PacificCPE

COURSE
90052A

Fraud Prevention and Management Misconduct

Fraud doesn't always come from outside an organization. This course tackles two of the most pressing fraud risks facing CPAs in business: internal fraud carried out by employees and fraud orchestrated by management itself. Understanding how these schemes work, how they're concealed, and how they can be detected is essential for any accounting professional with oversight or governance responsibilities. Whether you work in internal audit, finance, or a controller role, this course helps you recognize red flags and strengthen your organization's defenses against fraud from within.

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

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LEARNING ASSIGNMENTS AND OBJECTIVES

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

- Recognize common frauds in business and how fraud prevention should be implemented.
- Recognize management fraud techniques as they relate to misstated financial statements.

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Publication Date: January 2026

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Chapter 1: INTERNAL FRAUD PREVENTION

Chapter Objective

After completing this chapter, you should be able to:

- Recognize common frauds in business and how fraud prevention should be implemented.

Unofficial estimates of internal theft and fraud range from good, educated guesses to wild predictions. Some of the most intriguing estimates come from self-report surveys. In The Day America Told the Truth, researchers Paterson and Kim conducted anonymous surveys of 3,000 Americans on a variety of "hidden" topics. They claim their research accurately portrays what people think, do, and feel when no one is watching. They concluded that the following are the top five office "crimes":

- Taking office supplies
- Taking office equipment
- Lying to a boss or co-worker
- Stealing company funds
- Taking credit for work not done

In addition, the survey revealed the following statistics about American workers:

- Workers admit that they spend more than 7 hours a week goofing off–20 percent of the work week
- Almost half the workers admit to chronic malingering, calling in sick when they are not, and doing it regularly
- One in six Americans surveyed used drugs or drank on the job
- Half the work force believes that one gets ahead on the basis of politics, rather than on hard work
- One-quarter of workers expect to compromise their beliefs to get ahead on the job
- Only one in five workers say they are "very satisfied" with their jobs
- Workers say they put in about 45 percent effort into their jobs.

Prevention Versus Detection

Most experts agree that it is much easier to prevent than detect fraud. Increasing the perception of detection may well be the most effective fraud prevention method. Controls, for example, do little good in forestalling theft and fraud if their presence is not known by those at risk. In the audit profession, this means letting employees, managers, and executives know that auditors are actively seeking out information concerning internal fraud. This can be accomplished in several ways.

Employee Education

Organizations should have a policy for educating managers, executives, and employees about fraud. This can be done as a part of employee orientation, or it can be accomplished through memoranda, training programs, and other intercompany communication methods. The goal is to make others within the company be the eyes and ears.

Education efforts should be positive and non accusatory. Illegal conduct in any form eventually costs everyone in the company through lost profits, adverse publicity, and decreased morale and productivity. These facts should be emphasized in training.

Reporting Programs

Each employee in the company should know where to report suspicious, unethical, or illegal behavior. A reporting program should emphasize that:

- Fraud, waste and abuse occurs in nearly all companies
- Such conduct costs the company jobs and profits
- The company actively encourages any employee with information to be able to come forward
- The employee can come forward and provide information anonymously and without fear of recrimination for good faith reporting
- There is an exact method for reporting; i.e., a telephone number, name, or other information
- The report need not be made to one’s immediate superiors

Hotlines

Hotlines have proved to be a very effective reporting mechanism. However, most hotline reports do not result in fraud cases. At the federal level, published reports indicate about five percent of hotline calls result in serious allegations. With careful screening of calls and proper handling, spurious complaints can be effectively weeded out. The advantages and disadvantages of three general types of hotlines are summarized next.

Part-time, In-house. These hotlines are assigned to an employee with other duties. The typical in-house hotline is manned by the audit or security department. When the employee is out, a recorder takes calls. The main advantage is cost. The main disadvantage is that the hotline is not staffed full-time, which can discourage calls. Also, some persons may be reluctant to report to the company.

Full-time, In-house. A full-time, in-house hotline may be feasible depending on the company size. The advantage is that persons can make reports at any time, day or night, and talk to a person. The disadvantage is cost, and like the part-time line, some persons may be reluctant to report directly to the company.

Third-Party. A third-party hotline is staffed by an outside company that typically provides services of this type as a specialty. The advantages are cost, efficiency, and anonymity. A few are staffed around the clock and will provide the information immediately to the client involved for the client to handle. They also provide anonymity to those who might be more comfortable with it. Their disadvantage is that the operation is beyond the company's control and sometimes the cost is high.

Rewards

Some companies have a policy of rewarding information that leads to the recovery of merchandise, property, or money. Others offer rewards upon the criminal conviction of the person(s) involved. If a reward policy exists, strict criteria should establish reward payments, and such proposed policies should be reviewed and approved by counsel. The amount of reward paid by companies varies from fixed fees to a percentage of the recovery. Studies indicate that rewards should not exceed a few thousand dollars. Crime Stoppers recommends rewards not over $1,000.

Proactive Audit Policies

Proactive fraud policies are generated from the top of the operation. A proactive policy simply means that a company will aggressively seek out possible fraudulent conduct instead of waiting for cases to come to its attention. This can be accomplished by several means.

Increased Use of Analytical Review. Much internal fraud is discovered as a result of analytical review. To uncover such fraud and defalcations, they must materially affect the financial statements. Auditors should be especially mindful of the following trends:

- Increasing expenses
- Increasing cost of sales
- Increasing receivables/decreasing cash

- Increasing inventories
- Increasing sales/decreasing cash
- Increasing returns and allowances
- Increasing sales discounts

Fraud Assessment Questioning. Fraud assessment questioning is a non-accusatory interview technique used as a part of a normal audit. It operates on the theory that attitudes by employees are a good indicator of potential problems, and that one of the most effective ways to deal with fraud is to ask about it.

Enforcement of Mandatory Vacations. Much internal fraud requires manual intervention and is, therefore, discovered when the perpetrator is away on vacation. The enforcement of mandatory vacations will aid in the prevention of some fraud.

Surprise Audits. All too many fraud perpetrators are aware when auditors are coming and, therefore, have time to alter, destroy, or misplace records and other evidence. A proactive fraud policy involves using surprise audits as much as possible. It could have a significant deterrent effect.

Fraud Policy and Ethics Policy

Companies often have an ethics policy that sets forth in detail the ethical expectations of the company. Still other companies have a fraud policy that specifically spells out who handles fraud matters under what circumstances. The components of a fraud policy will differ from company to company. Many fraud policies have some of the following elements.

Policy Statement

The policy sets forth that management is responsible for fraud, and each member of the management team should be familiar with the types of signals present within his or her scope of responsibilities. The policy statement also states who is in charge of investigating suspected irregularities.

Scope of Policy

This area of the fraud policy statement covers definitions of irregularities and the fact that the policy covers everyone from management to worker.

Actions Constituting Fraud

This area sets forth in detail the actions that constitute fraudulent conduct. This is important because it gives management and legal the grounds to investigate and punish violators. The actions listed can include:

- Any dishonest or fraudulent act
- Forgery or alteration of documents
- Misapplication of funds or assets
- Impropriety with respect to reporting financial transactions
- Profiting on insider knowledge
- Disclosing securities transactions to others
- Accepting gifts from vendors
- Destruction or disappearance of records or assets
- Any similar or related irregularity

Non-Fraud Irregularities

This section covers allegations of personal improprieties or irregularities and states that these should be resolved by management and not by the audit department.

Investigation Responsibilities

This part deals with who will investigate suspected irregularities as well as to whom these irregularities will be reported: management, law enforcement, and legal counsel.

Confidentiality

Under this section, the confidential nature of the investigation is set forth. It states that the investigation will not be disclosed to outsiders except as required.

Authorization for Investigation

This section delineates that whoever is in charge of the investigation has the authority to take control of and examine records.

Reporting Procedures

This part states that anyone suspecting fraud should report it and not attempt an investigation. It also states that management and others should not make statements regarding the alleged guilt of the perpetrator.

Termination

This section states that any recommendations to terminate employees should be reviewed by counsel and management.

Communicating the Fraud Policy

It obviously does little good to have a fraud or ethics policy if it is not communicated to the employees. This communication can be accomplished in several ways. The communication of the policy should be presented in a positive, non-accusatory manner.

Orientation

During initial employee orientation, the fraud policy should be discussed. This is the first opportunity the company has to make its point, and it should be made thoroughly.

Memoranda

An interoffice memorandum from the chief executive officer detailing the fraud policy is a good idea. Once again, the policy should concentrate on the positive aspects of working for an ethical company.

Posters

Some companies may wish to use posters displayed in common areas. However, this should be carefully considered as some employees may object to such tactics.

Employee Morale

If an employee is properly instructed, communication of a fraud policy can have a positive impact on morale. Honest workers want to work for an honest company. A fraud policy helps set the proper tone.

Legal Considerations

Many companies have learned that it is best to spell out specific unacceptable conduct. If the type of conduct that is considered unacceptable is not accurately detailed, legal problems in discharging a dishonest employee may arise. Check with your counsel regarding any legal considerations with respect to a fraud policy. One of the most important legal considerations is to insure every person and every allegation is handled in a uniform manner.

Selling Fraud Prevention to Management

Management may not support fraud prevention for one or more of several reasons.

- Management’s concerns are often elsewhere than audit or fraud. Managers typically do not understand that fraud is hidden and that losses go on undetected without their knowledge. They might also refuse to believe that their own workers are capable of stealing even when studies suggest a third of employees might do such a thing.

- Because of the hidden nature of fraud, managers are understandably reluctant to believe the presence of fraud. And if one employee is caught committing fraud, management may claim that this is an isolated problem, and not worth additional consideration. Management must understand that when instances of fraud are detected, it is too late to do anything about it.
- Management sometimes unreasonably feels that by bringing up the issue, the work force will be alienated. This problem can be addressed by reminding management that the rank-and-file workers appreciate working for an honest company. It is also helpful to point out to management what the losses might be.

Many auditors complain that management does not adequately support fraud prevention efforts. Managers may believe that fraud is not really a problem in the company, or they may believe that even addressing the subject has a negative impact. In either scenario, it is difficult to break down management's built-in resistance to dealing with fraud prevention. The suggestions below may be helpful in "selling" fraud prevention to management.

The Impact on the Bottom Line

One of the best ways to sell management on fraud prevention is by showing the impact on the bottom line. Fraud reduces net sales more than dollar-for-dollar. For example, if a company nets 20 percent on sales, it must sell five items at regular prices to recover losses from the theft of one item. Fraud can be very expensive.

Computing Fraud Losses

One of the problems in selling fraud prevention is convincing management that these hidden situations are costing the company money. Because fraud is hidden, the auditor can try to estimate losses.

In absence of good data, fraud examiners and financial professionals can use the "two percent rule" to compute potential fraud losses. This assumes that within a given population of people, at least two percent will steal in quantity. Or put another way, two percent of sales might be lost to fraud and other forms of dishonesty. This figure is an extrapolation and should be reasonably conservative for most companies. If it seems high, remember this: one percent of the population of the United States is under care of the courts for criminal offenses. These are the ones who are caught, prosecuted and convicted.