PacificCPE

COURSE
11803A

Ethics, Fraud Prevention, and Compliance Strategies

Preventing fraud starts long before an investigation begins. This chapter focuses on the antifraud and compliance frameworks that organizations use to deter misconduct and promote ethical behavior. Designed for CPAs and financial professionals involved in compliance, governance, or advisory roles, it covers the principles behind effective fraud prevention programs, the ethical responsibilities of accounting professionals, and practical deterrence strategies. Walk away better equipped to help clients and employers build cultures and controls that reduce fraud risk from the ground up.

CREDIT HOURS 2 | FIELD OF STUDY AUDITING | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Identify fraud deterrence best practices.

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Chapter 1: ANTIFRAUD AND COMPLIANCE EFFORTS: ETHICS, PREVENTION, AND DETERRENCE

Chapter Objective

After completing this chapter, you should be able to:

- Identify fraud deterrence best practices.

Perspectives from an Anti-fraud Practitioner

I'm not gonna lie to you: I think it'd be pretty cool to jet around the world with a gun and a badge like some of my fellow fraud fighters, bringing down notorious, large-scale fraudsters. And maybe that's how you will join the fight to protect people from fraud, but allow me a moment to share another angle of attack with you: working to deter fraud, waste, and abuse within organizations whose mission happens to be meaningful to you.

For example, as you know, there are countless not-for-profit organizations which exist to end hunger, educate people, and provide medical services to some of the most impoverished people on the planet. Yet, such lofty purposes notwithstanding, not-for-profits are just as vulnerable as for-profit ventures to fraud, waste, and abuse. In fact, an argument could be made that they are often more vulnerable because they do not have the expertise within their ranks to deter and detect fraud. As a result, they've never even heard of things that we in the fraud-fighting profession take for granted, such as COSO's Frameworks, Enterprise Risk Management (including risk assessment), an organizational fraud reporting hotline, and tone at the top. Sometimes, they turn to consultants for help. This is how I fight fraud.

Having been a professional educator/consultant for most of the past 30+ years, I choose to work with charter public schools. (It's a little known fact that some two-thirds of charter schools serve impoverished students in inner cities.) As a sector with about 8,000 schools nationwide, charter schools have unfortunately been anything but immune from fraud in the past three decades in which they have existed. (The first charter school opened its doors in 1992.)

Some schemes in charter schools are sufficiently opaque as to not really be detectable by a volunteer board (such as the A3 scandal in California), but many other schemes are garden variety in nature, making them relatively easy to deter and detect. I don't use the word "prevent" in my work because almost any control can be compromised (using "Collusion, for example). Deterrence controls such as control of check stock, separation of duties (especially separating the duties of maintaining the ledger and reconciling it), and not having debit cards can, and do,

greatly reduce the risk of fraud for the typical charter school. Similarly, teaching board members that they need to review source documents such as bank statements, credit card statements, and quarterly payroll reports—not just monthly financials—provides them with powerful detection techniques that vastly strengthen a school's fraud risk management. Even something as simple as teaching board members the importance of having (and enforcing) a whistleblower protection policy and a fraud reporting hotline (not under the control of management) is often an eye-opener for my clients.

Sometimes deterrence and detection are even simpler. For example, in a performance audit I conducted on a school a few years ago, I discovered that neither the board president nor the board treasurer had completed a criminal background check, despite being required by state law to do so. Yet both individuals were expending school funds, acquiring check stock without proper procedure, and providing "oversight" of school finances on behalf of the board. When I confronted their failure to comply with the law, both resigned rather than submit to the required background check. Were they hiding something? I don't know; but I believe any school is better off without board members whose actions reflect a real disdain for setting a proper tone at the top. By the way, the bookkeeper in the school told me she suspected that their activities were improper, but she didn't know who to tell, and she was afraid of losing her job. "Textbook," right?

So, no, I never get to say, "Book 'em Danno" (reference to Hawaii Five-0), but I get a deep sense of inner satisfaction anytime I succeed at teaching charter school board members and executives how to deter and detect fraud, waste, and abuse, including how to reduce their school's exposure to risk. And, every now and then, one of those schools will call me and say something like, "Hey, do you remember when you recommended that we do this or that procedure? Well, we did. And guess what? We discovered that so and so has been stealing from us, but thankfully, we caught them quick enough that there's no real harm to the school."

In that moment, I smile, knowing that some kids I will never meet will continue going to a school that helps them. If this kind of satisfaction appeals to you, we need more fraud fighters in the charter school sector.

Brian L. Carpenter, PhD, CFE

Independent charter school consultant/author/speaker

This chapter covers ethics, compliance, fraud deterrence, and fraud prevention. Franco Frande, Assistant Director (Management)/CFO for the U.S. Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF) often cited the anecdotal 10–80–10 Rule of Ethics: 10% of the population will commit bad acts whenever the opportunity presents itself (consistent with the notion of predators), 80% of the population might commit bad acts, depending on the circumstances (consistent with the notion of situational fraudsters), and the remaining 10% of the population will never commit fraud.

[1]

In a 2018 report from ABC affiliate KTRK Channel 13 Action News in Houston and USA Today, a megachurch pastor and a Louisiana financial planner were accused of defrauding investors of more than $1 million. [2] According to the news sources, a federal grand jury indicted Gregory Alan Smith, 55, of Shreveport, LA, and Kirbyjon H. Caldwell, 64, of Houston, TX on six counts of wire fraud, four counts of money laundering, and one count each of conspiracy to commit wire fraud and conspiracy to commit money laundering.

Apparently, the pair offered quick and impressive returns on prerevolutionary Chinese bonds dating back to the 1940s, allegedly collecting as much as $3.5 million from investors. The indictment suggests that the bonds were worthless. To keep investors on the hook, the defendants made frequent calls and promises of pay back to investors, suggesting that they "keep the faith." Rather than invest their client's funds, the defendants were alleged to have used the money to pay personal loans, credit card balances, mortgages, vehicle purchases, and other personal expenses.

Caldwell had been the pastor of Windsor Village United Methodist Church, a 14,000-member megachurch in Windsor Village in Houston. News sources also indicate that Caldwell led the benediction at both inaugurations for former president George W. Bush and officiated at Jenna Bush's wedding in 2008. Caldwell was convicted and sentenced to 72 months (6 years) in prison followed by 1 year of supervised release for conspiracy to commit wire fraud. Caldwell was ordered to pay restitution in the amount of $3,588,500, as well as a fine of $125,000. [3]

News reports, such as this, suggest that fraud is possible across all socioeconomic classes and even (some would say especially) among the most trusted individuals. Yet, with an ethical commitment and an understanding of compliance and strong fraud deterrence and prevention efforts, organizations can minimize the likelihood of fraud and other bad acts and minimize its impact when it does occur. In this chapter, the authors examine these topics across several modules. Those modules, along with the learning objectives, include the following:

- Module 1 provides an overview of ethics and its important role in setting a solid foundation upon which compliance and antifraud efforts can be built. Module 1 has two overarching objectives: (a) Identifying ethical issues, conflicts of interest, and noncompliance with corporate policies and procedures in the context of decision-making and (b) discuss alternative courses of action in a given scenario within the framework of appropriate ethical conduct.
- Module 2 dives deeper into organizational compliance—the process of making sure the organization and its employees follow ethical practices, laws, regulations, standards, policies, and procedures. While deterring and preventing fraud is consistent with the notion of compliance, it has a greater role that, properly implemented, helps organizations avoid civil and criminal litigation and reputation-damaging acts. The goal of

Module 2 is for readers to be able to articulate the role of compliance efforts and apply those in organizational decision-making.

- Module 3 examines fraud deterrence efforts. In short, deterrence is not about preventing bad acts but rather about creating environments where bad acts are less likely. The learning outcomes for Module 3 include the ability to identify major categories of fraud deterrence and evaluate organizational deterrence efforts.
- Module 4 considers fraud prevention. No organization can prevent all fraud from occurring; however, when properly designed, organizations can reduce the risk of certain categories of fraud. The design of fraud prevention controls tends to rely heavily on the separation of duties for transaction initiation, authorization, recording, and asset safeguarding. This suggests that even the best fraud prevention efforts are at risk from management override and collusion. The objective for Module 4 is for the reader to be able to evaluate an organization's fraud prevention efforts and identify potential weaknesses in the system.

Many of the topics in compliance, fraud deterrence, and fraud prevention are also examined with regard to fraud detection, a topic detailed in PES course #8325. [4]

MODULE 1: ETHICS

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

The rest of the story ...

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

Oreo hatches a scheme to catch Jim ...

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

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

The above scenario highlights some of the ethical dilemmas faced by professionals confronting individuals who perpetrate financial crimes. Ethics, trust, and responsibility are at the heart of compliance, fraud examination, and forensic accounting.

Ethics is defined as the branch of philosophy dealing with values relating to human conduct, with respect to rightness and wrongness of actions and the goodness and badness of motives and ends. [5] Ethics has certain key elements:

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

A discussion of ethics goes hand-in-hand with that of criminology because fraudsters often make poor ethical decisions prior to committing criminal acts. Consider, for example, financial statement fraud: perpetrators frequently find themselves on an ethical slippery slope, using an accounting choice as a tool for earnings management to maximize bonuses and influence financial returns and the financial markets. When earnings management isn't enough, the individual finds himself at a point of no return, moving from the slippery slope of earnings management to fraudulent financial statements.

When does the fraud examiner or forensic accountant face an ethical dilemma? Whenever there are several choices, all outcomes have somewhat negative effects, and the correct choice is not obvious. Such dilemmas arise when many people could be harmed and some may benefit while others will not.

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

Approaches to Ethical Problem Solving

Is It Legal, or Does the Conduct Violate Known Rules?

The law and rules is one approach to resolving an ethical dilemma. Most professional associations' codes of conduct, for example, require that professionals avoid breaking the law. This is a practical approach, and a starting point for determining if certain conduct should be avoided. The law, however, is the lowest threshold for ethical decision-making.

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

The Means versus the Ends

A second approach to ethics suggests that it is ok to "fight fire with fire." As Sean Connery's character, Malone, asks Elliott Ness (Kevin Costner) in *The Untouchables*, "What are you prepared to do? ... You wanna know how to get Capone? They pull a knife, you pull a gun. He sends one of yours to the hospital; you send one of his to the morgue." Essentially, this is an outcome-based ethical framework. This has the purpose of justifying actions that otherwise could be considered immoral, unethical, or illegal. The problem with means–ends analyses is that they are often superficial, ending with the needed justification but failing to fully consider other aspects and consequences of the actions. [6]

Ethical Principles

The Imperative Principle

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

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

The Utilitarian Principle

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

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

The difficulty with utilitarianism is the variation in outcomes. In any situation, almost any act can be justified and the choice is always a product of from where a person (act) or society (rule) came: