16. Which of the following common vices motivates people to commit fraud?
   a. Gambling  b. Drugs  c. Expensive extramarital relationships  d. Alcohol  e. All of the above

17. Which of the following is a way that management can establish a good control environment?
   a. Having a clear organizational structure  b. Proper training  c. Communicating openly  d. Appropriate hiring procedures  e. All of the above

18. Which of the following is not an element of most frauds?
   a. Taking the assets  b. Concealment  c. Breaking and entering  d. Conversion  e. All of the above

Case 1. As an auditor, you have discovered the following problems with the accounting system of Jefferson Retailers. For each of the following occurrences, list which of the five internal control procedures was lacking. Also, recommend how the company should change its procedures to avoid the problem in the future.

   a. Jefferson Retailers’ bank account has been debited for overcharged checks. The accounts payable register is not reconcile monthly. The company should assign a dedicated personnel to reconcile accounts payable on a monthly basis.

   b. An account payable specialist is responsible for both receiving and processing invoices. The company should assign these tasks to separate personnel.

   c. Steven Meyer works in the warehouse. He maintains the inventory records, counts the inventory, and has access to the warehouse. The company should institute a policy that requires employees to take vacations.

   d. Receiving reports are sometimes filled out days after shipments have arrived. The company should implement a system to verify the accuracy of receiving reports.

Case 2. A few years ago, the top executive of a large oil refineries company (based in New York) was convicted of financial statement fraud. One of the issues in the case involved the way the company accounted for its oil inventories. In particular, the company would purchase crude oil from exploration companies and then process the oil into finished oil products, such as jet fuel, diesel fuel, and so forth. Because of the ready market for these finished products, the company would record its oil inventory at the selling prices of the finished products less the cost to refine the oil (instead of at cost) as soon as it purchased or discovered the crude oil. In addition to the fraud in the case, the company benefited from increased commodity prices in recent years. The company's stock price rose dramatically. The fraud was discovered when one of the company's clients sold the company at a substantial profit. The client then purchased the same type of oil from another company and was able to sell the oil at a lower price. The company then realized that it had overvalued its inventory. The company should implement a system to verify the accuracy of inventory records and to establish a policy that requires employees to take vacations.

Case 3. Full-of-Nature is a vitamin supplement company in New York that makes different herbal pills for gaining muscle strength, losing weight, and living a healthier life. You have been hired by Full-of-Nature and you soon realize that the company has many problems. You notice the following funds being committed and are writing a report to the Board of Directors about what should be done to fix the problem. For each fraud, list one control procedure that was not followed and suggest how the company should eliminate the fraud and deal with the perpetrator.

   1. What internal controls are missing in Full-of-Nature’s company?
   2. What opportunities gave Full-of-Nature the opportunity to perpetrate the fraud?
   3. What could the fraud be prevented in the future?
Case 7. Bob's Country Kitchen, a small family-owned restaurant in northern New York, has seen a drop in profitability over the past 3 years and the owners want to know why. Bob's has been a local favorite for the past 3 years. Two brothers opened it in the early 1980s but they couldn't find a buyer who liked them. Bob's initial strategy was to offer unique American food with a focus on locally sourced ingredients. However, the restaurant's popularity and loyalty declined, and they were forced to close.

Bob and Tom felt that their new management was doing a good job and so they gradually became less involved and less involved. In 2000, Bob and Tom gave up all management duties to Joe, a friend of the family who had been employed at Bob's for 15 years. Bob's had no computer system in place for customer orders, each order was written on a pad with a duplicate carbon, one copy is taken to the kitchen, and the other is given to the customer. All customers pay at the cash register at the front of the restaurant, after which the receipts are pegged on a tack and stapled at the end of the day. The company has since automated the total sales. Bob and Tom have noticed a gradual decline in profits over the past three years and, up until now, it was just because of the increased competition and the restaurant's location. However, it seemed odd to Bob and Tom that revenues had increased substantially but profits had not. When asked about the change in relationships between revenues and profits, Joe said it was because of a large increase in the cost of food and that he had to pay his employees more with the increased competition. Bob and Tom have no reason to disbelieve Joe, since he is a trusted family friend. Joe's responsibilities at Bob's include preparing the nightly deposits, managing accounts payable, handling payroll, and performing the bank reconciliations. Joe also has the power to write and sign checks. No one checks his work.

1. What possible opportunities does Joe have to commit fraud?
2. What signs could signal a possible fraud?
3. How likely is it that a few internal controls could reduce the opportunities for fraud?
4. Which internal controls would you suggest be implemented?

Case 8. In October 2001, the following case was heard in New Jersey.

A former restaurant owner was sentenced to seven years in State prison for conspiracy, theft by deception, falsification of records, and falsification of records relating to medical care. He is serving a sentence for insurance fraud. In addition to his prison sentence, the restaurant owner was ordered to pay a criminal insurance fraud fine of $100,000 and restitution of $97,975. The state is also in the process of seeking an additional $810,000 in civil insurance fraud penalties.

The restaurant owner was found guilty of false insurance billing for providing eyeglasses and routine eye exams at no cost or at reduced cost, and making up the difference by billing insurance carriers for services not rendered to customers. The restaurant owner also had his office and practice approximately 99% false patient records and charts along with false insurance carriers for prescribed optometric services that were not rendered to his patients. He would also bill insurance companies for optometric treatments and items for ocular conditions that patients did not actually suffer. The optometric was also changed for falsifying patient records and charts. What noncontrol factors provided the optometric with an opportunity to commit fraud?

1. What factors made it easy for the optometrist to commit fraud?
2. What are the elements of fraud, if any, that are present in this situation?
3. How would you respond to your mentor or to other employees who may encourage you to pull a similar stunt at your workplace to earn money?
4. What do you consider to be the two essential elements of a conspiracy to commit theft? Describe how the rationalization element of the fraud tri-angle is present in this case.

Case 9. Len Haxton is the owner of a local CFA firm with four separate offices in a medium-size town. He and his wife started the firm 20 years ago, and they now have more than 50 full-time employees. Recently, he discovered that one of his employees had stolen $20,000 from the business during the past six months because of lax internal controls. Len was furious about the situation, but was uncertain about whether he should initiate a criminal investigation or just fire the employee. He decided that if anything goes wrong with the investigation, he will be placed in a difficult position. Since his own legal practice is in the area of taxation, and he is well known, he wants assistance from the company. He is considering whether to initiate a criminal investigation or just fire the employee. He has a personal interest in the case, but he is clearly in a difficult position. Len is considering whether to initiate a criminal investigation or just fire the employee. He has a personal interest in the case, but he is clearly in a difficult position.

1. What factors made it easy for Len Haxton to commit fraud?
2. What are the elements of fraud, if any, that are present in this situation?
3. How would you respond to your mentor or to other employees who may encourage you to pull a similar stunt at your workplace to earn money?
4. What do you consider to be the two essential elements of a conspiracy to commit theft? Describe how the rationalization element of the fraud tri-angle is present in this case.
the office doesn’t require an additional employee, Nancy assumed all office managing responsibility. The receptionist could share the office managing duties but she is too busy managing accounts, doing bookkeeping, and answering phone calls. Nancy is also a single mother of four. She likes to give her children the best possible care and enjoys the finer things of life to the extent that she can afford them. Nancy also works a second job because her job as office manager “just never seems to pay the bills.”

Most patients visiting the doctor have insurance and are only required to pay a copayment for the services that they receive. As you are filling out some patient information during a routine visit you overhear the patient say to her husband, “Honey, do you have any cash with you today? This office prefers the copayment be paid in cash and I forgot to stop by the ATM this morning.” You thought that this comment was interesting because you had never heard of the office having a cash copayment preference. In addition, you haven’t seen a written sign or ever heard the doctor preferring cash copayments be made. You are aware that in addition to a copayment, Nancy bills the entire remaining cost of services. The remaining amount is then billed directly to the patient. While you filed patient records you often heard Nancy complain that “full payment cannot be collected from you another patient.” You are aware that several accounts are written off each month due to the high amount of uncollectable accounts. A high percentage of bad debts seems to be a common and expected occurrence in the physician/patient business. You are currently taking a fraud class and realize that several opportunities for fraud exist.

1. Consider the fraud triangle. What opportunities and motivation exist for Nancy to commit fraud?
2. What should be done to improve internal controls and reduce the risk of fraud as it relates to the segregation of duties?

EXTENSIVE CASES

**Extensive Case 1. GreenGras**

GreenGras is a small, family-owned company whose core service is in horticultural care and lawn care services in the local city. The owner of the company is the father of the family. He has used the company to cover the costs of his children’s college educations. As he has been able to give his children some work experience and an opportunity to earn their own money to pay for school. The company has traditionally operated for about five years, and the manager has hired many employees outside of the family to be able to keep up with the demand of the increasing number of customers. The company is run from a small office building, with only one employee running the operations in the company office. The father had usually been in charge of this aspect of the company, but now leaves the responsibility to his trusted friend, who has experience in accounting and information systems. The employee is in charge of scheduling the routes of all the employees and is responsible for payments, receipts, and balancing the books.

The company performs two major operations. First, it provides lawn care using insecticides, fertilizers, and weed killers. Eight employees are responsible for this activity. They each drive a truck and are responsible for collecting money from the customers they serve. They are also responsible for loading and mixing chemicals in the tanks they use during the day. The second part of the operations involves mowing. A four-person crew is responsible for all the machines used, and crew members are responsible for taking care of the lawn on their daily schedule lists. The manager hired his children to work on this crew, and the whole team is usually made up of workers younger than the team that works with the chemicals.

Over the years, GreenGras experienced small growth and success. Profits increased substantially as the company picked up new clients. However, the manager noticed that last year’s accounts were different. The revenue increased by a small amount, while the expenses for the company increased more than they should have. The manager noticed that his interactions with his clients in the office have been fewer. Also, his employees have been finishing their routes earlier in the day than in previous years.

**Questions**

1. What are some of the fraud opportunities within GreenGras?
2. What symptoms of fraud exist, and what symptoms should the manager look for if he believes fraud may be occurring?
3. What steps should be taken to make sure fraud does not occur, and what are the cost associated with these steps?

**Extensive Case 2. James Watkins**

James Watkins, an ambitious 22-year-old, started an entertainment business called Best Club after he graduated from California State University. Best Club initially was a business failure because James ignored day-to-day operations and cost controls. One year later, James was heavily in debt. Despite his debt, James decided to open another location of Best Club. He was confident that Best Club would bring him financial success.

However, as his expenses increased, Watkins could not meet his debts. He turned to insurance fraud to save his business. He would stage a break-in at a Best Club location. He would work with a small, fictitious equipment to secure loans, falsified work order contracts to secure loans, stole money orders for cash, and used his credit card to purchase gifts and credit cards. Watkins was living the “good life,” with an expensive house and a new sports car.

Two years later, Watkins decided to make Best Club a public corporation. He falsified financial statements to greatly improve the reported financial position of Best Club. In order to avoid the SEC’s scrutiny of his financial statements, Watkins merged Best Club with Red House, an inactive New York computer firm, and acquired Red House’s publicly owned shares in exchange for stock in the newly formed corporation. Watkins personally received 79 percent of the shares. He was now worth $24 million on paper. Watkins was continually raising money from new investors to pay off debts. A few months later, Best Club’s stock was selling for $21 a share, and the company’s book value was $310 million. Watkins had raised $30 million in new equity. A few months later, Watkins met John Gagnon, president of AM Firm, an advertising service. Gagnon agreed to raise $100 million, via junk bond, for Best Club to buy our Sun Society, a travel service.

Afterward, with television appearances, Watkins became a “hot figure” and developed a reputation as an entreprenurial genius. However, this reputation changed after an investigative report was published in a major newspaper. The report chronicled some of Watkins early credit card frauds. Within two weeks, Best Club’s stock plummeted from $21 to $5.

After an investigation, Watkins was charged with insurance, bank, stock, and mail fraud, money laundering, and tax evasion. But Best Club’s shares were already selling for just pennies. A company once supposedly worth hundreds of millions of dollars dropped in value to only $48,000.

From this case, identify the following:

1. The pressures, opportunities, and rationalizations that led Watkins to commit his fraud
2. The signs that could signal a possible fraud
3. Controls or actions that could detect Watkins’ frauds

**Extensive Case 3. Johnson Manufacturing**

Johnson Manufacturing, a diversified manufacturer, has seven divisions that operate in the United States, Mexico, and Canada. Johnson Manufacturing historically allowed its divisions to operate independently. Corporate intervention occurs only when planned results were not obtained. Corporate management and board integrity, although the board of directors is not especially active. Johnson has a policy of performing employee screenings on all employees before hiring them. Johnson feels its employees are all well-educated and honest.

The company has a code of conduct, but employees are not closely monitored. Employee competition is highly dependent on the performance of the company.

During the past year, a new competitor entered one of the Johnson’s highly successful markets and undercut Johnson’s prices. The Johnson unit, Harris, responded by matching price cuts in hopes of maintaining market share. Harris is concerned because she cannot see any other areas where costs can be reduced so that the division’s growth and profitability can be maintained. If profitability is not maintained, the division managers’ salaries and bonuses will be reduced.

Harris decides that one way to make the division more profitable is to increase inventory. Harris believes the company spends too much money on inventory and that the division’s sales forecast, which assumes sales in all areas are up, was overly optimistic. Harris decided to increase inventory. Harris supports his decision by sharing a memo with the divisional controller. The manager in charge of the division that oversaw inventory also supports Harris’s decision. It is expected that the division will make a profit this year. Harris has been asked to increase inventory by 50% for the upcoming year. Harris figures that this increase in inventory will allow the division to maintain its growth.

**Questions**

1. What factors in Johnson’s control environment led to and facilitated the manager’s manipulation of inventory?
2. What pressures did Harris feel in deciding to overstate inventory?
3. What rationalization did Harris use to justify his fraud?

**Extensive Case 4. Armstrong Manufacturing**

Armstrong Manufacturing was founded in 1899 by a former employee of the Armstrong Manufacturing Company. Armstrong Manufacturing operates in the United States, Mexico, and Canada. Armstrong Manufacturing has a decentralized management structure, allowing each division to operate independently. Corporate intervention occurs only when planned results were not obtained. Corporate management and board integrity, although the board of directors is not especially active. Armstrong has a policy of performing employee screenings on all employees before hiring them. Armstrong feels its employees are all well-educated and honest.

The company has a code of conduct, but employees are not closely monitored. Employee competition is highly dependent on the performance of the company.

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