CHAPTER ONE

Nature of Fraud

COPYRIGHTED MATERIAL

Fraud is like cancer. Most of us know someone who has it. We know people who will eventually have it. It has become common but we can take steps to protect ourselves through healthy choices and regular checkups using the latest tools and technology. But if people ignore the problem and live dangerously, then there's a much greater chance of becoming a victim.

—Toby Bishop, CEO, Association of Certified Fraud Examiners

After studying this chapter, you should be able to:

- Briefly outline the definitions and concepts underlying fraud and irregularities

- Describe the basic types of fraud
- Understand the profiles and motivators of fraud
- Define the responsibilities for fraud detection and prevention

More and more incidents of private and public fraud are being reported daily in the media, and increasingly prosecutions for this offense are being conducted in the various courts. This chapter examines the phenomenon in order to obtain a full appreciation of what exactly fraud is.

FRAUD AND IRREGULARITIES: DEFINITIONS AND CONCEPTS

Throughout history, the development of negotiable instruments, from cowrie shells to plastic cards, have led to the creation of a set of rules and conventions for trade and the promotion of smooth and orderly commercial interactions among individuals and countries. The breaking of these rules and conventions helps white-collar criminals make a living—in some cases a fortune—while evading discovery. In many countries, the courts and judicial system do not afford economic crimes the priority of crimes involving violence.

Fraud itself is a legal concept existing within the criminal laws of virtually every civilized country, although slight variations exist. In most countries, fraud may be deemed to occur when these individual elements exist:

- An untrue representation about a material factor event is intentionally made by an individual or organization.
- Such representation may or may not be believed by the person or organization to which the representation was made.
- The victim could suffer the possibility of harm or prejudice as a result of the misrepresentation.

For example, within South African law, fraud may be conveniently defined as being "the unlawful and intentional making of a misrepresentation which causes actual prejudice or which is potentially prejudicial to another."[1] Actual proprietary prejudice is not necessarily required for fraud. Even nonproprietary or potential prejudice may be sufficient. Thus, fraud is not a crime against property only; it also can be regarded as a crime against the interests of the community in general.

The Arkansas Department of Finance and Administration defines occupational fraud in this way:

> Occupational fraud and abuses can be defined as the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of government resources or assets. Occupational fraud and abuses include misappropriation of assets in the form of cash theft, fraudulent disbursements, theft or personal use of inventory or other non-cash assets. Fraud can also take the form of bribery and corruption when kickbacks, gifts, or gratuities are offered to government employees from contractors or vendors to influence decisions of government agents or employees.[2]

A clear distinction must be drawn between the intention to deceive and an intention to defraud since a causal link is required between the misrepresentation and the actual prejudice.

Courts have traditionally worked on the basis that fraud is punished not because of the actual harm it causes but because of the potential harm or prejudice inherent in the misrepresentation, so that even if the potential victim should not believe the misrepresentation or not have acted on it the intent and possibility of harm means that a fraud has still occurred. Put more simply the intent and possibility of harm means that a fraud had been committed even if no loss occurred.

A crime that is commonly confused with fraud is *theft by false pretenses*. Fraud is always committed when a theft by false pretenses occurs, but the converse is not necessarily true since, in addition to misrepresentation and actual or potential prejudice, theft by false pretenses requires an appropriation of property capable of being stolen.

The misrepresentation leading to fraud can also be committed by means of an admission whereby the perpetrator fails to disclose a material fact that, unless revealed, could induce the victim to act to his or her prejudice if there was, in fact, a legal duty to disclose.

Once this broader definition of fraud is realized, it can be understood that occurrences of fraud are much more prevalent than we believe based on the large-scale frauds that hit the newspapers. Fraudulent misrepresentation is an everyday occurrence in our lives; it ranges from bending the truth in providing an excuse for an employer to utilizing company assets for personal benefit on the pretext that it was in the company's interest. Each of these acts falls under the heading of criminal fraud in its most literal sense and potentially could result in a criminal conviction. Due to this broad definition, a level of white noise results, whereby fraudulent acts of a petty nature become tolerated and norms and ethical standards decline. As a result, fraud becomes acceptable if the end justifies the means. The economic stresses in today's society internationally create pressures and aspirations to attain a standard of living higher than many individuals are capable of achieving on merit. This situation, in turn, increases the likelihood of such persons achieving those aspirations by deceit.

No definitive preventive control can stop all fraud in its tracks since fraud is developed based on the ingenuity of defrauders. Some new, not-yet-anticipated variation on a theme always occurs.

Victims of Fraud

One common misconception is that frauds are carried out only by individuals against organizations. In many cases, when fraud is carried out by an individual acting on behalf of an organization, the fraudulent activity could be looked on as: *any business activity in which deceitful practices are resorted to by an organization or representative of an organization with the intent to cause economic injury that would deprive another of property or other entitlements.*

Although it is tempting to make the assumption that frauds may be confined to one class of victim—for example, the cost of insurance fraud being borne by the insurance industry—in reality, in most cases, the ultimate bearer of the cost of fraud is the general public. By the same token, government losses to taxation fraud ultimately are passed on to the taxpayers in general. Losses from corporate fraud, either from embezzlement or financial manipulation, are normally ultimately borne by customers.

In the event of fraud covered by government regulation, recourse for losses may be sought from the regulatory body. Nevertheless, ultimately they get passed on once again to the consumer or public.

In complicated cases such as payment card frauds, the ultimate loser may appear to be the cardholder (rarely and only if negligence can be shown), the merchant who accepted the fraudulent card, the merchant-acquiring bank that processes the transaction of the cardholder, and the card issuer. Once again, in reality, costs generally are passed on through higher insurance premiums, higher fees for banking services, higher interest rates, higher credit card fees, or reduced dividends to shareholders.

The net effect is that the public ends up bearing the brunt of losses from fraud. Thus, the public perception of fraud as a "victimless" crime can therefore be seen as a false supposition and true only in that the cost may be spread over a large population. Thus, it may be seen that there are two forms of victims of fraud.

The *primary* victims are those who suffer the initial harm of fraud, whether these victims are individuals, corporations, or governmental bodies. The *secondary* victims are those who sustained the ultimate economic impact of losses attributable to fraud.

Nature of Fraud

Although many executives have an image in mind of what fraud is, the image may differ from executive to executive and may, indeed, differ widely in respect of the true nature of fraud. In order to adopt a comprehensive policy toward the minimization of fraud within the organization, a full fraud risk assessment is required to identify those opportunities specific to a given set of operations. Only once the fraud risks are understood can a system of internal controls be designed to address those specific risks. Even then, fraud can never be truly eliminated, but the internal controls can provide reasonable assurance that both instances of fraud and also waste and general misuse of resources can be reduced.

Much of the corporate fraud that takes place results from poor bookkeeping practices combined with poorly trained and inattentive staff. When this situation is combined with the inadequate internal and interdepartmental communications commonly found within organizations, the opportunities for undetected business scams grows exponentially. Making staff members aware of fraud opportunities and their responsibility in preventing and detecting fraud combined with a conduit through which to report fraud is fundamental in establishing good corporate control.

In order for fraud to occur, three elements must be in place. This trio is known as the fraud triangle (see Exhibit 1.1) and is used both in fraud prevention and fraud detection. Its origin is attributed to the criminologist Donald R. Cressey, who formulated this hypothesis regarding trust-violating behavior to explain why people commit fraud.

Pressure or Motivation

In general, the motivating factor leading individuals to commit fraud can be defined as a form of pressure. This pressure can take the form of significant financial need (or perceived need) and may include anything from medical expenses to a simple case of expensive tastes. For this pressure to translate into

EXHIBIT 1.1 Fraud Triangle

a fraud-enabling pressure, generally some secrecy is involved; the potential perpetrator believes that the motivator must be kept secret and solved privately. Motivation can also be nonfinancial, such as the need to cover up for a third party's poor performance in the workplace or to produce good results and work.

Rationalization

Rationalization is the process by which fraudsters can reconcile their behavior in committing the fraud with their own internal belief system regarding honesty and trust. For those who are generally dishonest, rationalization is easy; for others, however, rationalization involves the prioritization of the pressure source against their own moral code. For example, placing the needs of a family member ahead of the need to remain loyal to an employer. In this way they can convince themselves that, despite their moral standards, the fraud is OK. Rationalizations may include these and others:

- The money is needed for the benefit of a family member or loved one.
- The money is not being stolen, simply borrowed and will be returned in due time.
- The employee feels unfairly done by, so there is a degree of entitlement to the theft.
- There is no other recourse, no alternative source of aid; it is a choice between steal or lose everything.
- The person has a lower set of ethical values and does not believe that stealing in such a fashion is wrong.
- The employee holds a poor opinion of the ethical standards implemented within the organization; therefore, he or she is only doing what everyone else does.

Once an apprehended fraudster attempted to justify his theft by pointing out that he only stole $5,000 while the company had claimed $10,000 on its insurance policy; therefore, he had done nothing wrong since the company had made 100 percent profit on his theft.

Opportunity

Opportunity involves the capability of people to commit the fraud in what they believe will be an undetectable manner. The opportunity may come about due to the individual's job-related access to the assets to be stolen combined with knowledge that management oversight is weak in this area, and other internal controls will be ineffective in either preventing or detecting the fraud. Most fraud opportunities are created by poor management oversight or weak preventive controls. An absence of detective controls increases the probability that fraud will occur.

Within the fraud triangle, organizations have limited opportunities to recognize pressure and rationalization, but they can significantly reduce opportunities by the design and implementation of business procedures, processes, and controls that will limit employees' ability to commit a fraud, and will increase the probability of detection should an opportunity be seized.

Detection involves not only being alert for anomalies in business records and areas where internal controls may be ineffectual but also for red flags in employee behavior traits and changes in behavior patterns.

Red Flags

Red flags are early warning indicators that the risk of fraud in a particular area either is higher than is normally tolerable or has increased over a period. Once again, these red flags can be categorized as pressure sources, changes in behavior, and general personality traits.

Pressure Sources

Pressure sources in individuals that supervisors should be alert for include:

- Medical problems for the employee or a family member
- Substance abuse
- Family member's loss of a job
- Lifestyle exceeding income capacity
- Divorce
- Financial pressures from a variety of sources

Changes in Behavior

Changes in behavior that could alert supervisors to the possibility of fraudulent practices include:

- Sudden increase in the visibility of material possessions
- Apparent increase in absenteeism
- Decreases in productivity and increases in signs of dissatisfaction at work
- Mood changes and irritability increase
- Borrowing money from coworkers
- Refusing promotion
- Refusing to take vacation time
- Working unnecessary overtime
- Carrying large amounts of cash
- Rewriting records for neatness sake

General Personality Traits

Studies in organizations where high levels of fraud occurred indicate that certain specific personality traits may be indicative of potential fraudsters. These include:

- Work performance levels considerably higher than the norm
- Dominating and controlling attitudes
- Living beyond their means
- Disliking their work being reviewed
- Maintaining close relationships with vendors or customers
- Exhibiting a strong desire to display material wealth

It should be noted that none of these red flags proves that a fraud has taken place or will take place. They are simply indicators that should alert supervisors or management to a higher potential fraud risk, particularly when combined with known weakness in internal controls within an area where an employee has sole authority and responsibility.

Frauds can take many forms and come from a variety of sources, both within and outside of an organization. Within an organization, fraud can be perpetrated by any level of staff or management. Outside of the organization, fraud can be perpetrated by customers or clients, suppliers—indeed, by persons without any contractual connection to the organization. A particular fraud could be directed against the organization itself or against assets it holds on behalf of clients.

Typically, the primary objective of fraudsters is to obtain something of value. The secondary, although essential, objective is to conceal their actions in order to avoid detection. In order to obtain value, typical fraudsters commonly seek to:

- Remove funds or other assets
- Understate payments due to the organization
- Overstate claims on the organization and receive payment
- Misrepresent applications for credit on insurance

Types of Fraud

Frauds can be split into two broad categories: frauds against the individual and frauds against the organization. These two categories are not necessarily mutually exclusive, and some frauds involve a combination of techniques. These fraud categories will be covered in depth in Chapters 3 and 4.

Frauds against the Individual

- Consumer frauds
- Telephone frauds
- Online auction fraud
- Charity frauds
- Misrepresentation of material facts
- Concealment of material facts
- Advance fees (4–1–9) frauds
- "Middleman" frauds
- Bait and switch
- Larceny
- Extortion
- Counterfeit goods and intellectual property
- Affinity frauds
- Pyramid schemes
- Ponzi schemes
- Career opportunities
- Cash recovery frauds

Frauds against the Organization

- Check fraud
- Obtaining fraudulent loans
- Unsolicited orders
- Embezzlement
- Bribery
- Corruption
- Conflicts of interest
- Theft of trade secrets
- Breach of fiduciary duty
- False claims
- False conveyancing
- Tunneling
- Conspiracy
- Lapping
- Kiting
- Fraudulent affiliations
- Counterfeit money
- Benefit frauds
- Insurance fraud
- Payment card frauds
- Pension frauds
- Tax fraud
- Insider trading and market abuse
- Procurement fraud
- Falsification of time sheets
- Falsification of expense claims
- Forgery
- Creation of fictitious employees (ghost employees) and collecting the payments
- Failing to terminate existing employees and collecting the payments
- Billing for services not rendered

COST OF FRAUD

A major difficulty in estimating the cost of fraud is the fact that fraud often goes undiscovered and therefore unreported. For this reason, the available statistics may fail to reflect actual losses. In the past, such undetected fraud was subject to guesstimates with no indication of the reliability for the figures produced. Recently targeted measurement has given greater reliability to the estimated values for such fraud.

Fraud losses impact virtually every business enterprise and governmental function. Despite advances in fraud detection technologies, fraud losses have grown exponentially, imposing major cost increases in many industries. The impact on individual industries is explored more thoroughly in Chapter 12. In addition to direct losses, fraud may be seen as part of the economic externalities. An economic externality occurs when one business implements actions, or refrains from taking action, and in doing so passes on costs to another business.

For example, where an employee is dismissed for fraud-related offenses but no prosecution takes place, the ex-employee is free to seek employment with another organization and repeat the offense. Prieston and Dreyer in their book *Mortgage Fraud, The Impact of Mortgage Fraud on Your Company's Bottom Line,* sum this situation up: "While fraud does exist in retail organizations, it is typically related to a particular loan officer and is more often than not quickly discovered. The employee is usually terminated from his [or her] position and moves on to new company until the same thing happens all over."[3]

For many organizations, this migration of the fraud risk to a third party is seen to be "not my problem" as long as the perpetrator no longer works for their business. Indeed, some organizations see such a movement as to their advantage since the likelihood is that the perpetrator will stay in a similar industry and may well end up working for a competitor and imposing economic disadvantage on that organization. Such organizations typically refrain from publicizing in any form either the fact of the fraud or the method by which it was carried out. As a result, fraudsters can utilize the same techniques without an increase in the likelihood of detection.

According to the Association of Certified Fraud Examiners Report to the Nations on Occupational Fraud & Abuse,[4] a typical organization will, in all probability, lose some 5 percent of its annual revenue to fraud. When this percentage is applied to the estimated gross world product (GWP) for 2009, this figure translates to a potential total fraud loss of more than $2.68 trillion (now $3.2 trillion based on the 2010 GWP). Other key findings included:

- The median loss caused by the occupational fraud cases in the study was $160,000. Nearly one quarter of the frauds involved losses of at least $1 million.
- The frauds lasted a median of 18 months before being detected.

- Fraud perpetrators often display warning signs that they are engaging in illicit activity. The most common behavioral red flags displayed by the perpetrators in our study were living beyond their means (43 percent of cases) and experiencing financial difficulties (36 percent of cases).
- Occupational frauds are much more likely to be detected by tip than by any other means.

In 2006, the International Fraud and Corruption Report[5] examined the nature and costs of fraud in six countries: Australia, Canada, France, Germany, Ireland, and the United States.

Although the research was conducted in the United Kingdom, that country was excluded from the report due to difficulties with measuring losses to fraud since there was no legal definition of fraud as an offense in its own right.

The research was based on 2004 figures. Germany led the way in the cost of fraud in terms of the percentage of gross domestic product at 9 percent; in the United States, the cost amounted to 6 percent of GDP, although the actual cost of fraud in the United States at that time amounted to $660 billion.

In 2010, the National Fraud Authority (NFA) in the United Kingdom published its first Annual Fraud Indicator, estimating fraud losses in that country to be at least £30.5 billion per annum. The NFA readily acknowledged that the figure was underestimated as some significant areas of fraud were excluded. By the time of publication of the 2011 report,[6] many of these areas were included, resulting in a more comprehensive indication of the extent of fraud lost in the United Kingdom. According to the 2011 estimate, the cost of fraud was around £38.4 billion per annum. The public sector accounted for some 55 percent of fraud losses with tax fraud forming the largest component of that sector; its losses ran at an estimated £15 billion per annum.

The private sector losses were £12 billion per annum. The financial services industry saw the highest losses in this sector at £3.6 billion, while charities accounted for a further £1.3 billion. Direct losses suffered by individuals as a result of fraud were estimated to cost £4 billion, primarily as a result of schemes involving mass marketing, rentals, and online ticket fraud.

Another 2011 report in the United Kingdom[7] indicated that the financial cost of fraud and error can be accurately measured like any other business cost. According to the report, a typical 12-year average loss to fraud was more than 5 percent of total costs with fraud losses rising in the first two years after the start of the recession to over 6 percent. Fraud was "the last great unreduced business cost," but implementation of appropriate control mechanisms could reduce such costs by up to 40 percent within 12 months. The report draws a distinction between the traditional costing areas of an organization, in which costs can be forecast and budgeted and control mechanisms typically are designed and implemented in advance in order to improve efficiency. It is accepted that, within these areas, costs are a necessary part of doing business. Fraud, however, is frequently a "denied" cost. People believe that fraud happens to other organizations, not to their own; therefore, companies often do not implement preventive controls until after a significant fraud occurs. In reality, fraud is an unnecessary cost in that the business would continue at the same level of effectiveness should fraud not be present but at considerably higher levels of efficiency.

Where appropriate fraud preventive measures have been implemented, the results have been impressive. For example, government departments in the United States reporting loss reductions in several programs of up to 35 percent over a five-year period.[8] In the United Kingdom, the National Health Service reported loss reductions of up to 60 percent between 1999 and 2006.[9]

However, organizations that do not effectively manage fraud risks can incur a much larger costs. The longer the fraud continues, the greater the loss that is incurred.

In addition to the initial losses, cost of fraud includes the cost of insuring against loss of assets due to employee dishonesty as well as loss of reputation. Cost of investigation to substantiate such insured losses may also be expensive and can, in some cases, exceed the original cost of the fraud sustained. Some insurance policies cover investigation costs, but others do not or cover them only for proven fraud that is covered by the specific policy.

In the event of a claim, typically only losses that can be proven and quantified can be claimed successfully. Therefore, determining the cost of the loss is a critical component of successful asset recovery.

Intangible losses, such as the impact on corporate morale, may not be insured unless previously agreed to within the terms of the policy.

Internal fraud involving employee dishonesty cannot be completely eliminated but can be deterred with an effective internal control structure. One of the main deterrents to insider fraud is the degree of certainty that any attempt will be detected early and that the perpetrator will be caught. This deterrent appears to have more impact than the punishment the apprehended fraudster may expect. For that reason, it is critical that organizations encourage the reporting of fraudulent activities or suspected wrongdoing by maintaining a strong culture of ethics and integrity, while at the same time giving employees a method and the confidence to carry out such reporting without fear of retribution.

Costs of Corruption

In addition to straight losses caused by conventional fraud, another class of loss is that brought about by corruption such that "insiders" profit at the expense of "outsiders." Previously, corruption was seen as a by-product of lack of regulation in the commercial world and of corrupt political systems. In practice, however, heavily regulated economies suffer corruption at about the same rate as poorly regulated economies.

Various forms of corruption exist, from low-level bribes to junior public officials that have little financial impact on the economy as a whole but are very hard to prevent, through systematic corruption affecting whole areas of government and organizations, where dishonesty is the norm and honesty is seen to be irrational. Once again, as with other forms of fraud, it frequently is seen as someone else's problem. Complacency and attitudes that "such things only happen in the developing world" and "that sort of thing doesn't happen here" open the door to the bending of the rules as well as actively seeking exceptions to rules and regulations. Corruption includes the purchasing of intangibles, such as access to decision makers, direct influence, or political appointment, and can be seen in virtually every country in the world.

One of the major problems in dealing with large-scale corruption is deciding just what the term *corruption* means. Corruption includes not only *bribery* (payments made in order to gain an advantage over competitors or a rival, typically including the abuse of power) but also embezzlement (misappropriation of funds from the organization or government department) as well as direct *fraud* (theft through misrepresentation as previously defined).

Corruption is dealt with in more detail in Chapter 5.

In the United States, the Improper Payments Information Act of 2002 required public agencies to publish a "statistically valid estimate" of the extent of fraud and error in their programs and activities. In 2010, this act was reinforced by the passage of the Improper Payments Elimination and Recovery Act, which required increased reviews, audits, and reports for certain high-cost programs with high rates of improper payments.

Under these acts, the government pursues perpetrators of allegedly fraudulent acts and holds individual officers and directors accountable for compliance breaches of procurement policies and procedures. Regulators now require that the governance boards of organizations have a working knowledge of the regulatory scheme under which their organizations operate and with the compliance programs enforced within their own particular organization.

Corruption is covered in more detail in Chapter 7.

NOTES

1. *The Law of South Africa*, Vol. 6, pp. 330–331. (1994) Butterworths: Durban.
2. www.dfa.arkansas.gov/offices/accounting/internalaudit/Pages/Relationship-betweenInternalControlsandFraud.aspx.
3. Arthur J. Prieston and Jaqueline A. Dreyer, *Mortgage Fraud, The Impact of Mortgage Fraud on Your Company's Bottom Line* (Mortgage Bankers Association of America, 2001, Washington, DC).
4. ACFE, 2010 *Report to the Nations on Occupational Fraud and Abuse*, www.acfe.com/uploadedFiles/ACFE_Website/Content/documents/rttn-2010.pdf.
5. NHS Counter Fraud and Security Management Service, International Fraud and Corruption Report (2006). NHS Counter Fraud and Security Management Service, London.
6. National Fraud Authority, Annual Fraud Indicator, 2011, www.homeoffice.gov.uk/publications/agencies-public-bodies/nfa/annual-fraud-indicator/annual-fraud-indicator-2011?view = Binary.
7. Jim Gee, Mark Button, and Graham Brooks, *The Financial Cost of Fraud— what Data from Around the World Shows* (PKF [UK] LLP and the Centre for Counter Fraud Studies at University of Portsmouth, 2011), Portsmouth.
8. Maggie Mahar, *Taking On The "Epidemic" of Health* Care *Fraud*, www.healthbeatblog.com/2011/08/-taking-on-the-epidemic-of-health-care-fraud.html.
9. NHS Press Release NHS PATIENT FRAUD REDUCED BY MORE THAN HALF SINCE 1998: www.nhsbsa.nhs.uk/Archive/pr.patient.fraud._11.08.06.pdf.