retail Sector (N = 3,567)					
Take a long lunch or break without approval	6.9	13.3	15.5	20.3	56
Come to work late or leave early	0.9	3.4	10.8	17.2	32.3
Use sick leave when not sick	0.1	0.1	3.5	13.4	17.1
Do slow or sloppy work	0.3	1.5	4.1	9.8	15.7
Work under the influence of alcohol or drugs	0.5	0.8	1.6	4.6	7.5
Total involved in production deviance					65.4
Hospital Sector (N = 4,111)					
Take a long lunch or break without approval	8.5	13.5	17.4	17.8	57.2
Come to work late or leave early	1	3.5	9.6	14.9	29
Use sick leave when not sick	0	0.2	5.7	26.9	32.8
Do slow or sloppy work	0.2	0.8	4.1	5.9	11
Work under the influence of alcohol or drugs	0.1	0.3	0.6	2.2	3.2
Total involved in production deviance					69.2
Manufacturing Sector (N = 1,497)					
Take a long lunch or break without approval	18	23.5	22	8.5	72
Come to work late or leave early	1.9	9	19.4	13.8	44.1
Use sick leave when not sick	0	0.2	9.6	28.6	38.4
Do slow or sloppy work	0.5	1.3	5.7	5	12.5
Work under the influence of alcohol or drugs	1.1	1.3	3.1	7.3	12.8
Total involved in production deviance					82.2

Source: Adapted from Richard C. Hollinger and John P. Clark, *Theft by Employees* (Lexington, KY: Lexington Books, 1983), p. 45.

Hollinger and Clark presented the employees with a list of eight major concerns, from personal health, to education issues, to financial problems. “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 ‘unsharable [*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.”³⁸

The study concluded that “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.”³⁹ The researchers were unable to confirm any connection between community pressures and the level of theft.

Age and Theft

Hollinger and Clark believe there is 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.”⁴⁰ The reason, they concluded, was that younger employees had less tenure with the organization and therefore lower levels of commitment to it. “By definition,” they say, “these employees are more likely to be younger workers.”⁴¹ In addition, there is a long history of connection between many levels of crime and youths. 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.

The researchers suggest that the policy implications from the commitment to conformity theory is that, rather than subject 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.”⁴²

Hollinger and Clark were able to confirm a direct relationship between an employee’s position and the level of the theft, with those levels of theft highest in jobs with almost unrestricted access to the things of value in the work organization. Although they saw obvious connections between opportunity and theft (e.g., 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.”⁴³

Job Satisfaction and Deviance

The research of Hollinger and Clark strongly suggests that all age groups of employees who are dissatisfied with their jobs, but especially the 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. You can probably remember your own instances of “getting back” at the organization for its perceived shortcomings, as I did with Mr. Zac.

As another example, I heard a legendary story when I was in the FBI about an agent we will call Willis. Stories such as this one have a way of taking on a life of their own, and I therefore cannot vouch for its complete accuracy. At any rate, Willis was apparently attempting to arrest a fugitive when his suit was ripped to shreds. On his next expense voucher, Willis claimed \$200 for the suit. But a clerk in charge of paying the voucher for the FBI called him. “Willis,” the clerk said, “there is no way the government is going to pay you for ripping your suit—forget it.” Willis reasoned this was extremely unfair. After all, he would now have to come out-of-pocket for a new suit. This would not have been necessary were it not for his job, Willis rationalized. The clerk, however, was unimpressed.

The following month the clerk received the FBI agent's next expense voucher and examined it with a fine-tooth comb to make sure Willis didn't try again. Convinced the voucher was satisfactory, the clerk called Willis. "I'm glad to see you didn't try to claim the cost of that suit again," the clerk said. Willis reputedly replied, "That's where you're wrong. The cost of that suit is in the voucher. All you have to do is find it."

This story illustrates the same concept that Mars observed consistently among hotel dining room employees and dock workers. The employees believed that pilferage was not theft, but was "seen as a morally justified addition to wages; indeed, as an entitlement due from exploiting employers."⁴⁴ Altheide also documented that theft is often perceived by employees as a "way of getting back at the boss or supervisor."⁴⁵ From my own experience with Mr. Zac, I can verify this sentiment. 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."⁴⁶

Organizational Controls and Deviance

Try as they might, Hollinger and Clark were unable to document a strong relationship between control and deviance. 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 felt employee education as an organizational policy has a deterrent effect. Control through selection of personnel is exerted by hiring persons who will conform to organizational expectations. Inventory control is required not only for theft, but for procedures to detect errors, avoid waste, and insure 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 that "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."⁴⁷

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.

Introduction

Hollinger and Clark conclude 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.”⁴⁸

Employee Perception of Control

The researchers 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.”⁴⁹

Social control in the workplace, according to Hollinger and Clark, consists of both formal and informal social controls. The former control can be described as the internalization by the employee of the group norms of the organization; the latter, external pressures through both positive and negative sanctions. 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.”⁵⁰

Conclusion

Hollinger and Clark reached several other conclusions based on their work. First, they believe 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.”⁵¹ Second, they conclude 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 hypothesize 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.” That is, tightening controls over property deviance may create more detrimental acts affecting the productivity of the organization—if we push down employee theft, that action may push up goldbricking. Fourth, they agreed that increased management sensitivity to its employees will reduce all forms of workplace deviance. Fifth, they believe special attention should be afforded young employees, as these are the ones statistically the most likely to steal. However, although the incidence of theft is higher among younger employees, the losses are typically lower than those of more senior employees with financial authority.

Hollinger and Clark believe 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
4. Publicizing the sanctions

The researchers sum up their observations:

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.⁵²

THE 2006 REPORT TO THE NATION ON OCCUPATIONAL FRAUD AND ABUSE

In 1993, the Association of Certified Fraud Examiners began a major study of occupational fraud cases with this goal: To classify occupational frauds and abuses by the methods used to commit them. There were other objectives, too. One was to get an idea of how the professionals—the CFEs—view the fraud problems faced by their own companies. After all, they deal with fraud and abuse on a daily basis. Another goal was to gather demographics on the perpetrators: How old are they? How well educated? What percentage of offenders are men? Were there any correlations that we could identify with respect to the offenders? What about the victim companies: How large were they? What industries did they cover? For good measure, we also decided to ask the CFEs to take an educated guess—based on their experience—of how much fraud and abuse occurs within their own organizations.

Beginning in 1993, we distributed a detailed four-page questionnaire to about 10,000 certified fraud examiners, asking them to report to us the details of one fraud case they had investigated. By early 1995, 2,608 surveys had been returned for analysis, including 1,509 usable cases of occupational fraud. Although the survey design was not perfect, the sheer number of responses made it—to our knowledge—the largest such study on this subject to date. Of the cases analyzed, the total was about \$15 billion, ranging from a low of \$22 to a high of \$2.5 billion. From that survey, we developed in 1996 the first *Report to the Nation on Occupational Fraud and Abuse*. Association President Gil Geis decided that the name “Report to the Nation on Occupational Fraud and Abuse” was a bit long, so he also titled it “The Wells Report.”

Introduction

Since 1996, the ACFE has conducted three more nationwide surveys on occupational fraud. The first was in late 2001 and early 2002, when we developed a new *National Fraud Survey* to update the data from the original *Report to the Nation*. CFEs were again asked to provide information on cases they had investigated, and from this information we were able to draw conclusions about how fraud is committed, how it can be classified, and how it affects American business. The results of this study were published in the *2002 Report to the Nation on Occupational Fraud and Abuse*. The new study was more than just an updating of the original *Report to the Nation*, though. It was also an expansion of the original report; we added questions about how the schemes were detected, what antifraud measures were used by the victim organizations, and what happened to the fraudsters after they were caught. The new study was smaller—it was based on 663 reported cases of occupational fraud—but it was more focused on how fraud is committed and the measures used to combat it. The ACFE published a third edition, the *2004 Report to the Nation on Occupational Fraud and Abuse*, based on a third survey completed in 2003 and early 2004 (with only minor revisions from the 2002 survey), which yielded 508 usable cases of occupational fraud.

Our most recent survey was conducted in early 2006 and resulted in the *2006 Report to the Nation on Occupational Fraud and Abuse*. The current edition of our *Report* is based on 1,134 actual cases of occupational fraud—more than twice the number that made up the data set in our *2004 Report*. The survey was again expanded, this time to provide data about how specific methods of fraud affect various industries and also how those methods are related to particular departments or job types within organizations. The 2006 survey also included a significant change in methodology that should be noted. In past editions of the *Report*, we asked respondents to report on *any one case* they had investigated within the relevant time frame. In our 2006 survey, we asked respondents to report on *the largest case* they had investigated in the past two years. We included this criterion because we believe that in studying how fraud affects organizations, where a limited number of cases can be analyzed, it makes sense to focus on the cases that cause the most harm. However, due to this change in methodology, we did not undertake comparisons of the data from our 2006 survey with the data from our prior surveys.

Because this information is the most up-to-date data at our disposal, most of the statistical data in this book related to the ACFE's research on occupational fraud will come from the 2006 survey.

Measuring the Costs of Occupational Fraud

Participants in the *2006 National Fraud Survey* were asked what percent of gross revenues they believe—based on their personal experience and general knowledge—the typical organization in the United States loses to fraud and abuse. The median response was 5 percent, a slight decrease from the 6 percent estimated by respondents in all three previous editions of the survey. Optimistically, this reduction could be viewed as progress in the war against fraud. However, because the responses provided were only estimates, the data should not be read as a literal representation of the true rate of fraud

in U.S. organizations. Nevertheless, even at a rate of 5 percent, this estimate of the cost of fraud is astounding. If multiplied by the U.S. Gross Domestic Product—which, for 2006, is projected to be \$13.037 trillion⁵³—then the total cost to organizations in the United States exceeds \$650 billion annually. It is a staggering sum, nearly one and a half times what was budgeted for national defense in 2006. It is more than we spend on education and roads, not to mention 32 times what the federal government budgeted to fight crime in 2006.

But what does the figure really mean? It is simply the collective opinions of those who work in the antifraud field. Unfortunately, finding the actual cost of fraud may not be possible by any method. One obvious approach would be to take a scientific poll of the workforce and ask them the tough questions: Have you stolen or committed fraud against your organization? If so, how? And how much was the value of the fraud or abuse you committed? But the unlikelihood of people answering such questions candidly would make any results obtained by this method unreliable at best.

Another approach to finding the cost of fraud would be to do a scientific poll of a representative sample of organizations. Even assuming the respondents answered the poll correctly, there would still be an obvious flaw in the data: Organizations typically don't know when they are being victimized. And of course, there is the definitional issue that plagues all the methods: Where do we draw the line on what constitutes occupational fraud and abuse? So asking the experts—the approach used here—may be as reliable as anything else. But the reader must be cautioned that, by any method of estimation, the numbers on fraud and abuse are soft and subject to various interpretations.

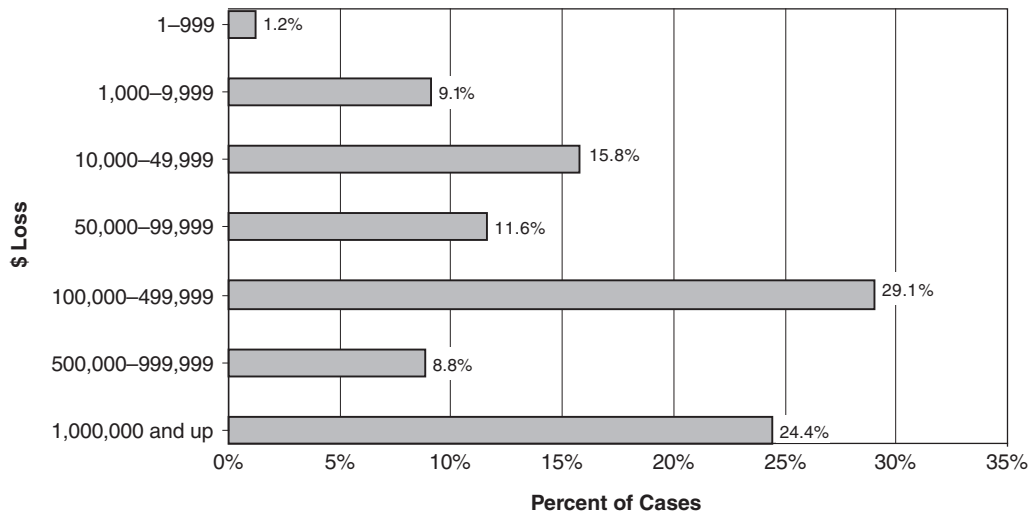
Whatever the actual costs, organizations are unwittingly paying them already as a part of their total operating expenses. Such is the insidious nature of fraud, and what to do? How can we possibly detect something we don't know about in the first place? It's as if a secret "fraud tax" has been levied on organizations. And interestingly, many organizations may silently condone fraud and abuse, which is committed from the top down. Indeed, some sociologists see abuse as an informal employment benefit, and have even suggested that chronic pilferage and certain other abuses might actually have a positive effect on morale and therefore increase productivity.⁴⁹

Losses Reported in the 2006 National Fraud Survey

As was stated earlier, the 2006 survey yielded 1,134 usable cases of occupational fraud for our study. Among those cases, the median loss experienced by the victim organizations was \$159,000. Exhibit 1.5 illustrates the distribution of all losses. Note that nearly one-fourth of the cases in the study (24.4%) caused losses of \$1 million or more. Although not shown in the chart as a separate category, there were nine cases with reported losses of at least \$1 billion.

The Perpetrators of Fraud

By definition, the perpetrators of occupational fraud are employed by the organization they defraud. Participants in the 2006 survey provided information on the perpetrators'

Exhibit 1.5 2006 National Fraud Survey: Distribution of Losses

position, gender, age, education, tenure, and criminal histories. In cases where there was more than one perpetrator, respondents were asked to provide data on the *principal perpetrator*, which was defined as the person who worked for the victim organization and who was the primary culprit.

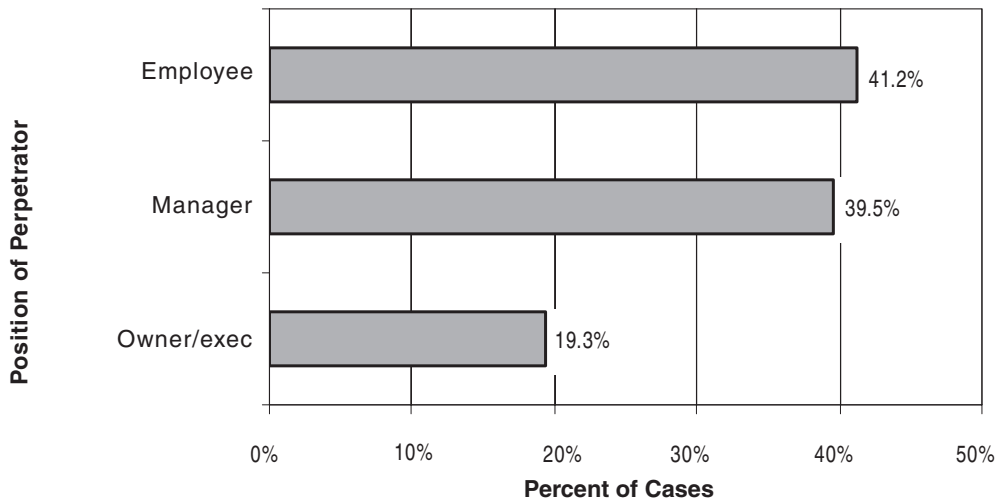
The Effect of the Perpetrator's Position

Personal data gathered about the perpetrators indicated that most of the frauds in this study were committed by either employees (41.2%) or managers (39.5%). Owner/executives made up less than one-fifth of the perpetrators. (See Exhibit 1.6.)

Although the highest percentage of schemes was committed by employees, these frauds had the lowest median loss, at \$78,000 per incident. Frauds committed by managers caused median losses of \$218,000 per incident, while the median loss in schemes committed by owner/executives was \$1,000,000. This figure is almost 13 times higher than the typical loss in employee schemes. The differences in the loss amounts were most likely a result of the degree of financial control exercised at each level: Those with the highest positions also have the greatest access to company funds and assets. (See Exhibit 1.7.)

The Effect of Gender

The 2006 National Fraud Survey showed that male employees caused median losses more than twice as large as those of female employees; the median loss in a scheme

Exhibit 1.6 2006 National Fraud Survey: Percentage of Cases by Position

caused by a male employee was \$250,000, while the median loss caused by a female employee was \$102,000. (See Exhibit 1.8.) The most logical explanation for this disparity seems to be the “glass ceiling” phenomenon. Generally, in the United States, men occupy higher-paying positions than their female counterparts. And, as we have seen, there is a direct correlation between median loss and position.

According to our survey data, as shown in Exhibit 1.9, males are also the principal perpetrator in a majority of cases, accounting for 61 percent of frauds in our study versus 39 percent in which a female was the primary culprit.

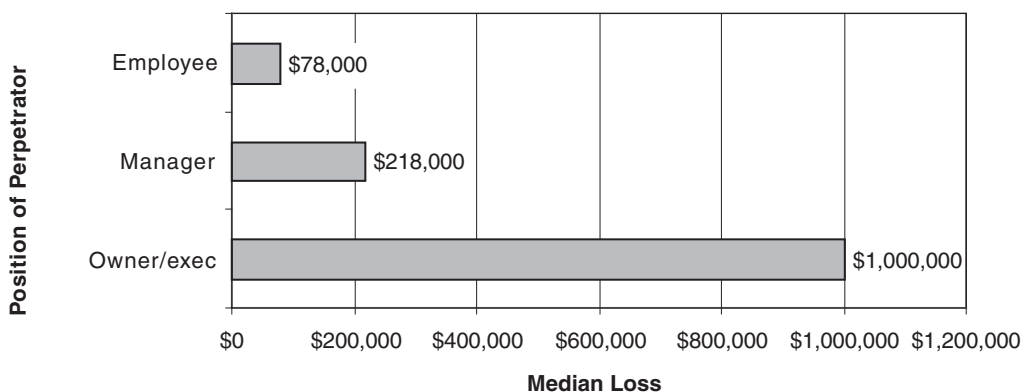
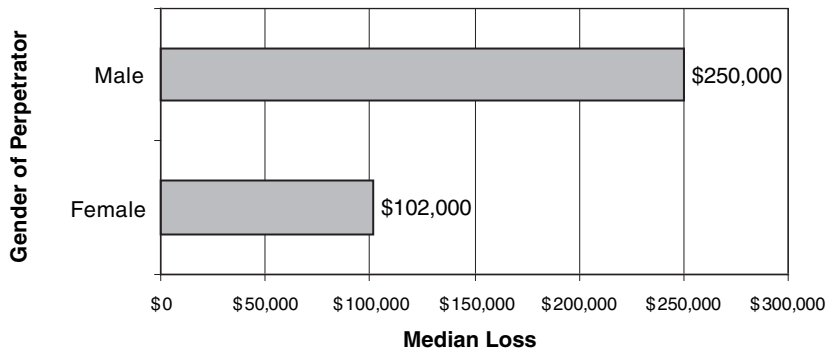
Exhibit 1.7 2006 National Fraud Survey: Median Loss by Position

Exhibit 1.8 2006 National Fraud Survey: Median Loss by Gender



The Effect of Age

One of the most noticeable trends of our 2006 survey was the direct and linear correlation between age and median loss, shown in Exhibit 1.10. The reason for the trend, we believe, is that those in an organization who are older generally tend to occupy higher-ranking positions with greater access to revenues, assets, and resources. In other words, we believe age to be only a secondary factor to that of position as a predictor of relative fraud losses.

Those in the oldest age group were responsible for median losses almost 29 times higher than the youngest perpetrators. Furthermore, although some studies, including Hollinger-Clark, have suggested that younger employees are more likely to commit occupational crime, only 6 percent of the frauds in our 2006 study were committed by

Exhibit 1.9 2006 National Fraud Survey: Percent of Cases by Gender

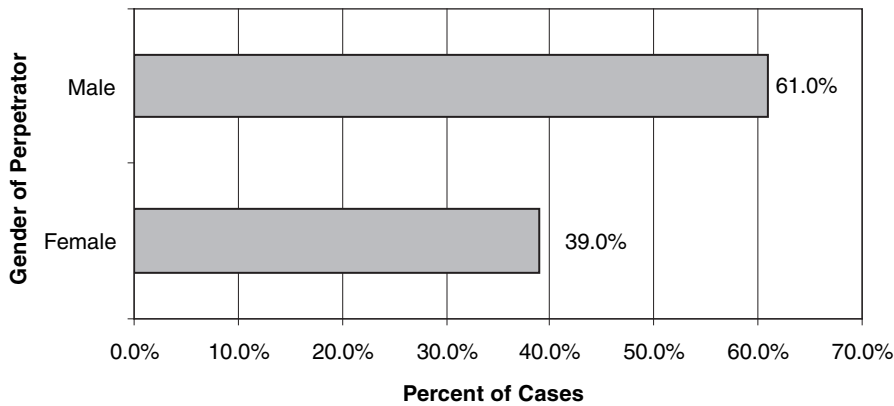
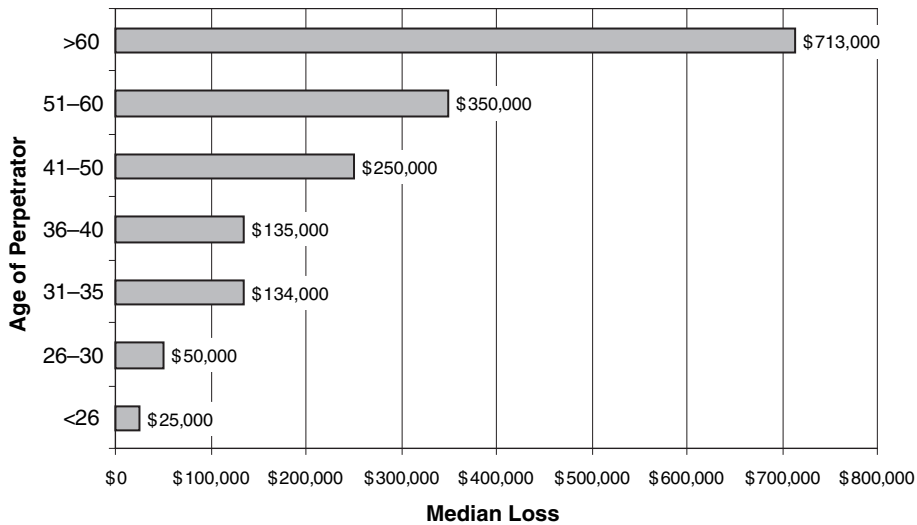
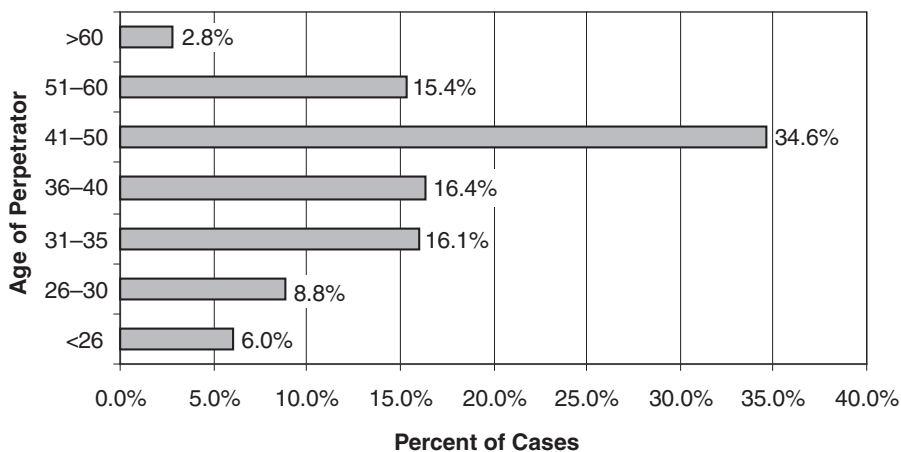


Exhibit 1.10 2006 National Fraud Survey: Median Loss by Age

individuals below the age of 26, while over 52 percent of the frauds were committed by persons over the age of 40. (See Exhibit 1.11.)

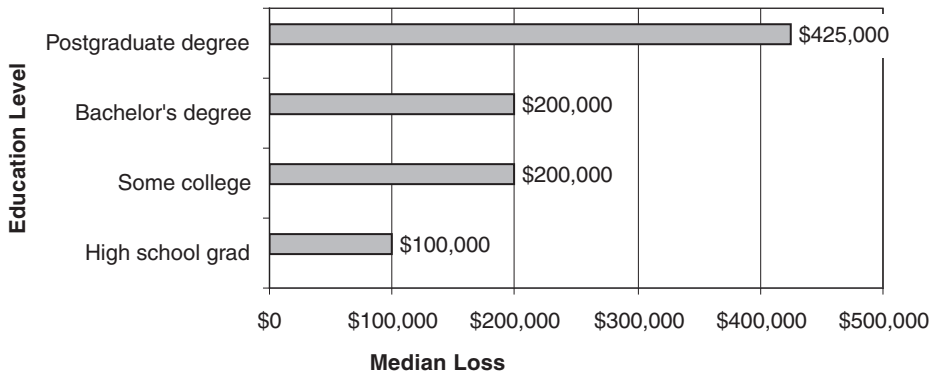
The Effect of Education

In general, those with higher education levels would be expected to occupy higher positions in an organization and to have greater access to organizational assets. Therefore,

Exhibit 1.11 2006 National Fraud Survey: Percent of Cases by Age

Introduction

Exhibit 1.12 2006 National Fraud Survey: Median Loss by Education



we expected a fairly linear correlation between education and median loss. This was evident in our 2006 study, as is shown by Exhibit 1.12. Fraudsters with only a high school education caused median losses of \$100,000, but that figure doubled for perpetrators who had an undergraduate education. The median loss caused by those with postgraduate degrees was \$425,000. (See Exhibit 1.13.)

The Effect of Collusion

It was not surprising to see that in cases involving more than one perpetrator, fraud losses rose substantially. The majority of 2006 survey cases (60.3%) involved only a

Exhibit 1.13 2006 National Fraud Survey: Percent of Cases by Education

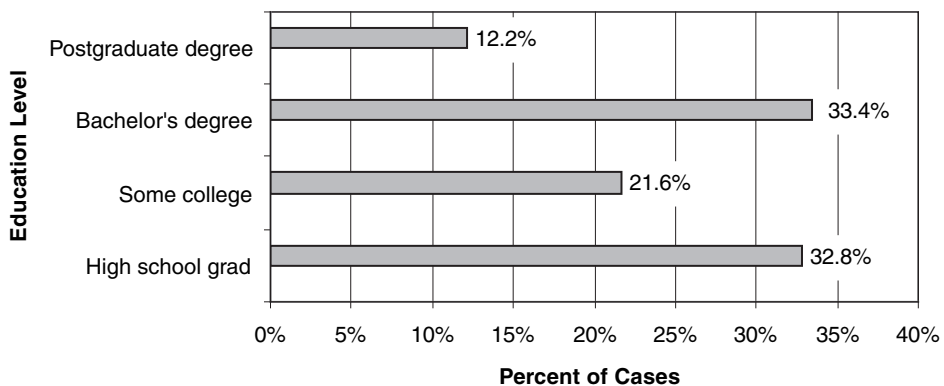
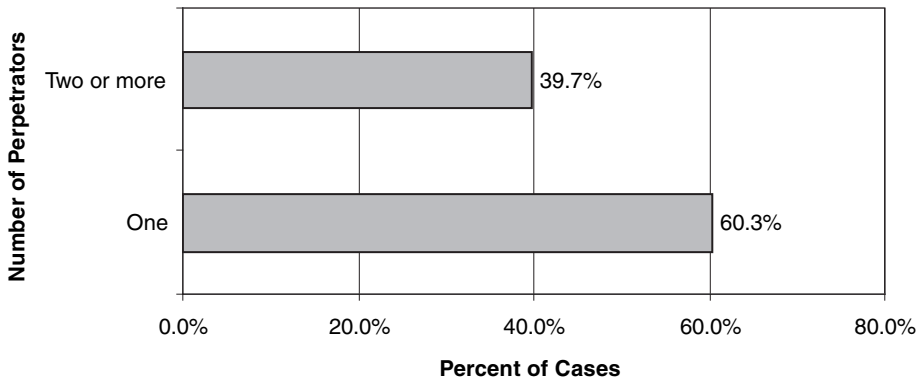


Exhibit 1.14 2006 National Fraud Survey: Percent of Cases by Number of Perpetrators

single perpetrator, but when two or more persons conspired, the median loss more than quadrupled. (See Exhibits 1.14 and 1.15.)

The Effect of Tenure

The 2006 survey revealed a direct correlation between the length of time an employee had been employed by a victim organization and the size of the loss in the case. Employees who had been with the victim for ten years or more caused median losses of \$263,000, whereas employees who had been with their employers for one year or less

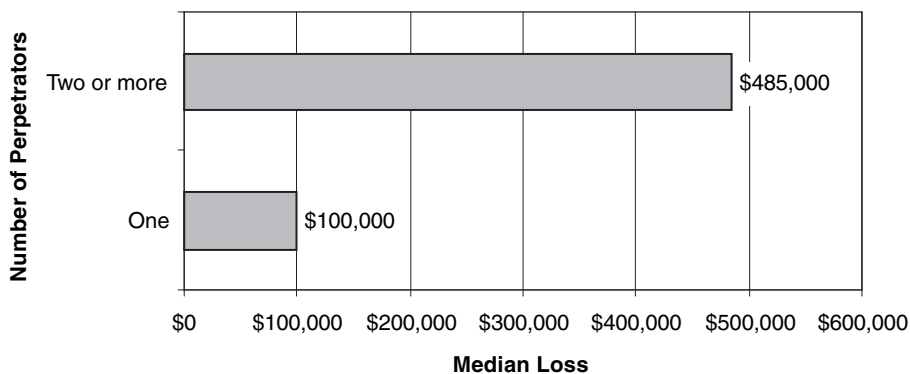
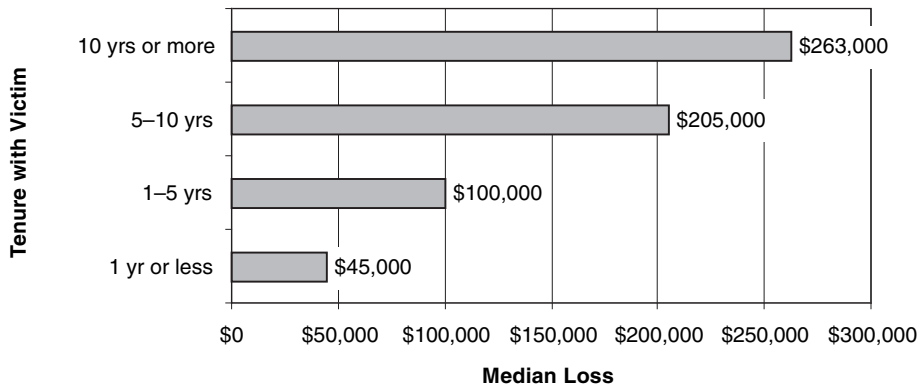
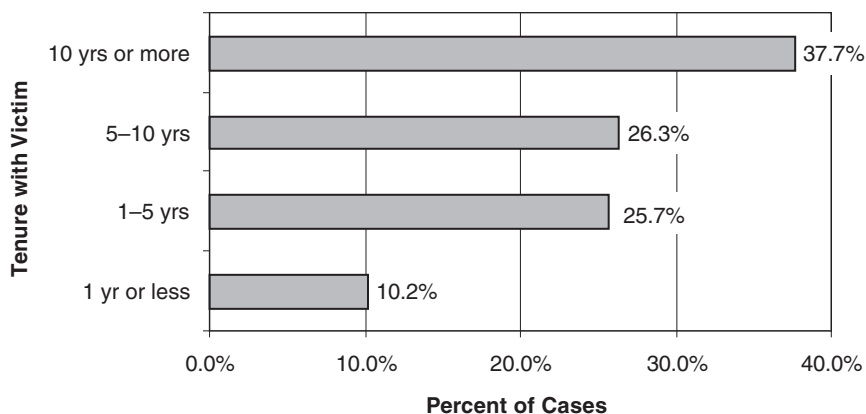
Exhibit 1.15 2006 National Fraud Survey: Median Loss by Number of Perpetrators

Exhibit 1.16 2006 National Fraud Survey: Median Loss by Years of Tenure

caused median losses of \$45,000. Additionally, employees with longer tenure were involved in a greater percentage of fraud cases than their more recently hired counterparts. We believe that both of these trends may be linked, at least in part, to the increased trust and organizational familiarity gained by employees with longer tenure. (See Exhibits 1.16 and 1.17.)

Criminal History of the Perpetrators

Only approximately 8 percent of the perpetrators identified in the 2006 study were known to have been convicted of a previous fraud-related offense. Another 4 percent of

Exhibit 1.17 2006 National Fraud Survey: Percent of Cases by Years of Tenure

the perpetrators in the 2006 survey had previously been charged but never convicted. These figures are consistent with other studies that have shown that most people who commit occupational fraud are first-time offenders. It is also consistent with Cressey's model, in which occupational offenders do not perceive themselves as lawbreakers. (See Exhibit 1.18.)

The Victims

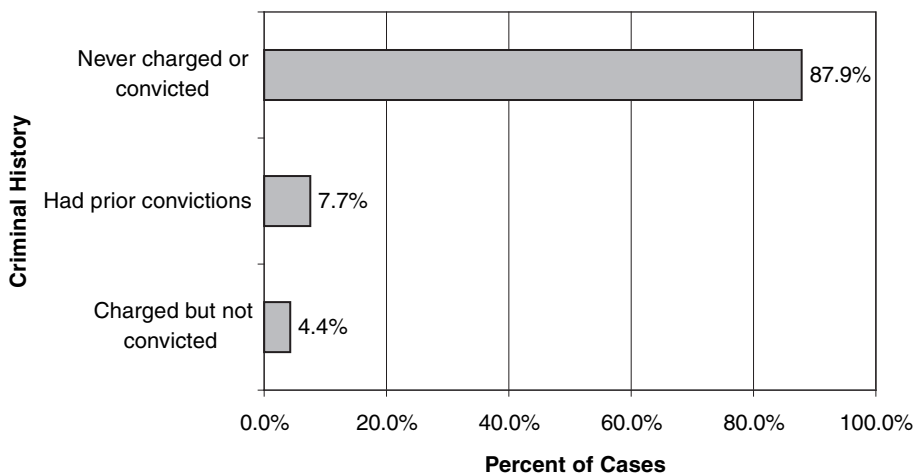
The victims of occupational fraud are organizations that are defrauded by those they employ. Our 2006 survey asked respondents to provide information on, among other things, the size and type of organizations that were victimized, as well as the antifraud measures those organizations had in place at the time of the frauds.

Type of the Victim Organization

Most of the cases in the 2006 *National Fraud Survey* involved victims that were privately held companies (36.8%), while not-for-profit organizations had the lowest representation (13.9%). It should be noted that we made no effort to obtain a random sample of business organizations; the *Report* was based on a survey of U.S. certified fraud examiners and so the demographics of the organizations that were victimized depended in large measure on the organizations that retain CFEs. (See Exhibit 1.19.)

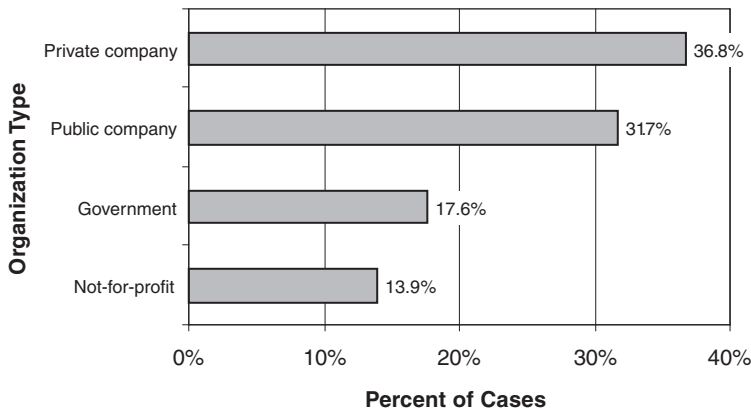
Our study revealed that privately held and publicly traded companies were not only the most heavily represented organization types; they also suffered the largest losses, at \$210,000 and \$200,000 respectively. Losses in government and not-for-profit organizations were about half as much, at \$100,000. (See Exhibit 1.20.)

Exhibit 1.18 2006 National Fraud Survey: Percent of Cases by Criminal History



Introduction

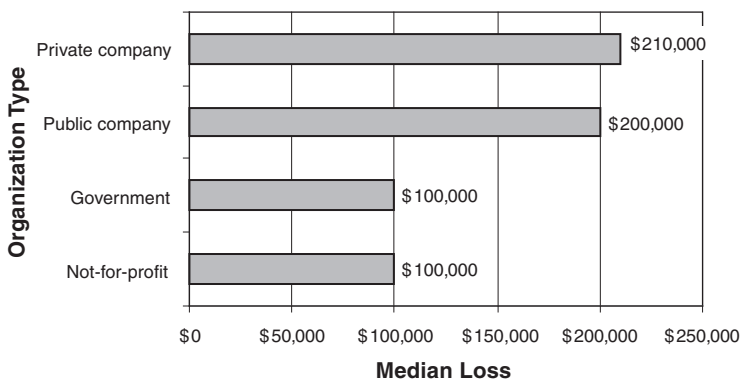
Exhibit 1.19 *2006 National Fraud Survey: Percent of Cases by Organization Type*



Size of the Victim Organization

The data for median loss per number of employees confirms what we always suspected, but did not know quantitatively. Accountants would logically conclude that small organizations, those with 100 employees or less, are particularly vulnerable to occupational fraud and abuse. The results from the *National Fraud Survey* bear this out, as losses in the smallest companies were larger than those in the organizations with the most employees. We theorize that this phenomenon exists for two reasons. First, smaller businesses have fewer divisions of responsibility, meaning that fewer people must perform more functions. One of the most common types of fraud encountered in these studies involved small business operations that had a one-person

Exhibit 1.20 *2006 National Fraud Survey: Median Loss by Organization Type*



accounting department—that employee writes checks, reconciles the accounts, and posts the books. An entry-level accounting student could spot the internal control deficiencies in that scenario, but apparently many small business owners cannot or do not.

Which brings up the second reason we believe losses are so high in small organizations: There is a greater degree of trust inherent in a situation where everyone knows each other by name and face. Who of us would like to think our co-workers would or do commit these offenses? As a result, our defenses are naturally relaxed. There again is the dichotomy of fraud: It cannot occur without trust, but neither can commerce. Trust is an essential ingredient at all levels of business—we can and do make handshake deals every day. Transactions in capitalism simply cannot occur without trust. The key is seeking the right balance between too much and too little. (See Exhibits 1.21 and 1.22.)

The Impact of Antifraud Measures on Median Loss

CFEs who participated in our national fraud surveys were asked to identify which, if any, of five common antifraud measures were utilized by the victim organizations *before* the reported frauds occurred: The antifraud measures tested for were: surprise audits, anonymous reporting mechanisms (such as hotlines), fraud awareness or ethics training, internal audits or internal fraud examination departments, and external audits. We measured the median loss and length of time it took to discover the fraud depending on whether each antifraud measure was or was not in place (excluding all other factors).

We found that surprise audits, anonymous reporting mechanisms, and fraud training measures—the three least implemented antifraud measures—were also the most effective mechanisms for reducing the cost and duration of fraud schemes. Organizations without these mechanisms in place reported frauds that cost twice as much and lasted

Exhibit 1.21 2006 National Fraud Survey: Percent of Cases by Number of Employees

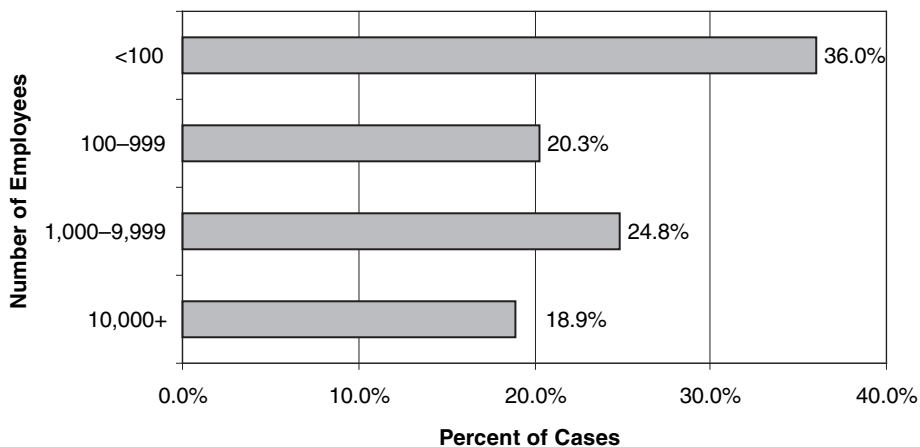
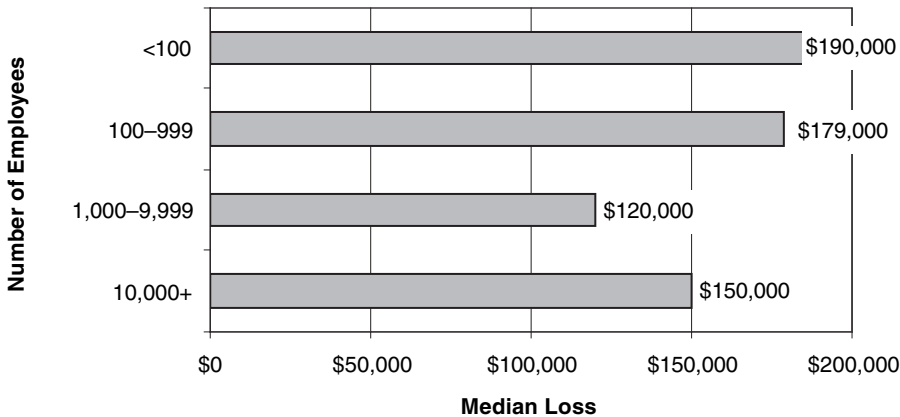


Exhibit 1.22 2006 National Fraud Survey: Median Loss per Number of Employees



60 percent longer than organizations with any one of these mechanisms in place at the time of the fraud.

Conversely, the most common antifraud measure was the external audit, utilized by approximately three-fourths of the victims. Despite the fact that this was the most frequently used antifraud measure, external audits showed the least impact on median losses and time to detection, under our test. In fact, the organizations that had external audits actually had *higher* median losses and *longer lasting* fraud schemes than those organizations that were not audited. Of course, there are a number of other factors that help determine the duration of the fraud and the size of the loss an organization suffers, but the fact remains that of all of the antifraud measures for which we tested, only external audits showed an inverse relationship with median loss and scheme length. (See Exhibit 1.23.)

Case Results

A common complaint among those who investigate fraud is that organizations and law enforcement do not do enough to punish fraud and other white-collar offenses. This contributes to high fraud levels—or so the argument goes—because potential offenders are not deterred by the weak or often nonexistent sanctions that are imposed on other fraudsters. Leaving aside the debate as to what factors are effective in deterring fraud, we sought to measure how organizations responded to the employees who had defrauded them.

Employment Actions Taken against Perpetrator

Generally speaking, the most direct method by which victim organizations can deal with fraud perpetrators is through adverse employment decisions such as firing the

Exhibit 1.23 2006 National Fraud Survey: Impact of Antifraud Measures on Median Loss

	Percent of Cases	Median Loss	Length of Scheme (in months)
Surprise Audits			
Yes	29.2	\$100,000	15
No	70.8	\$200,000	24
Hotline			
Yes	45.2	\$100,000	15
No	54.8	\$200,000	24
Fraud Training			
Yes	45.9	\$100,000	15
No	54.1	\$200,000	24
Internal Audit			
Yes	59.0	\$120,000	18
No	41.0	\$218,000	24
External Audit			
Yes	75.4	\$181,000	23
No	24.6	\$125,000	18

perpetrator, placing him on probation, and so on. In our survey, we asked respondents to indicate what adverse employment actions the victims in their cases took against the perpetrators.

Not surprisingly, the most common response by victims was to terminate the perpetrator, which occurred in 83 percent of the cases we reviewed. (This does not mean that the perpetrators in the other 17 percent of the cases were allowed to keep working for the victim organizations. In many cases, the perpetrator quit or disappeared before the fraud was discovered, or immediately thereafter, before the victim organization had any opportunity to take action). (See Exhibit 1.24.)

Criminal Referrals

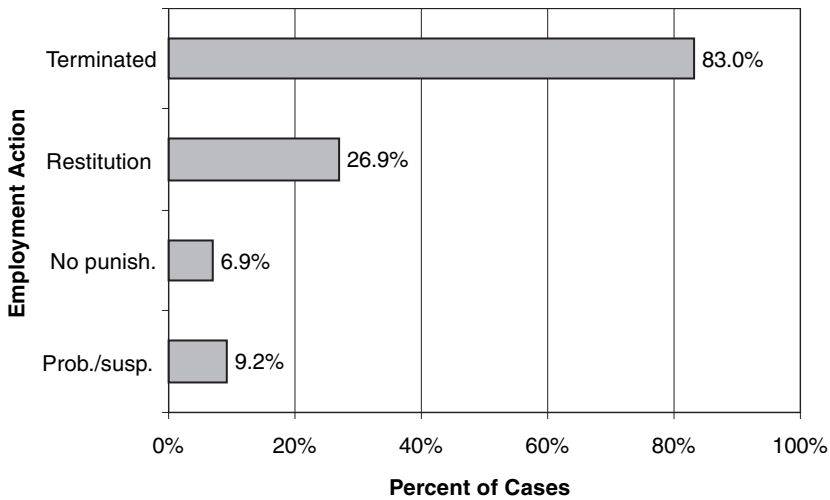
Of the 1,072 CFEs who provided information about criminal referrals, almost 71 percent said that the victim organization referred their case to law enforcement. This figure was higher than might have been expected given frequent anecdotal evidence suggesting that organizations historically have been reluctant to have fraud perpetrators prosecuted. (See Exhibit 1.25.)

The median dollar loss in cases that were reported to law enforcement authorities was twice as high as the median loss in unreported cases, indicating that smaller frauds are more likely to go unreported. However, even in cases that did not get referred to law enforcement, the median loss was still considerable, at \$100,000. (See Exhibit 1.26.)

There were 684 cases referred to law enforcement in our 2006 study in which the respondents were able to provide information on the outcome of the cases. Almost half of these cases were still pending at the time of our study. Among cases that had reached their conclusion, the most common outcome was for the perpetrator to plead guilty or no

Introduction

Exhibit 1.24 2006 National Fraud Survey: Employment Actions against Perpetrators



Note: The sum of percentages in this chart exceeds 100% because some respondents reported more than one action taken against the perpetrator.

Exhibit 1.25 2006 National Fraud Survey: Percent of Cases by Criminal Referral Status

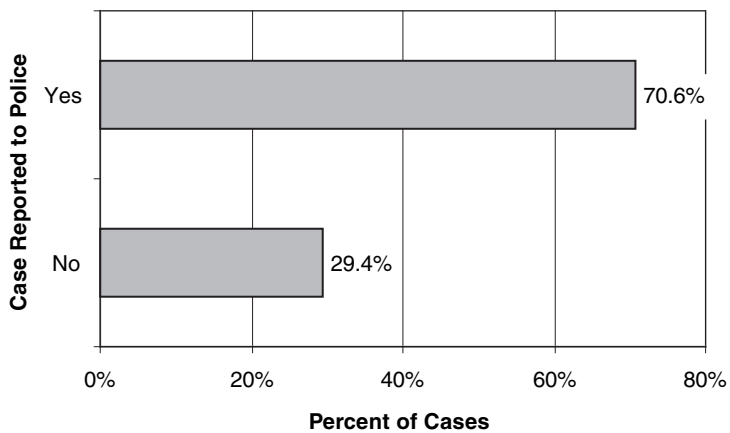
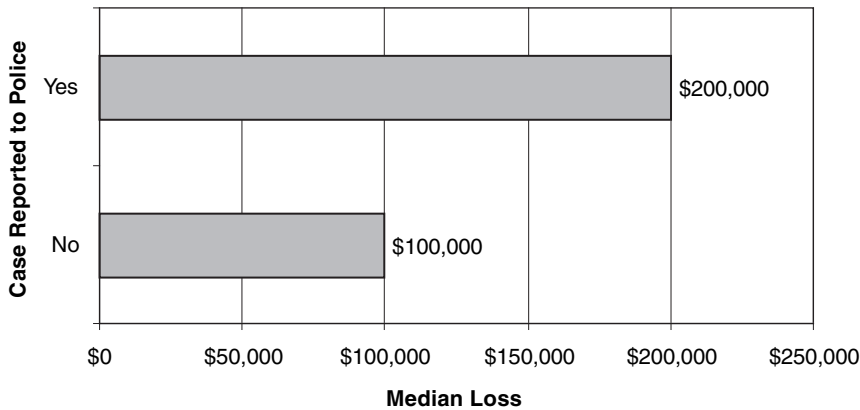
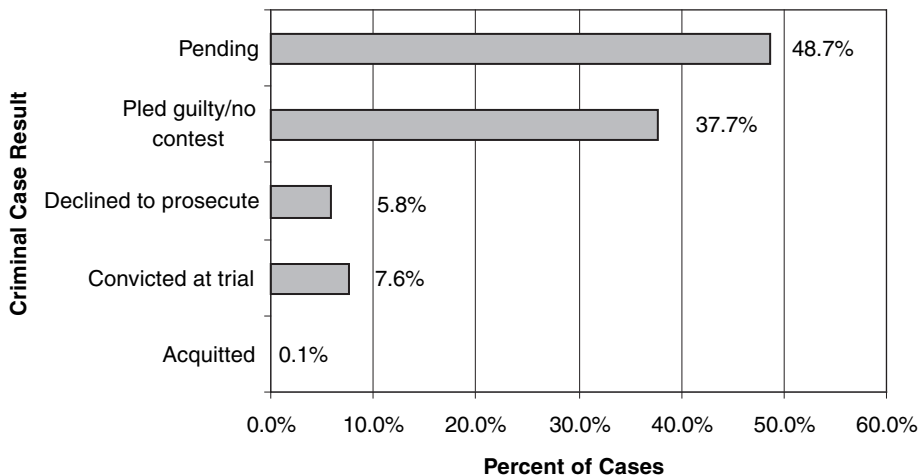


Exhibit 1.26 2006 National Fraud Survey: Median Loss by Criminal Referral Status

contest. This occurred in nearly 38 percent of the referred cases. Another 8 percent of perpetrators were convicted at trial, while less than 1 percent (only one perpetrator) was acquitted. In 6 percent of cases the state declined to prosecute the offense. Anecdotal evidence had suggested this number would be higher. (See Exhibit 1.27.)

Civil Suits

Civil suits were a much less common response to occupational fraud than were criminal referrals. This was to be expected. A civil lawsuit can be very costly for an organization

Exhibit 1.27 2006 National Fraud Survey: Results of Criminal Referrals

Introduction

to undertake, both in terms of money and time spent. In addition, even if a civil lawsuit is successful, there is no guarantee that the organization will be able to recover whatever judgment it receives. Fraudsters frequently squander the proceeds of their crimes, and thus are unable to pay back what they have stolen, even if required to by a court order. For these reasons, many organizations are very reluctant to go to civil court to try to recover their losses.

In our study, 940 CFEs responded to questions about civil lawsuits against occupational fraudsters. We found that the victim organizations sued the fraudsters in only 24 percent of these cases. Not surprisingly, the civil suits were generally associated with high-dollar frauds where the benefit of potential recovery presumably outweighed the costs of litigation. The median loss in cases that resulted in a civil lawsuit was \$1,200,000, as opposed to a median loss of \$100,000 in those that did not. (See Exhibits 1.28 and 1.29.)

When victim organizations did initiate civil lawsuits, they had a good success rate. There were 238 cases in our study in which we received information about the outcome of civil suits. Over 60 percent of those cases were still pending at the time of our survey, but of the remaining 91 cases, the victim won a judgment in 54, while there were only 2 judgments in favor of the perpetrator. In the other 35 cases the parties settled out of court. (See Exhibit 1.30.)

No Legal Action Taken

One goal of our study was to try to determine why organizations *decline* to take legal action against occupational fraudsters. In cases where no legal action was taken, we provided respondents with a list of commonly cited explanations and asked them to mark any that applied to their case. Exhibit 1.31 summarizes the results. The most commonly cited reason was fear of bad publicity. The fact that a private settlement

Exhibit 1.28 2006 National Fraud Survey: Percent of Cases by Civil Suit

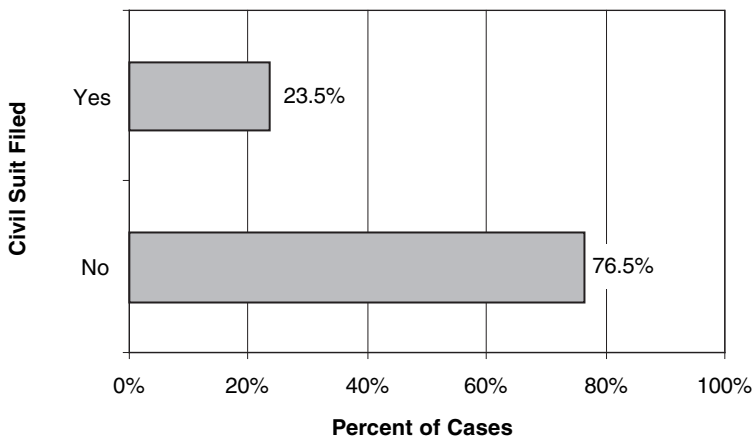
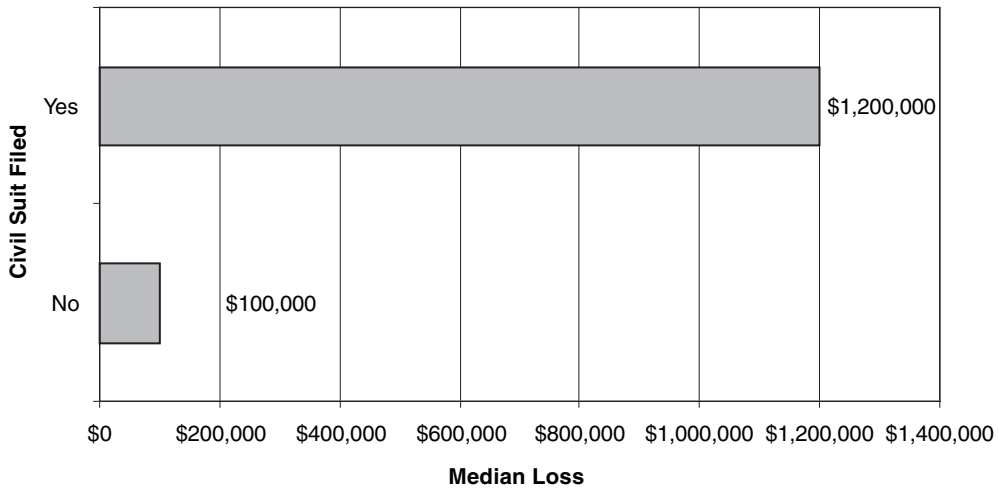


Exhibit 1.29 2006 National Fraud Survey: Median Loss Based on Whether Civil Lawsuit Was Filed

was reached, and the fact that the organization considered its internal discipline to be sufficient, were also both cited in over 30 percent of the nonreferred cases.

Victims' Recovery

When an organization has been victimized by occupational fraud, generally the organization's most pressing goal is to recover what was lost. Unfortunately, in 42 percent of

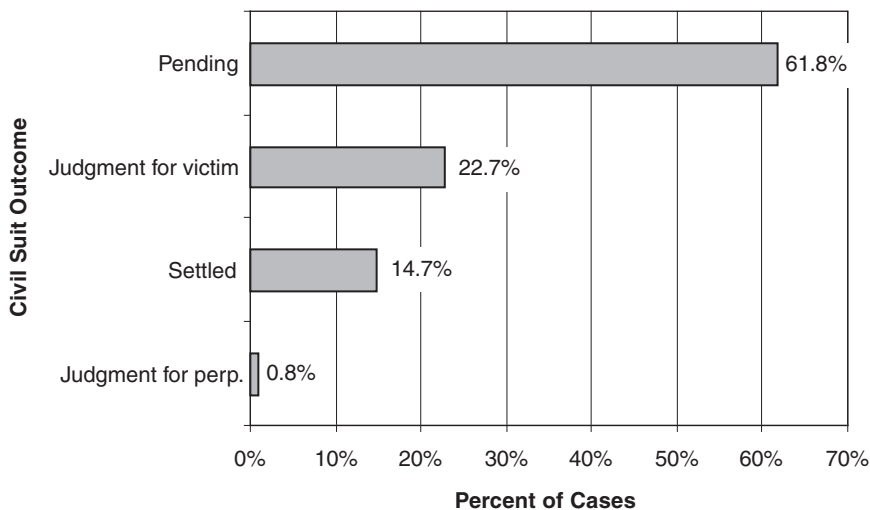
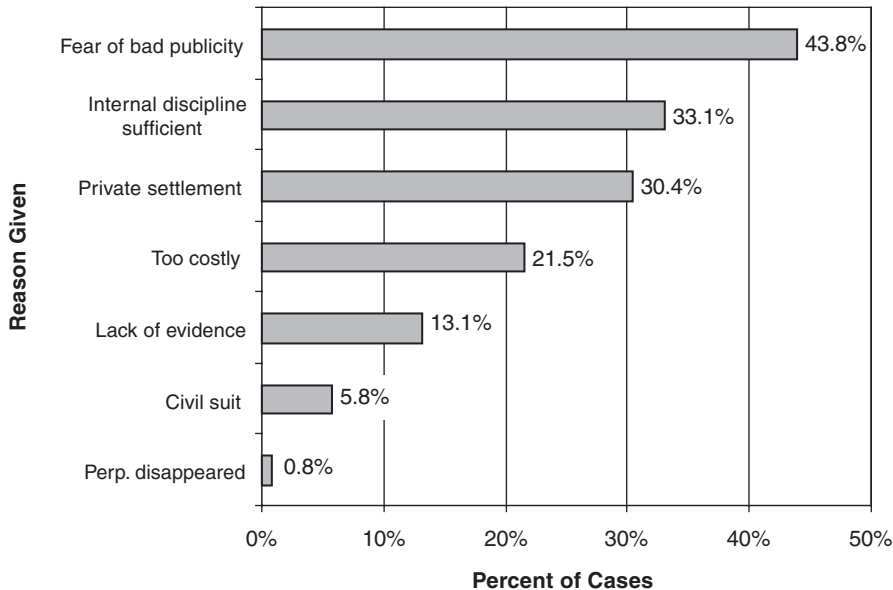
Exhibit 1.30 2006 National Fraud Survey: Results of Civil Lawsuits

Exhibit 1.31 2006 National Fraud Survey: Reasons for Declining to Take Legal Action



Note: The sum of percentages in this chart exceeds 100% because some respondents cited more than one reason for why victim organizations declined to prosecute.

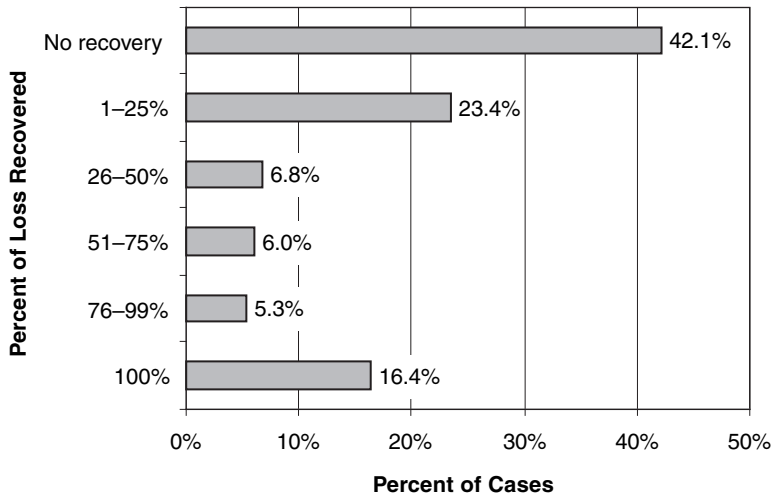
the cases that were reported in our 2006 study, the victim recovered nothing. On the other hand, over 16 percent of the victims made a full recovery, usually through their insurance. (See Exhibit 1.32.)

Detecting and Preventing Occupational Fraud

Initial Detection of Frauds

The obvious question in a study of occupational fraud is: What can be done about it? Given that our study was based on actual fraud cases that had been investigated, we thought it would be instructional to ask how these frauds were initially detected by the victim organizations. Perhaps by studying how the victim organizations had uncovered fraud, we would be able to provide guidance to other organizations on how to tailor their fraud-detection efforts. Respondents were given a list of common detection methods and were asked how the frauds they investigated were initially detected. As these results show, the frauds in our study were most commonly detected by *tip* (34.2%).

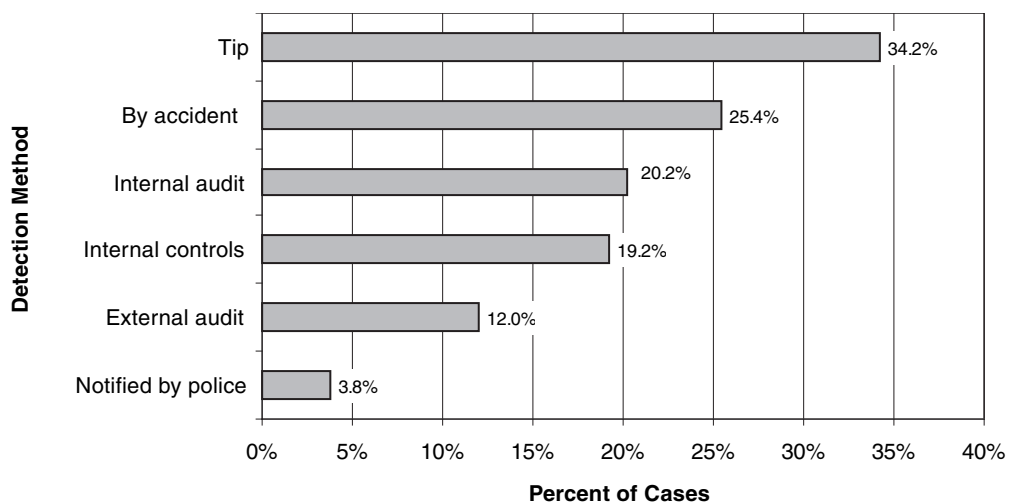
Unfortunately, as shown earlier, the majority of fraud victims did not have established reporting structures in place at the time they were defrauded. It is also interesting—and rather disconcerting—to note that *accident* was the second most common detection method, accounting for over a quarter of the frauds in our survey. This certainly seems

Exhibit 1.32 2006 National Fraud Survey: Recovery of Victims' Losses

to support the contention that organizations need to do a better job of actively seeking out fraud. (See Exhibit 1.33.)

The Methods

The principal goal of the first *Report to the Nation* was to classify occupational frauds and abuses by the methods used to commit them. As a result of the 1996 study we were able to develop a classification system known informally as the *Fraud Tree* (see page 46) that

Exhibit 1.33 2006 National Fraud Survey: Initial Detection of Frauds

Note: The sum of percentages in this chart exceeds 100% because in some cases respondents identified more than one detection method.

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accounts for most, if not all, of the most common occupational fraud and abuse schemes. We tested the structure of the fraud tree against the cases in the 2002, 2004, and 2006 *National Fraud Surveys* to make sure that our classification system accounted for every scheme that was reported. Between the four studies, we have applied the Fraud Tree classification system to well over 3,600 cases of fraud and have found that it has covered them all.

By classifying and categorizing occupational frauds, we are able to study these crimes in more detail. Instead of lumping every case under the general heading of “fraud,” we observe discrete groups of frauds with similar characteristics in order to learn what methods are most commonly used to commit occupational fraud and what schemes tend to cause the biggest losses. Also, by comparing schemes in well-defined categories, we can identify common methods used by the perpetrators and common vulnerabilities in the victim organizations that allowed these frauds to succeed. This in turn should help in the development of better, more efficient antifraud tools.

According to the Fraud Tree, there are three major categories of occupational fraud:

- *Asset misappropriations*, which involve the theft or misuse of an organization’s assets. (Common examples include skimming revenues, stealing inventory, and payroll fraud.)
- *Corruption*, in which fraudsters wrongfully use their influence in a business transaction in order to procure some benefit for themselves or another person, contrary to their duty to their employer or the rights of another. (Common examples include accepting kickbacks, and engaging in conflicts of interest.)
- *Fraudulent statements*, which involve purposeful misreporting of financial information about the organization that is intended to mislead those who read it. (Common examples include overstating revenues and understating liabilities or expenses.)

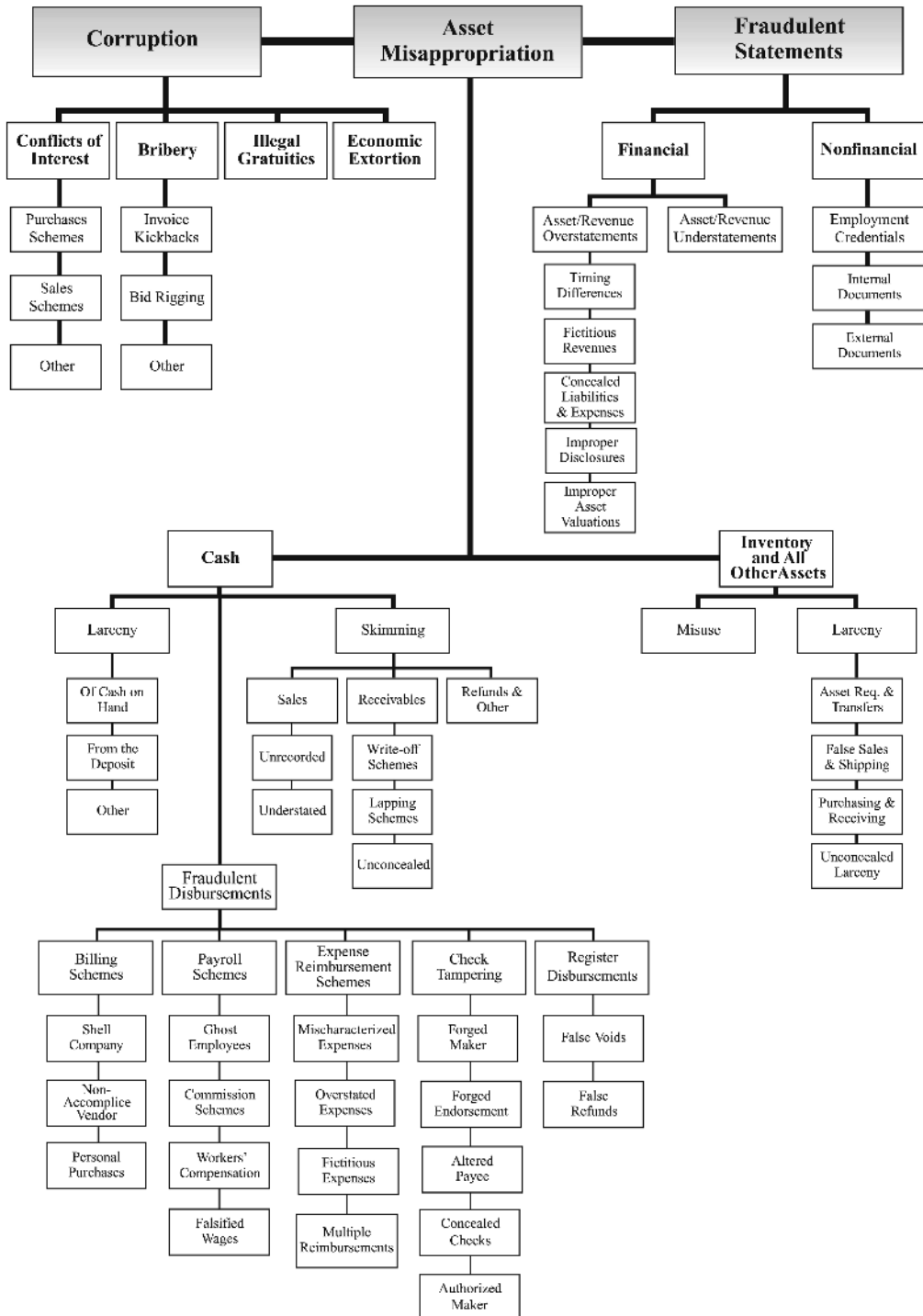
The data from our study on frequency and median loss for the three major occupational fraud categories are presented in Exhibit 1.34. Asset misappropriations made up over 90 percent of the cases encountered, but were by far the least costly in terms of median loss. Meanwhile, fraudulent statements were the least common, accounting for only 10 percent of cases, but they caused far greater harm, on average, than schemes in the other two categories. Corruption schemes were the “middle children” of the study; they were more common than fraudulent statements, and more costly than asset misappropriations.

Exhibit 1.34 2006 National Fraud Survey: Major Occupational Fraud Categories

Scheme Type	Percent of Cases	Median Cost
Asset Misappropriations	91.5	\$150,000
Corruption Schemes	30.8	\$538,000
Fraudulent Statements	10.6	\$2,000,000

Note: The sum of percentages in this chart exceeds 100% because some cases involved multiple fraud schemes that fell into more than one category. The same is true for every scheme classification chart in this book based on the 2006 *National Fraud Surveys*.

Occupational Fraud and Abuse



Introduction

Within each of the three major categories there are several subcategories of fraud scheme types. In coming chapters we will address each of these subcategories in turn, looking at research on their costs and effects, identifying how the schemes are committed, and discussing how organizations can defend against them.

NOTES

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52. Ibid., p. 146.
53. Based on U.S. Commerce Department first quarter 2006 GDP growth estimate.