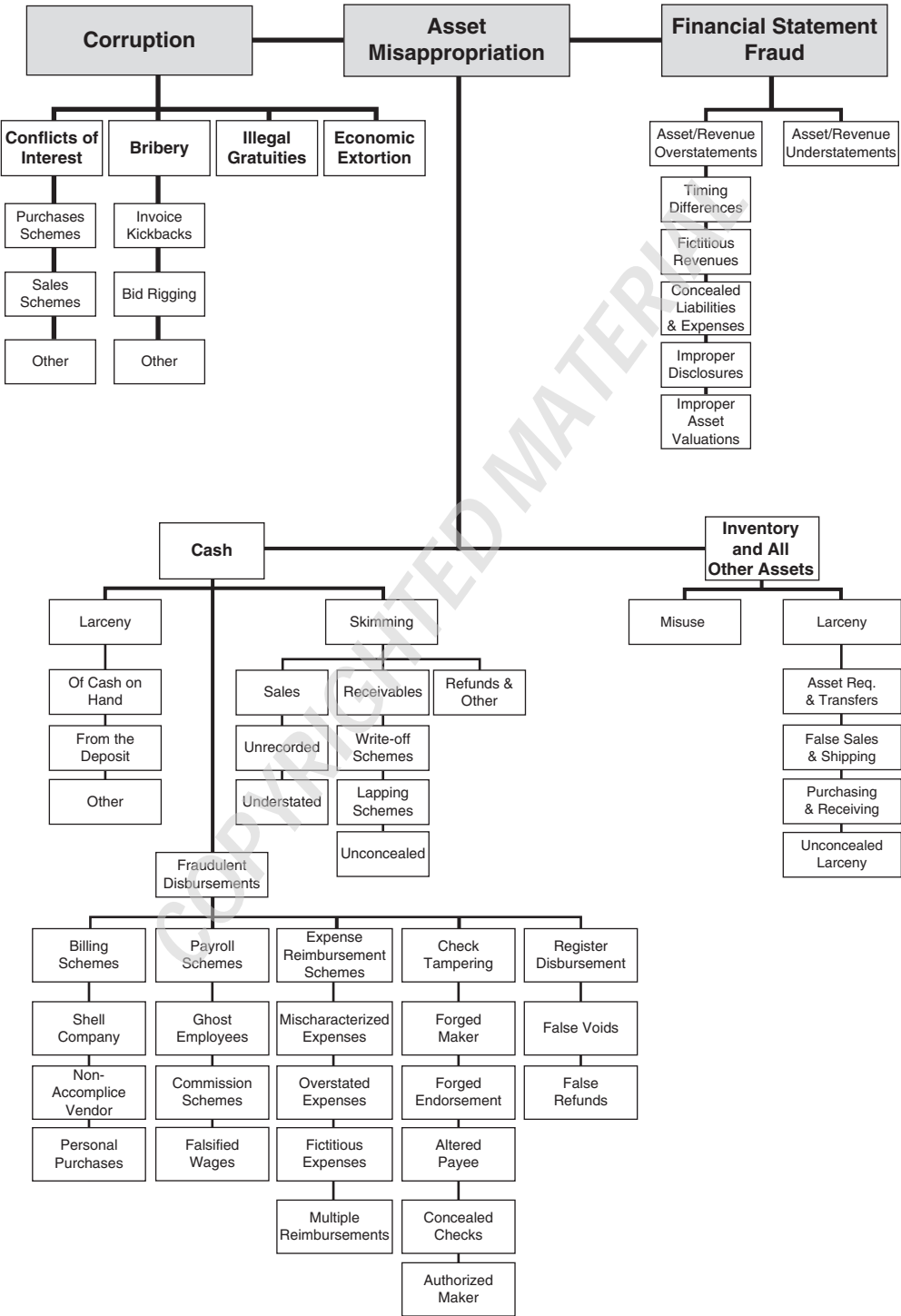


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Occupational Fraud and Abuse



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

This definition’s breadth means that 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, financial statement fraud, corruption, pilferage and petty theft, false overtime, use of company property for personal benefit, and payroll and sick time abuses. Four elements common to these schemes were reported by the Association of Certified Fraud Examiners (ACFE) in its first *Report to the Nation on Occupational Fraud and Abuse*, released in 1996: “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

An *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 staff members; it also includes corporate executives, company presidents, top and middle managers, contract employees, and other workers.

Defining Fraud

In the broadest sense, fraud can encompass any crime for gain that uses deception as its principal modus operandi. Of the three ways to illegally relieve a victim of money—force, trickery, or larceny—all offenses that employ trickery are frauds. Thus, deception is the linchpin of fraud.

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However, while all frauds involve some form of deception, not all deceptions are necessarily frauds. Under common law, four general elements 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 of the victim on the false statement
4. Damages resulting from the victim's reliance on the false statement

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's assume an employee who worked in the warehouse of a computer manufacturer stole valuable computer chips when no one was looking and resold them to a competitor. This conduct is certainly illegal, but what law has the employee broken? 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. Let's briefly review the legal ramifications of the theft.

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

One who owes to another the duties of good faith, trust, confidence, and candor.

The term *fiduciary relationship* is further defined as

*A relationship in which one person is under a duty to act for the benefit of the other on matters within the scope of the relationship. Fiduciary relationships—such as trustee-beneficiary, guardian-ward, agent-principal, and attorney-client—require the highest duty of care.*³

So, in our example, the employee has not only stolen the chips; in so doing, he has violated his fiduciary duty. That makes him an embezzler. *Embezzlement* is defined as

*The fraudulent taking of personal property with which one has been entrusted, esp. as a fiduciary. The criminal intent for embezzlement—unlike larceny and false pretenses—arises after taking possession (not before or during the taking).*⁴

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

Under tort and criminal law, *conversion* is

*The wrongful possession or disposition of another's property as if it were one's own; an act or series of acts of willful interference, without lawful justification, with any chattel in a manner inconsistent with another's right, whereby that other person is deprived of the use and possession of the chattel.*⁵

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

*The unlawful taking and carrying away of someone else's personal property with the intent to deprive the possessor of it permanently. Common-law larceny has been broadened by some statutes to include embezzlement and false pretenses, all three of which are often subsumed under the statutory crime of "theft."*⁶

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 trick is a type of larceny

*in which the taker misleads the rightful possessor, by misrepresentation of fact, into giving up possession of (but not title to) the goods. —Also termed larceny by trick and deception; larceny by trick and device; larceny by fraud and deception.*⁷

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 Law Dictionary* defines *clandestine* as "secret or concealed, especially for illegal or unauthorized purposes."⁸

Defining Abuse

Obviously, not all misconduct in the workplace meets the definition of fraud. A litany of abusive practices plagues organizations, causing lost dollars or resources but not actually constituting fraud. 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 supplies or use equipment 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.
- Surf the Internet on the job.
- Attend to personal matters during business hours.

The term *abuse* has taken on a largely amorphous meaning over the years, frequently being used to describe any misconduct that does not fall into a clearly defined category of

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wrongdoing. *Merriam-Webster's* states that the word *abuse* comes from the Latin word *abusus*—to consume—and that it means “1. A corrupt practice or custom; 2. Improper or excessive use or treatment: misuse.”⁹

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 the teller 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 is typically handled within an organization, though: In the case of the embezzlement, the employee gets fired; there is also a possibility (albeit remote) that she will be prosecuted. In the case in which the employee misuses 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 of sick leave abuse. Misuse of public money in any form can end up being a serious matter, and the prosecution thresholds can be surprisingly low.

Here is one real example: Many years ago 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.

Because he was in the wrong place at the wrong time and did the wrong thing, our criminal paid dearly: He pleaded 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* is often used to describe a variety of petty crimes and other counterproductive behavior that have become common, and are 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. But next we turn to some classic research into why so-called good employees turn bad. Although some of these studies are decades old, they are landmarks in the anti-fraud field.

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, whether against shareholders or against the public. As renowned criminologist 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.*¹⁰

For the uninitiated, Sutherland is to the world of white-collar criminality what Freud is to psychoanalysis. 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, but since that time 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 lay elsewhere. Later in his career, Sutherland developed the theory of differential association, which is now among the most widely accepted theories 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.

Although 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 & Human Nature: The Definitive Study of the Causes of Crime* by Wilson and Herrnstein.¹¹) 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 are math, English, and guitar playing.¹²

Sutherland believed that 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

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a dysfunctional parent is more likely to produce dysfunctional offspring. Sutherland believed that the learning process involved two specific areas: the techniques for committing crime; and the attitudes, drives, rationalizations, and motives of the criminal mind. You can see how Sutherland's differential association theory fits with occupational offenders: Dishonest employees will eventually infect a portion of honest ones, but honest employees will also eventually have an influence on some dishonest ones.

Donald R. Cressey

One of Sutherland's brightest students at Indiana University during the 1940s was Donald R. Cressey (1919–1987). Although much of Sutherland's research concentrated on upper-world criminality, Cressey took his own studies in a different direction. Working on his doctorate in criminology, he decided to concentrate on embezzlers. Accordingly, Cressey arranged for permission to visit 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*.¹³

Cressey's final hypothesis was:

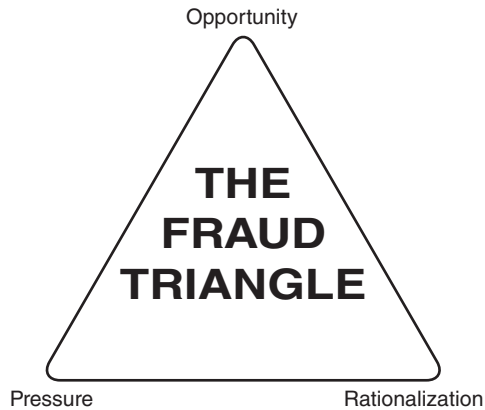
*Trusted persons become trust violators when they conceive of themselves as having a financial problem which is nonsharable, are aware this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property.*¹⁴

Over the years, the hypothesis has become better known as the fraud triangle. (See Exhibit 1.1.) The first leg of the triangle represents a *perceived nonsharable financial need*, the second leg represents *perceived opportunity*, and the third leg stands for *rationalization*. As Cressey said:

*When the trust violators were asked to explain why they refrained from violation of other positions of trust they might have held at previous times, or why they had not violated the subject position at an earlier time, those who had an opinion expressed the equivalent of one or more of the following quotations: (a) "There was no need for it like there was this time." (b) "The idea never entered my head." (c) "I thought it was dishonest then, but this time it did not seem dishonest at first."*¹⁵

*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.*¹⁶

Exhibit 1.1 The Fraud Triangle



Nonsharable Problems

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

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.¹⁷

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 of financial crimes.

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

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*implies that, in addition to being honest, they should behave in certain ways and should refrain from participation in some other kinds of behavior.*¹⁸

In other words, the mere fact that a person has a trusted position brings with it the implied duty to 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 nonsharable 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.*¹⁹

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 Failures

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."*²⁰

In short, pride goeth before the fall. If the potential offender has a choice between covering poor investment choices through a violation of trust and admitting to be an unsophisticated investor, it is easy to see how the judgment of some prideful people 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."*²¹

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. It's not that the person is afraid to share his problem; it's that he has no one with whom to share the problem. He is in a situation in which he has no access to trusted friends or associates who would otherwise be able to help.

Status Gaining

The fifth category consists of problems relating to status gaining. Although these problems 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.²²

In other words, it is not the desire for a better lifestyle that creates the nonsharable problem (we all want a better lifestyle); rather, it is the inability to obtain the finer things through legitimate means, and, at the same time, an unwillingness to settle for a lower status, that creates the motivation for trust violation. This problem might be referred to as the keeping-up-with-the-Joneses syndrome.

Employer–Employee Relations

Finally, Cressey described problems resulting from employer–employee relationships. The most common situation, he stated, was that of 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 seek revenge 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.

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The incident occurred during college. Like many of you, I did not 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 did not 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 ten 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 did not 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 underway, 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 that of today. But the employee faced with an immediate, nonsharable financial need has not changed much over the years. That employee is still placed in the position of having to find a way to relieve the pressure that bears down upon him. But simply stealing money is not enough; 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.²³

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 monies 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.²⁴

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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.”²⁵ 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 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. Such perpetrators also tended to espouse the idea that “everyone” in business misdirects deposits in some way, a fact that they considered would make their own misconduct less wrong than “stealing.” Also, the independent businessmen almost universally felt that their illegal actions were predicated by an “unusual situation” that Cressey perceived to actually be a nonsharable financial problem.

Long-Term Violators Cressey defined *long-term violators* as individuals who converted their employer's funds, or funds belonging to their employer's clients, by taking relatively small amounts over some duration of time. Much like independent businessmen, the long-term violators Cressey studied generally preferred the "borrowing" rationalization. He also described other rationalizations of long-term violators:

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 that 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 the outset. Later, as the embezzlements escalate, it is assumed that offenders would rather not know the extent of their "borrowings." All the long-term violators in the study expressed a feeling that they would like to eventually make amends 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."²⁶

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 with 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."²⁷

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 non-sharable 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.²⁸

Cressey says that although absconders recognize their behavior as criminal, they justify their actions by claiming that the behavior is caused by outside influences beyond

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their control. Absconders also frequently express an apathetic attitude. Moreover, they are more likely to claim that 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 funds over a limited period of time because of some personal problem, such as drinking or gambling, whereas “thieves” were considered persons of lower status who took whatever funds were at hand. Cressey noted:

Since most absconders identify with the lower status group, they look upon themselves as belonging to a special class of thieves rather than trust violators. Just as long-term violators and independent businessmen do not at first consider the possibility of absconding with the funds, absconders do not consider the possibility of taking relatively small amounts of money over a period of time.²⁹

One of the most fundamental observations of the Cressey study was that it took all three elements—motive, perceived opportunity, and the ability to rationalize—for the trust violation to occur. If any of the three elements were missing, trust violation did not occur.

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.³⁰

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. Furthermore, the study is over half a century old; there has been considerable social change during the interim. Now many anti-fraud 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 writing 13 books as well as nearly 300 articles on criminology matters. He rose to the position of professor emeritus in criminology at the University of California, Santa Barbara.

I was honored to know Cressey personally. Indeed, he and I collaborated extensively before he died in 1987, and his influence on my own anti-fraud 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, me the businessman; he the theoretical, me the practical.

I met him as the result of an assignment, in about 1983, when 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. But the \$75 million budget for which he was responsible proved too much of a temptation. Construction companies wined and dined the vice president and eventually provided 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 documentation and interviews, I worked with prosecutors, at the company's request, to put the perpetrator in prison. Then the company came to me with a very simple question: "Why did he do it?" As a former FBI agent with hundreds of fraud cases under my belt, I must admit I had not thought much about the motives of occupational offenders. To my mind, they committed these crimes simply because they were crooks. But the company—certainly progressive on the anti-fraud front for the time—wanted me to invest the resources required to find out why and how employees go bad, so that it could 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 Cressey's book, I realized that he had described to a T the embezzlers I had encountered. 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—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 that lasted until his untimely death in 1987. It was he who recognized the real value of combining the theorist with the practitioner; he used to proclaim that he learned as much from me as I from him. And in addition to Cressey's brilliance, he was one of the most gracious people I have ever met. Although we worked 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 ACFE, started about a year after his death, is in existence in large measure because of his vision. Moreover, although he did not know it at the time, he created the concept of what eventually became the Certified Fraud Examiner (CFE).

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. A hybrid professional was needed, someone trained not only in accounting but also in investigation methods: someone as comfortable interviewing a suspect as reading a balance sheet. Thus was the CFE program born.

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's vision: Traditional accountants, he said, were ill-equipped to deal with

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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 fraud prevention and deterrence.

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 under a grant from the Institute of Internal Auditors Research Foundation, leading to their book, *Deterring 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 that 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 pressure³¹

As can be seen from the list, these motivators are very similar to the nonsharable financial problems Cressey discussed. The study by Albrecht and associates 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, recreational 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.

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.*³²

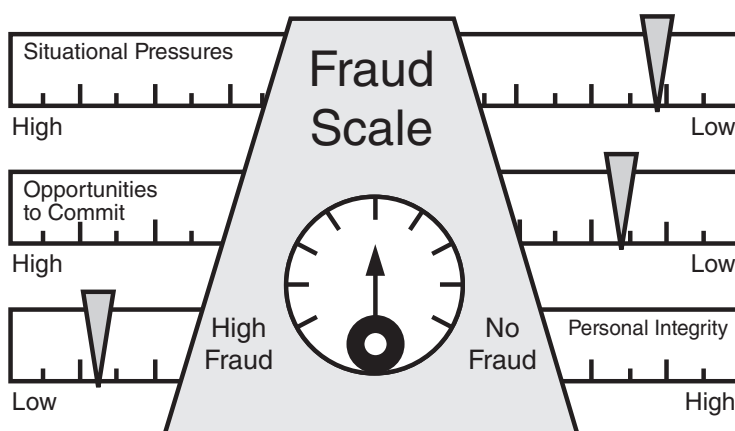
Fraud Scale

To illustrate this concept, Albrecht developed the "Fraud Scale," shown in Exhibit 1.2, which included the components of situational pressures, perceived opportunities, and personal integrity.³³ 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.³⁴

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."³⁵ Opportunities to commit fraud, Albrecht and coauthors 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."³⁶

Albrecht and his colleagues believe 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

Exhibit 1.2 Fraud Scale



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

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integrity variables, resulting in a collection 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.³⁷

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

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 from that 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."³⁸

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 "nonshareable [*sic*] 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. This theory 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 Hollinger and Clark's research led them to conclude that the fourth hypothesis was correct: Employee deviance is caused primarily by job dissatisfaction.

Employee Deviance

Employee theft is at one extreme of employee deviance, which can be defined as conduct detrimental to the organization and to the employee. At the other extreme is counterproductive employee behavior such as shirking, industrial sabotage, and even wildcat strikes. Hollinger and Clark define two basic categories of deviant behavior by

employees: (1) acts by employees against property and (2) violations of the norms regulating acceptable levels of production. The former includes misuse and theft of company property, such as of cash or inventory; the latter involves acts of employee deviance that affect productivity.

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 are discussed next. Exhibit 1.3 represents property deviance only.³⁹

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.⁴⁰

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 “nonshareable economic problems,” or it could also be that current realities are not matching one’s financial aspirations regardless of the income presently being realized.*⁴¹

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.”⁴² The researchers were unable to confirm any connection between community pressures and the level of theft.

Income and Theft

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

Despite this finding, Hollinger and Clark were able to identify a statistical relationship between employees’ *concern* over their financial situation and the level of theft. They presented the employees with a list of eight major concerns, ranging from personal health to education issues to financial problems. The researchers concluded that individuals who commit fraud are more likely to be concerned about their finances, particularly those who rank finances as their most important issue.

Age and Theft

Hollinger and Clark believe there is a direct correlation between age and the level of theft, stating: “Few other variables . . . have exhibited such a strong relationship to theft

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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	
Retail Sector (N = 3,567)					
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 undering 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
Hospital Sector (N = 4,111)					
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
Manufacturing Sector (N = 1,497)					
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.

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.

as the age of the employee.”⁴³ 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.”⁴⁴ 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

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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 are 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.*⁴⁵

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.”⁴⁶

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 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 go 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 did not 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; it was “seen as a morally justified addition to wages; indeed, as an entitlement

due from exploiting employers.”⁴⁷ Altheide also documented that theft is often perceived by employees as a “way of getting back at the boss or supervisor.”⁴⁸ From my own experience with Mr. Zac, I can verify this sentiment. Criminologist 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.”⁴⁹

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 a lesser problem with it. As a result, they would expect policies governing employee theft to have the same impact. Similarly, they believed that 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 ensure that 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 as well as others who might be tempted to act illegally.

Hollinger and Clark interviewed numerous employees in an attempt to determine their attitudes toward control. With respect to policy, they concluded:

The issue of theft by employees is a sensitive one in organizations and must be handled with some discretion. A concern for theft must be expressed without creating an atmosphere of distrust and paranoia. If an organization places too much stress on the topic, honest employees may feel unfairly suspected, resulting in lowered morale and higher turnover.⁵⁰

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 employees regarded the purpose of a security division as taking care of outside—rather than inside—security. Few 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 who were interviewed felt that theft would result in job termination in a worst-case scenario. They perceived that minor thefts would be handled only by reprimands.

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.⁵¹

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Employee Perception of Control

The researchers examined the perception—not necessarily the reality—of employees who believed that 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.”⁵²

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.”⁵³

Conclusion

Hollinger and Clark reached five 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.”⁵⁴ 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, late arrival, and early departure 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,” whereby tightening controls over property deviance may create more detrimental acts affecting the productivity of the organization—for example, pushing down employee theft may push up shirking. Fourth, they agreed that increased management sensitivity to its employees will reduce all forms of workplace deviance. Fifth, they concluded that 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. Clearly understanding theft behavior
2. Continuously disseminating positive information reflective of the company’s policies
3. Enforcing sanctions
4. Publicizing sanctions

The researchers sum up their observations by saying

perhaps the most important overall policy implication that can be drawn ... is that theft and workplace deviance are in large part a reflection of how management at all levels of the organization is perceived by the employee. Specifically, if the employee is permitted to conclude that his or her contribution to the workplace is not appreciated or that the organization does not seem to care about the theft of its property, we expect to find greater involvement. In conclusion, a lowered prevalence of employee theft may be one valuable consequence of a management team that is responsive to the current perceptions and attitudes of its workforce.⁵⁵

2016 REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE

In 1993, the ACFE began a major study of occupational fraud cases with the goal of classifying 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, the ACFE also decided to ask the CFEs to take an educated guess—based on their experience—of the extent of fraud and abuse within their own organizations.

Beginning in 1993, the ACFE distributed a detailed questionnaire to about 10,000 CFEs, asking them to report 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 the ACFE’s knowledge—the largest such study on this subject at the time. Of the cases analyzed, the total loss caused by fraud was about \$15 billion, ranging from a low of \$22 to a high of \$2.5 billion. From that survey, the ACFE 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 alternatively titled it *The Wells Report*.

Since 1996, the ACFE has released eight updated editions of the *Report*—in 2002, 2004, 2006, 2008, 2010, 2012, 2014, and the most recent version in 2016. Each edition has been based on detailed case information provided by CFEs and has built on the findings of its predecessors.

The 2016 *Report to the Nations on Occupational Fraud and Abuse* is based on 2,410 actual cases of occupational fraud from more than 110 countries that were investigated between January 2014 and October 2015. The CFEs who participated were asked to provide information on the single largest case they investigated during this time period; additionally, after completing the survey the first time, respondents were provided the option to submit information about a second case that they investigated. From these survey responses, the researchers were able to observe trends in and draw conclusions about how fraud is committed, how it can be classified, and how it affects business across the globe.

Introduction

The majority of statistical data pertaining to the ACFE's research on occupational fraud that is cited in this book is derived from the results of the 2015 *Global Fraud Survey*, as reported in the 2016 *Report to the Nations on Occupational Fraud and Abuse*.

Measuring the Costs of Occupational Fraud

Participants in the 2015 *Global Fraud Survey* were asked what percentage of gross revenues they believe—based on their personal experience and general knowledge—the typical organization loses to fraud and abuse. The median response was 5 percent, which was consistent with estimates provided by respondents in previous editions of the survey.

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 organizations throughout the world. Nevertheless, even at a rate of 5 percent, this estimate of the cost of fraud is astounding. Applying this figure to the gross world product—which, for 2015, was estimated to be \$73.7 trillion⁵⁶—results in a projected total global fraud loss of \$3.7 trillion annually. It is a staggering sum, to say the least.

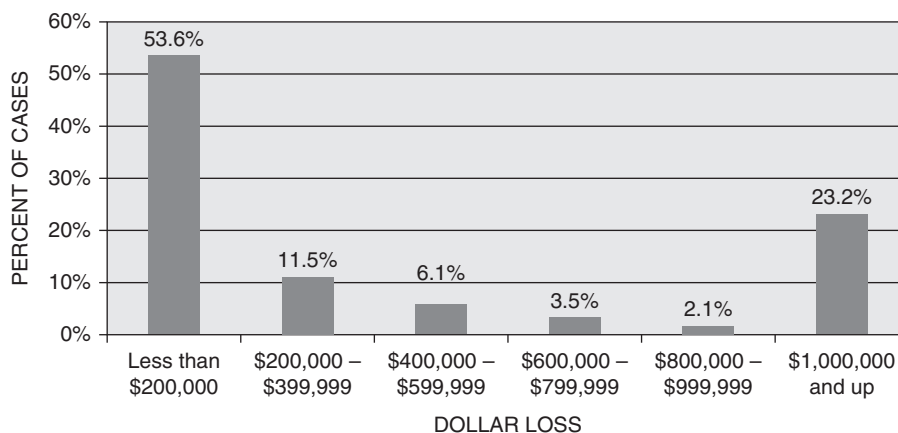
But what does the figure really mean? It is simply the collective opinions of those who work in the anti-fraud field. Unfortunately, finding the actual cost of fraud may not be possible by any method. After all, the very nature of fraud is that it is concealed. One obvious approach to figuring out the actual rate of fraud occurrence would be to take a scientific poll of the workforce and ask 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 that respondents answered the poll correctly, there would still be an obvious flaw in the data: Organizations typically do not 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 can we do about it? How can we possibly detect something we do not know about in the first place? It is 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.

Losses Reported in the 2015 *Global Fraud Survey*

As stated earlier, the 2015 *Global Fraud Survey* yielded 2,410 usable cases of occupational fraud for purposes of the study. Among those cases, the median loss experienced by the victim organizations was \$150,000. The chart in Exhibit 1.5 illustrates the

Exhibit 1.5 2015 Global Fraud Survey: Distribution of Losses

distribution of all losses. Note that more than 23 percent of the cases in the study caused losses of \$1 million or more.

Perpetrators of Fraud

By definition, the perpetrators of occupational fraud are employed by the organization they defraud. Participants in the 2015 survey provided information on the perpetrators' position, gender, age, education, department, 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.

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 (40.9 percent) or managers (36.8 percent). Owner/executives made up less than one-fifth of the perpetrators.

Additionally, although the highest percentage of schemes was committed by employees, these frauds had the lowest median loss, at \$65,000 per incident. Frauds committed by managers caused a median loss of \$173,000 per incident while the median loss in schemes committed by owner/executives was \$703,000—more than ten 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 1.6.)

Effect of Gender

The results of the 2015 *Global Fraud Survey* showed that male employees caused substantially larger median losses than female employees; the median loss in a scheme caused by a male employee was \$187,000 while the median loss caused by a female

Exhibit 1.6 2015 Global Fraud Survey: Percentage of Cases and Median Loss by Position of Perpetrator

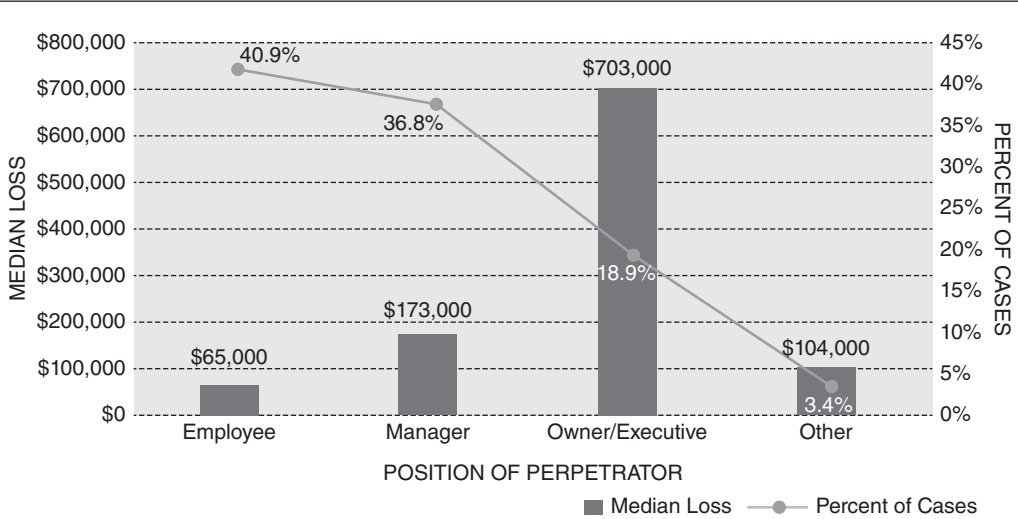
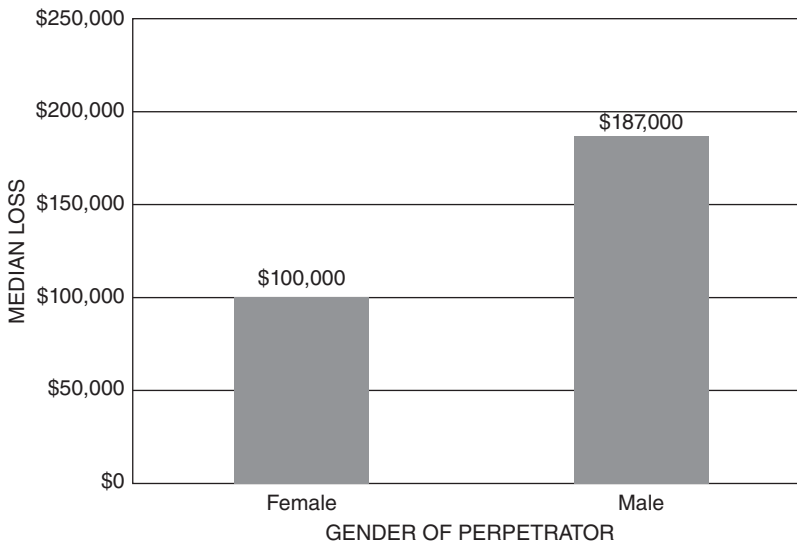


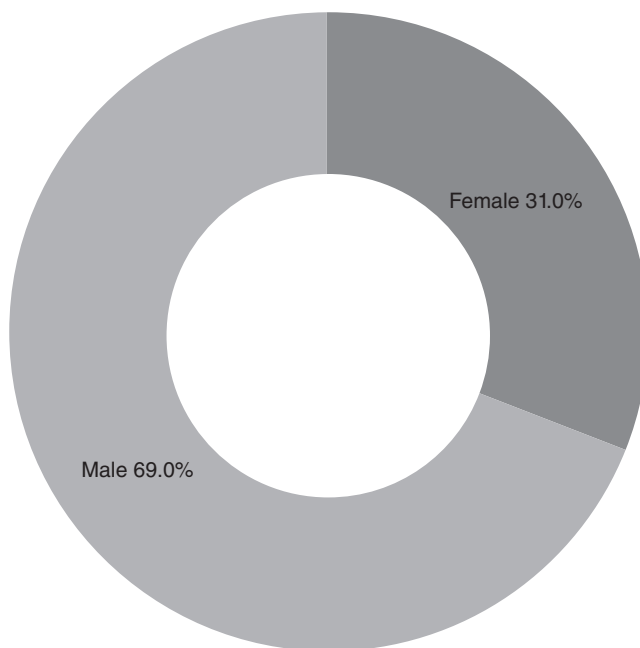
Exhibit 1.7 2015 Global Fraud Survey: Median Loss by Gender of Perpetrator



employee was \$100,000. (See Exhibit 1.7.) The most logical explanation for this disparity seems to be the “glass ceiling” phenomenon; generally, 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, males are also the principal perpetrator in a majority of cases, accounting for 69 percent of frauds in our study versus the 31 percent in which a female was the primary culprit. (See Exhibit 1.8.)

Exhibit 1.8 2015 Global Fraud Survey: Percentage of Cases by Gender of Perpetrator

***Effect of Age***

The ACFE *Reports* continually reveal a direct and linear correlation between the perpetrator's age and median loss. 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 42 times higher than the youngest perpetrators. Furthermore, although some studies, including those of Hollinger and Clark, have suggested that younger employees are more likely to commit occupational crime, less than 5 percent of the frauds in our study were committed by individuals below the age of 26 while nearly half the frauds were committed by people over the age of 40. (See Exhibit 1.9.)

Effect of Education

More than three-quarters of the perpetrators in the study had completed some college. Additionally, those with higher education levels would generally be expected to occupy higher positions in an organization, and to have greater access to organizational assets. Therefore, we expected a fairly linear correlation between education and median loss. Fraudsters with only a high school education caused median losses of \$90,000, but that

Exhibit 1.9 2015 Global Fraud Survey: Percentage of Cases and Median Loss by Age of Perpetrator

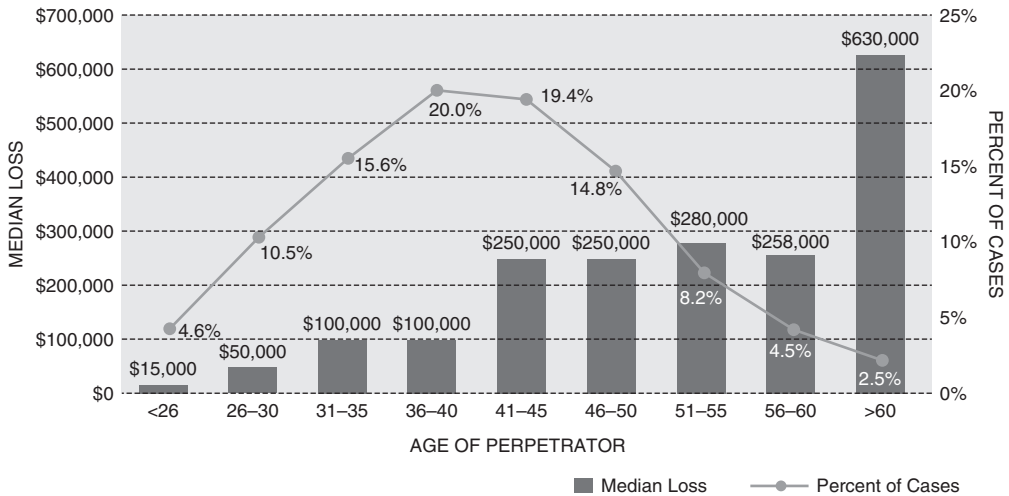


Exhibit 1.10 2015 Global Fraud Survey: Percentage of Cases and Median Loss by Education Level of Perpetrator

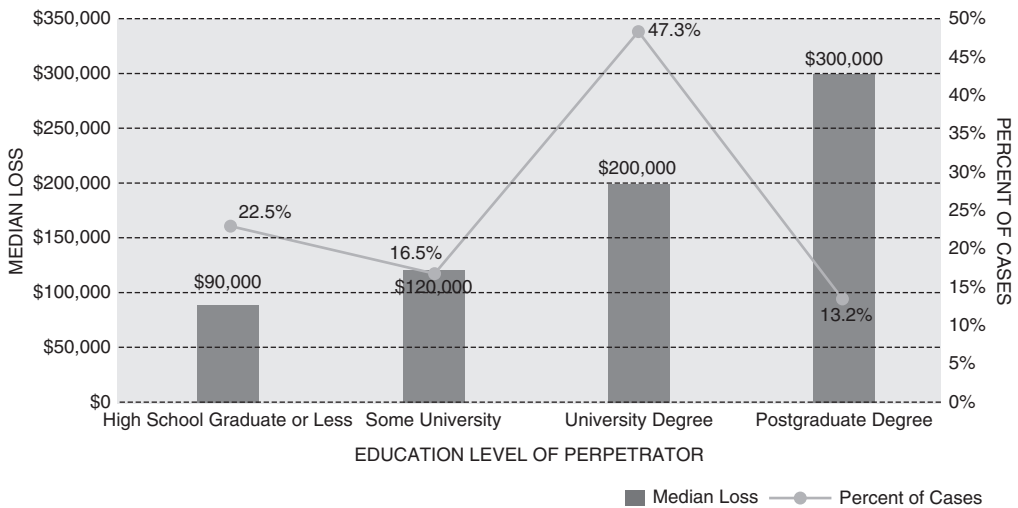
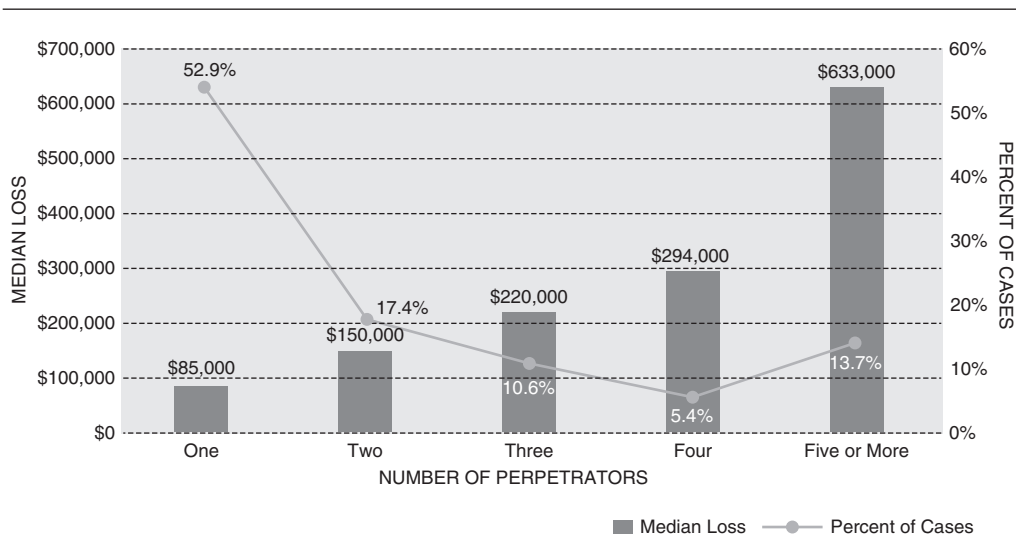


figure more than doubled for perpetrators who had a college degree. The median loss caused by those with postgraduate degrees was \$300,000. (See Exhibit 1.10.)

Effect of Collusion

It was not surprising to see that in cases involving more than one perpetrator, fraud losses rose substantially. The majority of survey cases (53 percent) only involved a single fraudster, but fraud losses increased with each additional perpetrator. (See Exhibit 1.11.)

Exhibit 1.11 2015 Global Fraud Survey: Percentage of Cases and Median Loss by Number of Perpetrators



Perpetrator's Department

Of the fraud cases studied, almost 17 percent were perpetrated by an employee in the accounting department. Further, more than three-quarters of all the frauds were committed by employees in six departments: accounting, operations, sales, executive/upper management, customer service, and purchasing. The perpetrators holding the highest levels of autonomy and authority inside the organization—those in executive/upper-management roles—caused the greatest losses to the victim organizations, at \$850,000. (See Exhibit 1.12.)

Effect of Tenure

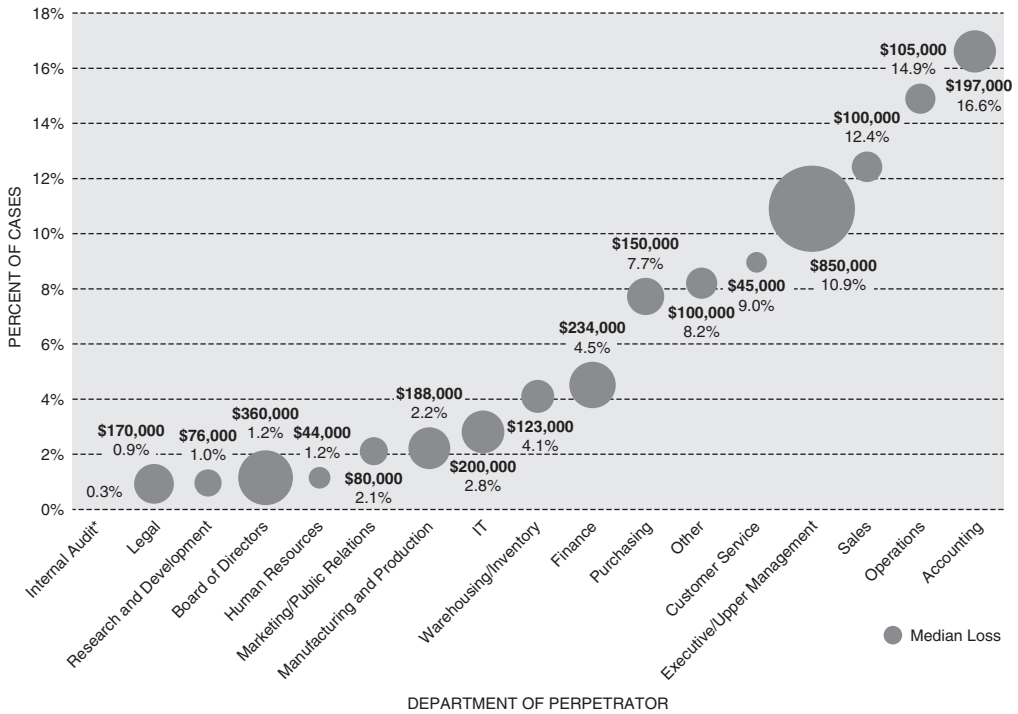
The results of the 2015 survey revealed a direct correlation between the length of time an employee had been employed by a victim organization and the size of the loss in the case. Employees who had been with the victim for more than ten years caused median losses of \$250,000, whereas employees who had been with their employers for less than one year caused median losses of \$49,000. Additionally, employees with tenure of one to five years were involved in the greatest percentage of fraud cases. (See Exhibit 1.13.)

Criminal History of the Perpetrators

Just over 5 percent of the perpetrators identified in the 2015 study were known to have been convicted of a previous fraud-related offense. Another 5.5 percent of the perpetrators had previously been charged but had never been convicted. These figures are consistent with other studies that have shown most people who commit occupational fraud are first-time offenders. The findings are also consistent with Cressey's model, in which occupational offenders do not perceive themselves as lawbreakers. (See Exhibit 1.14.)

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Exhibit 1.12 2015 Global Fraud Survey: Percentage of Cases and Median Loss by Department of Perpetrator



*Internal Audit category had insufficient responses for median loss calculation.

Exhibit 1.13 2015 Global Fraud Survey: Percentage of Cases and Median Loss by Tenure of Perpetrator

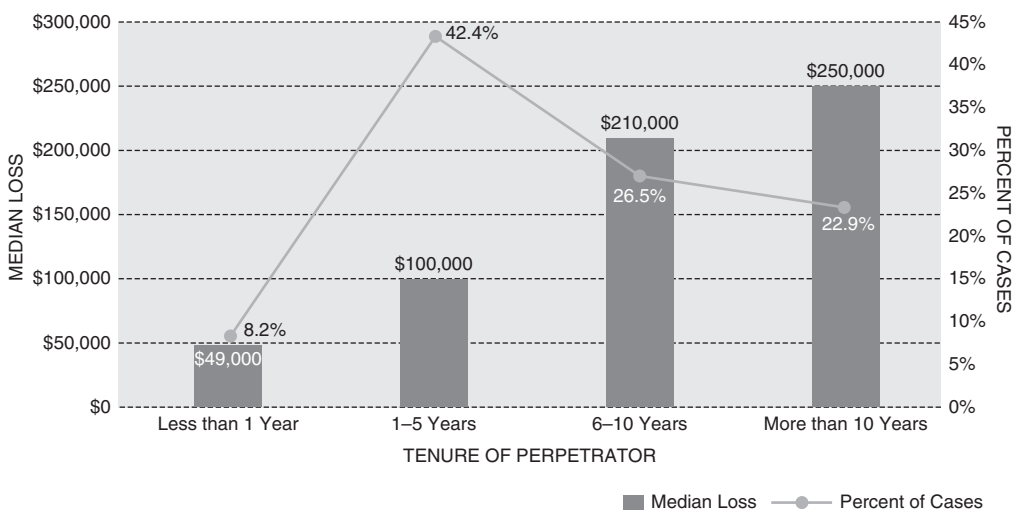
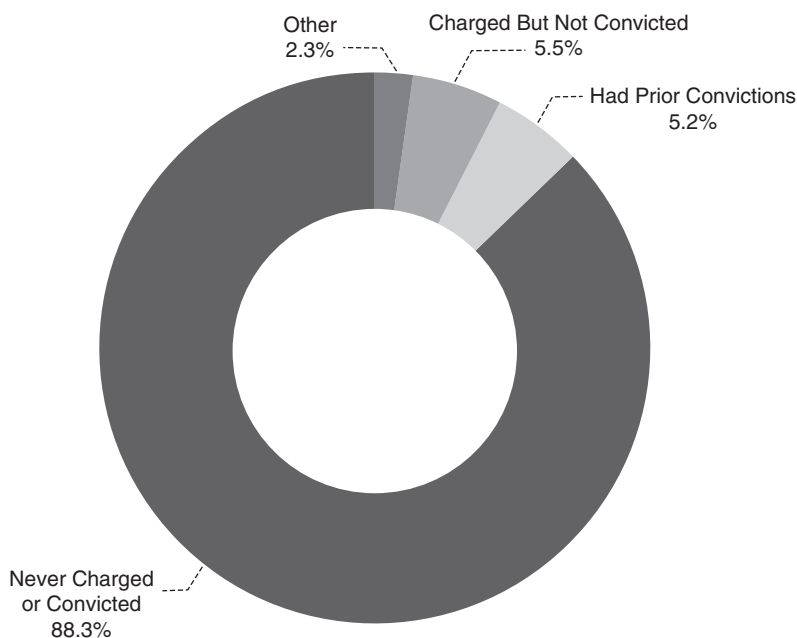


Exhibit 1.14 2015 Global Fraud Survey: Percentage of Cases by Criminal History of Perpetrator



Victims

The victims of occupational fraud are organizations that are defrauded by those they employ. The 2015 survey asked respondents to provide information on, among other things, the size and type of organizations that were victimized and the anti-fraud measures those organizations had in place at the time of the frauds.

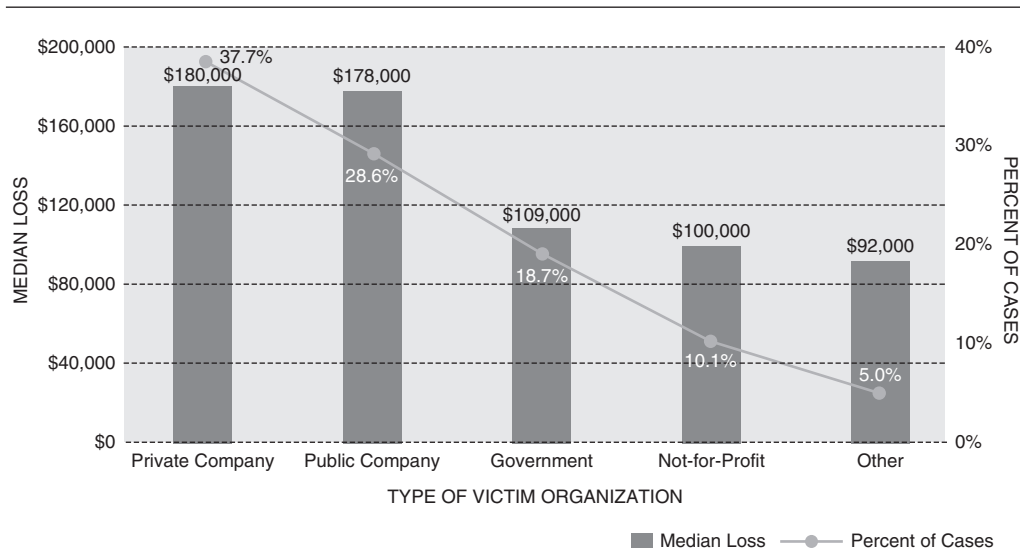
Type of the Victim Organization

Most of the cases reported in the 2015 *Global Fraud Survey* involved victims that were privately held companies (38 percent), whereas not-for-profit organizations had the lowest representation (10 percent). It should be noted that the researchers made no effort to obtain a random sample of business organizations. The study was based on a survey of CFEs throughout the world; consequently, the demographics of the victim organizations in the study depended in large measure on the organizations that retain CFEs.

The study also revealed that privately held companies suffered the largest median loss, at \$180,000. In comparison, the median losses in public companies, government agencies, and not-for-profit organizations were \$178,000, \$109,000, and \$100,000, respectively. (See Exhibit 1.15.)

Size of the Victim Organization

The cases in our 2015 study were fairly evenly distributed among organizations of all sizes, with the smallest entities experiencing the greatest percentage of frauds by a small

Exhibit 1.15 2015 Global Fraud Survey: Percentage of Cases and Median Loss by Victim Organization Type

margin. Over 30 percent of the cases occurred in small organizations—those with fewer than 100 employees. (See Exhibit 1.16.)

Organizations with 100 to 999 employees experienced the largest median loss (\$186,000) while the smallest organizations and the largest organizations (those with 10,000 or more employees) both had a median loss of \$150,000. (See Exhibit 1.17.) Although the smallest organizations did not experience the greatest median loss in absolute terms, the relative size of the median loss for small companies indicates that these entities are disproportionately vulnerable to occupational fraud and abuse. Put more simply, absorbing a \$150,000 loss is typically a much bigger burden on a small company than it would be on an organization with 10,000 or more employees.

We theorize that the disproportionate nature of fraud losses at small companies 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 our studies involved small-business operations that had a one-person 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 simply lack the resources to overcome them.

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 coworkers 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; transactions in capitalism simply cannot occur without trust. The key is seeking the right balance between too much and too little.

Exhibit 1.16 2015 Global Fraud Survey: Percentage of Cases by Number of Employees at Victim Organization

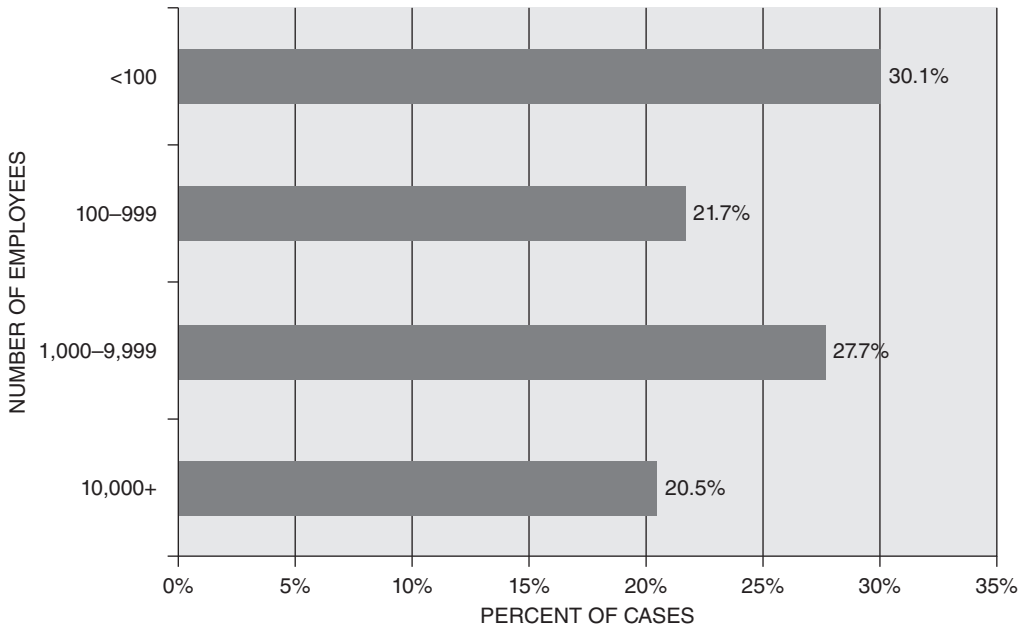
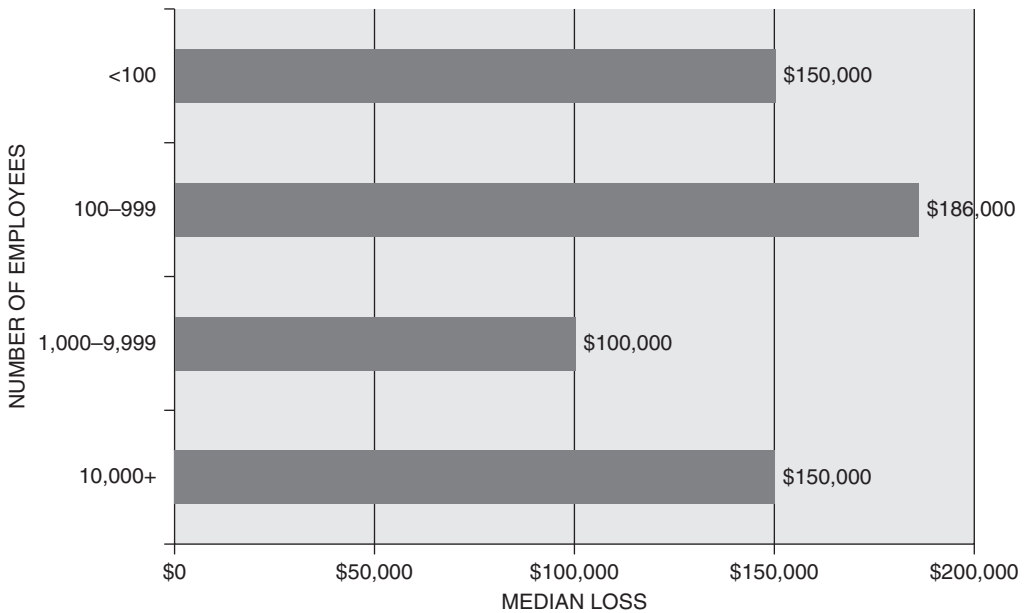


Exhibit 1.17 2015 Global Fraud Survey: Median Loss by Number of Employees at Victim Organization



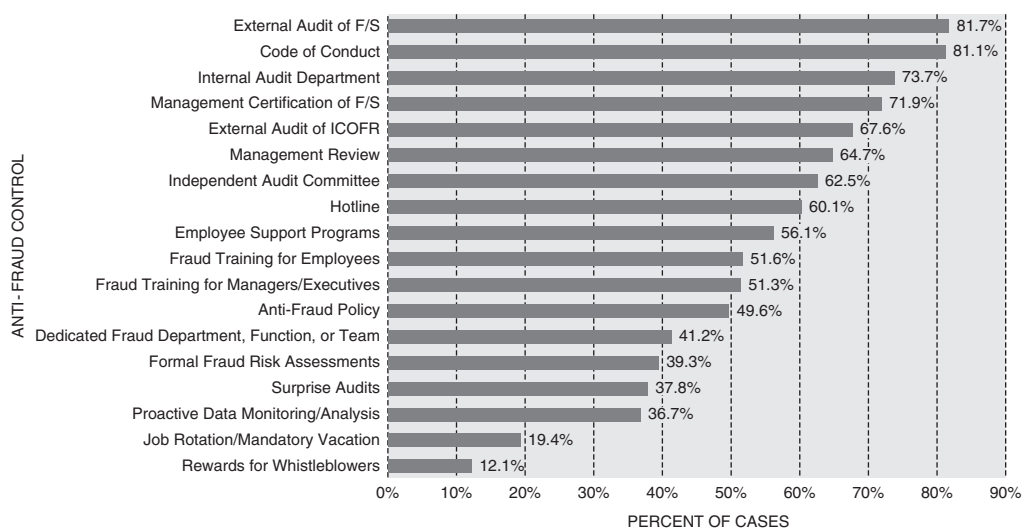
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Anti-Fraud Measures at the Victim Organization

CFEs who participated in our 2015 *Global Fraud Survey* were asked to identify which, if any, of 18 common anti-fraud measures were used by the victim organizations at the time the reported frauds occurred. Nearly 82 percent of the victim organizations had their financial statements audited by external auditors while 74 percent had an internal audit department and 72 percent had management certify the organization’s financial statements. Additionally, 81 percent of the victim organizations had a formal code of conduct in place at the time of the fraud, although only 50 percent extended that to include a formal anti-fraud policy. (See Exhibit 1.18.)

To examine the effectiveness of these common anti-fraud controls, the researchers also compared by those organizations that had a particular anti-fraud control in place against the median loss for those organizations without that control at the time of the fraud (excluding all other factors). The results indicate that the mechanisms most associated with a reduced cost of fraud were proactive data monitoring and analysis; management review of internal controls, processes, accounts, or transactions; employee support programs; and hotlines. Organizations with these mechanisms in place at the time of the fraud experienced frauds that cost 50 to 54 percent less than organizations that lacked these mechanisms. Conversely, external audits—the anti-fraud measure most commonly used by victim organizations—showed the lowest impact on median losses in our study. (See Exhibit 1.19.)

Exhibit 1.18 2015 Global Fraud Survey: Frequency of Anti-Fraud Controls



Key:

External Audit of F/S = Independent External Audits of the Organization's Financial Statements

Management Certification of F/S = Management Certification of the Organization's Financial Statements

External Audit of ICOFR = Independent Audits of the Organization's Internal Controls Over Financial Reporting

Exhibit 1.19 2015 Global Fraud Survey: Impact of Anti-Fraud Measures on Median Loss

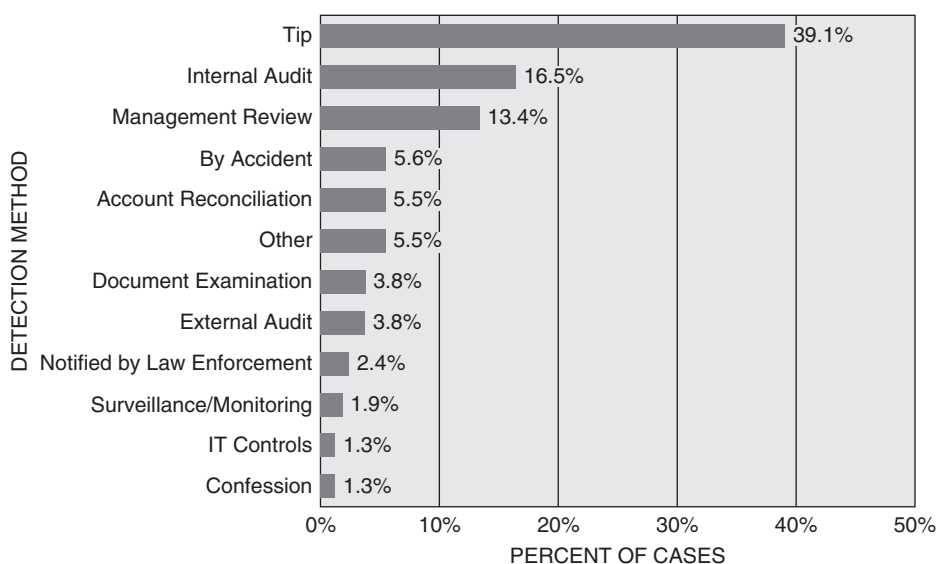
Control	Percent of Cases	Control in Place	Control Not in Place	Percent Reduction
Proactive Data Monitoring/Analysis	36.7%	\$92,000	\$200,000	54.0%
Management Review	64.7%	\$100,000	\$200,000	50.0%
Hotline	60.1%	\$100,000	\$200,000	50.0%
Management Certification of Financial Statements	71.9%	\$104,000	\$205,000	49.3%
Surprise Audits	37.8%	\$100,000	\$195,000	48.7%
Dedicated Fraud Department, Function, or Team	41.2%	\$100,000	\$192,000	47.9%
Job Rotation/Mandatory Vacation	19.4%	\$89,000	\$170,000	47.6%
External Audit of Internal Controls over Financial Reporting	67.6%	\$105,000	\$200,000	47.5%
Fraud Training for Managers/Executives	51.3%	\$100,000	\$190,000	47.4%
Fraud Training for Employees	51.6%	\$100,000	\$188,000	46.8%
Formal Fraud Risk Assessments	39.3%	\$100,000	\$187,000	46.5%
Employee Support Programs	56.1%	\$100,000	\$183,000	45.4%
Anti-Fraud Policy	49.6%	\$100,000	\$175,000	42.9%
Internal Audit Department	73.7%	\$123,000	\$215,000	42.8%
Code of Conduct	81.1%	\$120,000	\$200,000	40.0%
Rewards for Whistleblowers	12.1%	\$100,000	\$163,000	38.7%
Independent Audit Committee	62.5%	\$114,000	\$180,000	36.7%
External Audit of Financial Statements	81.7%	\$150,000	\$175,000	14.3%

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 the ACFE study was based on actual fraud cases that had been investigated, the researchers 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, the researchers 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 detected initially. The survey results indicate that the frauds in our study were most commonly detected by tip (39 percent).

Unfortunately, as shown previously, roughly 40 percent 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 fourth-most-common detection method, accounting for more than 5 percent of the fraud cases in

Exhibit 1.20 2015 Global Fraud Survey: Initial Detection of Occupational Frauds

the survey while external audits detected less than 4 percent of the reported frauds. (See Exhibit 1.20.)

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, the researchers were able to develop a classification system known informally as the *fraud tree* that accounts for most, if not all, common occupational fraud and abuse schemes. The researchers have tested the structure of the fraud tree against the cases in all subsequent studies to make sure that the classification system accounted for every scheme that was reported. Among the nine studies, the ACFE has applied the fraud tree classification system to thousands of 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 as well as common vulnerabilities in the victim organizations that allow such frauds to succeed. This in turn should help in the development of better, more efficient anti-fraud tools.

Exhibit 1.21 2015 Global Fraud Survey: Major Occupational Fraud Categories

	Percentage of Cases	Median Loss
Asset Misappropriation	83.5%	\$ 125,000
Corruption	35.4%	\$ 200,000
Financial Statement Fraud	9.6%	\$ 975,000

The sum of percentages listed in this column exceeds 100 percent because some cases involved fraud schemes that fell into more than one category. The same is true for every scheme classification chart in this book that is based on the *2015 Global Fraud Survey*.

According to the fraud tree, the three major categories of occupational fraud are:

1. *Asset misappropriations*, which involve the theft or misuse of an organization's assets. (Common examples include skimming revenues, stealing inventory, and payroll fraud.)
2. *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.)
3. *Financial statement fraud*, which involves purposeful misreporting of financial information about the organization with the intent to mislead those who rely on it. (Common examples include overstating revenues and understating liabilities or expenses.)

The data from the ACFE study on frequency and median loss for the three major occupational fraud categories are presented in Exhibit 1.21. Asset misappropriations made up more than 83 percent of the cases encountered but were by far the least costly in terms of median loss. Meanwhile, financial statement frauds were the least common, accounting for less than 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 costlier than asset misappropriations.

Within each of the three major categories, there are several subcategories of fraud scheme types. In coming chapters, we 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.

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