# *Fraud Examination 7th edition Albrecht Solutions Manual*

SKU: 9780357721759-SOLUTIONS

# Solution and Answer Guide

ALBRECHT, FRAUD EXAMINATION, 7E, ©2025, 9780357721759; CHAPTER 1: THE NATURE OF FRAUD

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## DISCUSSION QUESTIONS

1. What is fraud?

   **Answer:** Fraud always involves deception, confidence, and trickery. The following is one of the most common definitions of fraud:

   a. *"Fraud is a generic term, and embraces all the multifarious means that human ingenuity can devise, which are resorted to by one individual, to get an advantage over another by false representations. No definite and invariable rule can be laid down as a general proposition in defining fraud, as it includes surprise, trickery, cunning and unfair ways by which another is cheated. The only boundaries defining it are those which limit human knavery."*

   Fraud is deception that includes the following elements:

   1. A representation
   2. About a material point
   3. That is false
   4. Intentionally or recklessly so
   5. That is believed
   6. And acted upon by the victim
   7. To the victim's damage

2. How does fraud affect individuals, consumers, and organizations?

   **Answer:** Fraud affects individuals, consumers, and organizations in various ways. Fraud usually lowers organizations' net income dollar for dollar. To recover these costs, consumers and individuals must pay more for goods and services. For example, health care fraud and insurance fraud increase premiums that individuals must pay. The cost of fraud eventually reaches every part of the economy, including individuals, consumers, and organizations.
   The 2008 study by The Association of Certified Fraud Examiners estimates that U.S. organizations lose roughly 7 percent of their annual revenues to fraud. Applied to the U.S. gross domestic product (GDP), this 7 percent figure translates to approximately $994 billion in fraud losses.

3. List and describe the five different types of frauds.

   **Answer:**

   **a. Employee embezzlement**: In this type of fraud, employees deceive their employers by taking company assets. Embezzlement can be either direct or indirect.
   **b. Management fraud**: Distinguished from other types of fraud both by the nature of the perpetrators and by the method of deception. In its most common form, management fraud is deception perpetrated by top management's manipulation of financial statements. The victims of management fraud are typically stockholders, lenders, and others who rely on financial statement information.
   **c. Investment scams or consumer scams**: A type of fraud that is perpetrated when fraudulent and usually worthless investments are sold to unsuspecting investors.
   **d. Vendor fraud**: Perpetrated by vendors; comes in two main varieties: fraud perpetrated by vendors acting alone, and fraud perpetrated through collusion between buyers and vendors. Vendor fraud usually results in an overcharge for

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purchased goods, the shipment of inferior goods, or the nonshipment of goods even though payment was made.

**e.** **Customer fraud**: Usually involves customers not paying for goods purchased, getting something for nothing, or deceiving organizations into giving them something they should not have.

4. What is the difference between civil and criminal law?

**Answer:**

**a.** **Criminal law** is the branch of law that deals with offenses of a public nature. Criminal laws generally deal with offenses against society as a whole. Violators of criminal laws are prosecuted either federally or by a state for violating a statute that prohibits some type of activity.

**b.** **Civil law** is the body of law that provides remedies for violations of private rights. Civil law deals with rights and duties between individuals. The purpose of a civil lawsuit is to provide compensation for harm done to an individual. Unlike criminal cases, where juries consist of 12 jurors, juries in civil cases may have as few as six jurors, and the verdict of the jury need not be unanimous. Additionally, judges often hear civil cases instead of juries. In civil lawsuits, plaintiffs must only prove their case by the "preponderance of the evidence." In other words, there need be only slightly more evidence supporting the plaintiff than supporting the defendant.

5. For each of the following, indicate whether it is a characteristic of a civil or a criminal case:

**a.** Jury may consist of fewer than 12 jurors.
**b.** Verdict must be unanimous.
**c.** Multiple claims may be joined in one action.
**d.** Proven "beyond a reasonable doubt."
**e.** Purpose is to right a public wrong.
**f.** Purpose is to obtain remedy.
**g.** Consequences of jail and/or fines.
**h.** Juries may have a less than unanimous verdict.

**Answer:**

**a.** Civil
**b.** Criminal
**c.** Civil
**d.** Criminal
**e.** Criminal
**f.** Civil
**g.** Criminal
**h.** Civil

6. Why was Charles Ponzi so successful with his fraud scheme?

**Answer:** Charles Ponzi was successful for several reasons. First, Charles Ponzi built confidence in his scheme by giving early investors a return on their initial investments. Second, Charles Ponzi presented his coupon scheme in a way that was easy for investors to understand. Although the coupon scheme never made any real profits, investors believed that it had. Third, Ponzi was extremely talented at manipulating victims' emotions. Ponzi was able to capitalize on individuals' greed. When people

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began to see their friends and family members receive dividends from investments, they too wanted in on the investment scam.

7. What are some of the different types of fraud-fighting careers?

   **Answer:** As the number of frauds and the amounts of fraud losses increase, so do the opportunities for successful careers in fraud prevention and detection. In Chapter 1, we have listed five areas in fraud fighting that will be rewarding and have high demand in the future. They include the following:
   a. **Government**: This includes FBI, postal inspectors, Criminal Investigation Division of the IRS, U.S. marshals, inspectors general of various governmental agencies, state investigators, and law enforcement officials.
   b. **CPA firms, forensic accounting firms, litigation support firms, and law firms**: These individuals will conduct investigations, support firms in litigation, do bankruptcy-related fraud work, serve as expert witnesses, consult in fraud prevention and detection, and provide other fee-based work.
   c. **Corporations**: Individuals who work for corporations will prevent, detect, and investigate fraud within a company. This category includes internal auditors, corporate security officers, and in-house legal counsels.
   d. **Lawyers**: Lawyers will defend or prosecute organizations in civil and criminal cases.
   e. **Consulting**: University professors, hospital management, technology corporations, and the like. People who work in these areas will consult, serve as expert witnesses, extract evidence from computers and servers, investigate public records, and serve on grand or trial juries.

8. How do employee fraud and management fraud differ?

   **Answer:** When employee fraud takes place, employees deceive their employers by taking company assets. Management fraud is distinguished from employee fraud and other types of fraud in that top management typically commits it to deceive financial statement users. Employee fraud is usually committed against an organization, whereas management fraud is perpetrated on behalf of an organization.

9. Do you think the demand for careers in fraud prevention and detection is increasing or decreasing? Why?

   **Answer:** As the numbers of frauds committed and the total dollar amounts lost from fraud increase, the demand for careers to prevent and detect such fraud will increase. In fact, a few years ago, *Fortune* magazine identified forensic accounting or fraud examination as one of the fastest growing and most financially rewarding careers. The American Institute of Certified Public Accountants recently touted forensic accounting/fraud examination as one of the six fastest growing and most profitable opportunities for accountants.

10. Why are accurate fraud statistics hard to find?

    **Answer:** First, it is impossible to know what percentage of fraud perpetrators are actually caught. Are there perfect frauds that are never discovered, or are all frauds eventually exposed? Second, many frauds that are discovered are handled quietly within the victim organizations and are never made public. In many cases, companies

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merely hide frauds due to public relations concerns and terminate or transfer perpetrators quietly.

11. Describe the relationship between fraud, net income, profit margin, and the revenue required to make up for fraud losses.

    **Answer:** Losses incurred from fraud reduce a firm's income on a dollar-for-dollar basis, reducing net income by $1 for every dollar that is lost to fraud. To make up for the damage fraud does to net income, a company has to have much more revenue come in. For example, if a company has a profit margin of 10%, to make up for a $1,000,000 fraud, the company would have to have additional revenue of $10,000,000.

12. Why does it usually require trust for someone to be able to commit a fraud?

    **Answer:** Since confidence is typically needed for fraud to occur, people who are not trusted will not be in a position to commit a fraud.

13. In what ways is the Ponzi scam similar to other frauds?

    **Answer:** While answers may vary, the following is one possible answer: The case of Charles Ponzi involved deception, greed on behalf of the investors and the perpetrator and confidence in the perpetrator. These are traits that are common in many different cases of fraud.

14. In your own words describe a CFE.

    **Answer:** The Association of Certified Fraud Examiners (ACFE) provides the opportunity for individuals to become a Certified Fraud Examiner or "CFE". CFEs are considered to be leaders in the anti-fraud community and have recognition as such throughout the world. They represent the highest standards held by the ACFE and possess expertise in all aspects of the antifraud profession. The CFE designation is acknowledged globally and preferred by many employers. The ACFE states that becoming a CFE immediately sets an individual apart from others and launches that person to the top of the profession.

15. In your own words describe the purpose of the ACFE.

    **Answer:** Although answers may vary, the following is one possible answer: When an individual becomes a CFE, he or she automatically becomes a member of the ACFE. The ACFE is the world's largest anti-fraud organization and the premier provider of anti-fraud training and education. Together with more than 70,000 members throughout the world, the ACFE works toward the reduction of fraud and corruption around the globe.

16. A romance scam is usually perpetrated using a computer with the perpetrator pretending to be in love with the victim and finding ways to get them to send the perpetrator money. Romance scams can also be perpetrated in person, but most are done online. The romance scam explained at the beginning of the chapter with the perpetrator acting through the SilverSingles website is a typical romance scam.

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## TRUE/FALSE

1. All frauds that are detected by organizations are made public.

   **Answer:** False. In many cases, companies merely hide the frauds to avoid public relations issues and quietly terminate or transfer perpetrators rather than make them public.

2. Perpetrators use trickery, confidence, and deception to commit fraud.

   **Answer:** True

3. One of the most common responses to fraud is disbelief by those around the fraud.

   **Answer:** True

4. Manufacturing companies with a profit margin of 10 percent must usually generate about 10 times as much revenue as the dollar amount of the fraud in order to restore net income to its pre-fraud level.

   **Answer:** True

5. Fraud involves using physical force to take something from someone.

   **Answer:** False. Using physical force to take something from someone is robbery. Fraud involves deceit or trickery, not force.

6. Identity theft is an example of employee embezzlement.

   **Answer:** False. Identity theft is stealing someone's personal information so the thief can pretend to be that person.

7. When perpetrators are criminally convicted of fraud, they often serve jail sentences and/or pay fines.

   **Answer:** True

8. Management fraud is deception perpetrated by an organization’s top management.

   **Answer:** True

9. A Ponzi scheme is considered to be a type of investment scam.

   **Answer:** True

10. Most people agree that fraud-related careers will be in demand in the future.

    **Answer:** True

11. In civil cases, fraud experts are rarely used as expert witnesses.

    **Answer:** False. In civil cases, fraud experts often serve as expert witnesses.

12. Many companies try to hide their losses from fraud rather than make them public.

    **Answer:** True

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13. The only group/business that must report employee embezzlement is the federal government.

    **Answer:** False. Banks are required to report their frauds to the government because of their FDIC Insurance.

14. Advances in technology have had no effect either on the size or frequency of fraud or on the detection or investigation of fraud.

    **Answer:** False. Technology has tended to increase the size and frequency of frauds committed.

15. Fraud losses generally reduce a firm's income on a dollar-for-dollar basis.

    **Answer:** True

16. The single most critical element for a fraud to be successful is opportunity.

    **Answer:** False. Confidence is the single most critical element for a fraud to be successful.

17. Fraud perpetrators are often those who are least suspected and most trusted.

    **Answer:** True

18. Unintentional errors in financial statements are a form of fraud.

    **Answer:** False. Unintentional errors in the financial statements are not considered fraud. There must always be "intent" for something to be fraud.

19. Occupational fraud is fraud committed on behalf of an organization.

    **Answer:** False. Occupational fraud is usually committed against an organization.

20. Companies that commit financial statement fraud are often experiencing net losses or have profits that are significantly lower than expectations.

    **Answer:** True

21. Indirect fraud occurs when a company's assets go directly into the perpetrator's pockets without the involvement of third parties.

    **Answer:** False. Direct fraud does not involve third parties; indirect fraud involves a third party.

22. In vendor fraud, customers don't pay for goods purchased.

    **Answer:** False: Customer fraud involves a customer who does not pay for goods or services. Vendor fraud involves a vendor who provides inferior goods, overcharges, or pays bribes to get favored treatment.

23. A negative outcome in a civil lawsuit usually results in jail time for the perpetrator.

    **Answer:** False. Only criminal lawsuits result in jail time for the perpetrator. Negative outcomes in civil lawsuits result in restitution and damage payments.

24. When fraud is committed, criminal prosecution usually proceeds before civil litigation.

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**Answer:** True

25. A fraud may be perpetrated through an unintentional mistake.

    **Answer:** False. One of the seven elements of a fraud is that the deception must be intentional.

26. It is most often people who are not trusted who commit fraud.

    **Answer:** False. Fraud perpetrators come in all kinds and varieties, but always have to be trusted. If they did not have the trust of their victims, they would not have been put in a position where they could commit a fraud.

27. Management fraud is when managers intentionally deceive their employees about the potential of raises, vacations, and other perks.

    **Answer:** False: Management fraud most often means the deceptive manipulation of a company's financial statements.

28. Despite intense measures meant to impede it, fraud appears to be one of the fastest-growing crimes in the United States.

    **Answer:** True

29. The ACFE is a nonprofit organization dedicated to the prevention and dedication of fraud throughout the world.

    **Answer:** True

30. There is no difference between a certified fraud examiner (CFE) and a certified public accountant (CPA).

    **Answer:** False. A certified fraud examiner (CFE) is considered to be a leader in the anti-fraud community. A CFE focuses on the prevention and detection of fraud. A certified public accountant, on the other hand, focuses on all aspects of accounting.

## MULTIPLE CHOICE

1. Why does fraud seem to be increasing at such an alarming rate?
   a. Computers, the Internet, and technology make fraud easier to commit.
   b. Most frauds today are detected, whereas in the past many were not.
   c. A new law requires that fraud be reported within 24 hours.
   d. People understand the consequences of fraud to organizations.

   **Answer:** a

2. Which of the following is not an important element of fraud?
   a. Confidence
   b. Deception
   c. Trickery
   d. Intelligence

   **Answer:** d

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3. Fraud is considered to be:
   a. a serious problem that continues to grow.
   b. a problem that affects very few individuals.
   c. a mild problem that most businesses need not worry about.
   d. a problem under control.

   **Answer:** a

4. People who commit fraud are usually:
   a. new employees.
   b. not well groomed and have long hair and tattoos.
   c. people with strong personalities.
   d. trusted individuals.

   **Answer:** d

5. "The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets" is the definition of which of the following types of fraud?
   a. Employee embezzlement or occupational fraud
   b. Investment scams
   c. Management fraud
   d. Vendor fraud

   **Answer:** a

6. Corporate employee fraud-fighters:
   a. work as postal inspectors and law enforcement officials.
   b. prevent, detect, and investigate fraud within a company.
   c. are lawyers who defend and/or prosecute fraud cases.
   d. None of the above

   **Answer:** b

7. Investment scams most often include:
   a. an action by top management against employees.
   b. worthless investments or assets sold to unsuspecting investors.
   c. an overcharge for purchased goods.
   d. nonpayment of invoices for goods purchased by customers.

   **Answer:** b

8. Which of the following is not true of civil litigation?
   a. It usually begins when one party files a complaint.
   b. The purpose is to provide compensation for harm done by one person to another.
   c. It must be heard by 12 jurors.
   d. Only "the preponderance of the evidence" is needed for the plaintiff to be successful.

   **Answer:** c

9. Future careers in fraud will most likely be:
   a. in low demand.

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b. in moderate demand.
c. low paying.
d. in high demand and financially rewarding.

**Answer:** d

10. Studying fraud will help you:
    a. learn evidence-gathering skills.
    b. avoid high-risk and fraudulent activities.
    c. learn valuable interviewing skills.
    d. All of the above

    **Answer:** d

11. Which of the following is *the least* reliable resource for fraud statistics?
    a. FBI agencies
    b. Health agencies
    c. Insurance organizations
    d. Fraud perpetrators

    **Answer:** d

12. Which of the following statements is true?
    a. On a per-incident basis, bank robberies are more costly than frauds.
    b. Fraud is often labeled the fastest-growing type of crime.
    c. FBI agencies usually investigate frauds that occur within organizations.
    d. None of the above statements is true.

    **Answer:** b

13. Which of the following is not an element of fraud?
    a. False representation
    b. Accidental behavior
    c. Damage to a victim
    d. Intentional or reckless behavior

    **Answer:** b

14. What is the best way to minimize fraud expense within an organization?
    a. Effective early detection of fraud
    b. Effective investigation of fraudulent behavior
    c. Effective prevention of fraud
    d. Effective research of fraud

    **Answer:** c

15. What is the most important element in successful fraud schemes?
    a. Promised benefits
    b. Confidence in the perpetrator
    c. Profitable activities
    d. Complexity

    **Answer:** b

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16. Which of the following individuals is least likely to be involved in a fraud?
    a. A middle-aged person with a middle management position
    b. A long-haired teenager wearing leather pants
    c. A recent college graduate
    d. A senior executive who has significant stock options

    **Answer:** b

17. Which of the following is *not* a common type of fraud?
    a. Direct employee embezzlement
    b. Employee bribes
    c. Executives embezzling from petty cash
    d. Investment scams

    **Answer:** c

18. Which of the following is *not* a form of vendor fraud?
    a. Overcharging for purchased goods
    b. Shipment of inferior goods
    c. Nonshipment of goods even though payment has been made
    d. Not paying for goods purchased

    **Answer:** d

19. Civil law performs which of the following functions?
    a. Remedy for violation of private rights
    b. Remedy for violations against society as a whole
    c. Punishment for guilt “beyond reasonable doubt”
    d. Monetary fines for federal damages

    **Answer:** a

20. Fraud fighting can include which of the following type(s) of careers?
    a. Professors
    b. Lawyers
    c. CPA firms
    d. All of the above

    **Answer:** d

21. Which of the following is *not* an example of employee embezzlement?
    a. Land conservation employees stealing equipment
    b. Cashiers stealing money from the cash register
    c. Angry employees vandalizing the building with spray paint
    d. Salespeople overcharging for products and pocketing the excess cash

    **Answer:** c

22. Which of the following is *not* an example of vendor fraud?
    a. A vendor overcharges a contracting job that it completed on time
    b. A vendor bills for services not performed
    c. A vendor bills for goods not provided
    d. A vendor has much higher prices than its competitors

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**Answer:** d

23. "Intentional manipulation of financial statements" describes which kind of fraud?
    a. Management fraud
    b. Criminal fraud
    c. Stock market fraud
    d. Bookkeeping fraud

    **Answer:** a

24. Which of the following is required to become a CFE?
    a. An individual must commit to abide by a strict code of professional conduct and ethics.
    b. An individual must be an associate member in good standing of the ACFE.
    c. An individual must be of high moral character.
    d. All of the above are required to become a CFE.

    **Answer:** d

25. Which of the following is *not* true regarding the ACFE.
    a. It is the largest anti-fraud organization in the world.
    b. It has roughly 12,000 members throughout the world.
    c. The entire organization is dedicated to antifraud-fighting efforts.
    d. It is the premier provider of anti-fraud training.

    **Answer:** b

## SHORT CASES

### CASE 1

Clever, Inc., is a car manufacturer. Its 20124 income statement is as follows:

| **Clever, Inc. Income Statement for the Year Ended December 31, 2024** | |
|---|---|
| Sales revenue | $20,000 |
| Less cost of goods sold | 10,000 |
| Gross margin | $10,000 |
| Expenses | 8,000 |
| Net income | $2,000 |

Alexander, Inc., is a car rental agency based in Florida. Its 2024 income statement is as follows:

| **Alexander, Inc. Income Statement for the Year Ended December 31, 2024** | |
|---|---|
| Sales revenue | $20,000 |
| Expenses | 15,000 |
| Net income | $5,000 |

During 2024, both Clever, Inc., and Alexander, Inc., incurred a $1,000 fraud loss.

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1. How much additional revenue must each company generate to recover the losses from the fraud?
2. Why are these amounts different?
3. Which company will probably have to generate less revenue to recover the losses?

**Answer:** Clever, Inc., would have to generate up to another $10,000, calculated as follows, to recover the losses from the fraud:

**Profit Margin = Net Income Divided by Revenue**

**Profit Margin = $2,000/$20,000 = 10%**

With a profit margin of 10%, and especially being a manufacturing company, it could take up to another $10,000 in revenue to recover the $1,000 fraud loss.

Alexander, Inc., would have to generate no more than another $4,000, calculated as follows, to recover the loss from the fraud:

**Profit Margin = Net Income Divided by Revenue**

**Profit Margin = $5,000/$20,000 = 25%**

Because its profit margin is 25%, and because it is a service firm with no cost of goods sold, it would not take more than another $4,000 to recover the $1,000 fraud loss.

These amounts are different because the profit margins of these companies are different. Clever, Inc., is a manufacturing company, and for every $1,000 of net income it must generate $10,000. On the other hand, Alexander, Inc., must generate no more than $4,000 for each $1,000 lost from the fraud. It is usually easier for a service corporation with a higher profit margin to recover from fraud losses than it is for manufacturing companies that must generate more money to recover fraud losses, such as Clever.

## CASE 2

You are having lunch with another student. During the course of your conversation, you tell your friend about your new fraud examination class. After you explain the devastating impact of fraud on businesses today, she asks you the following questions:

**1.** What is the difference between fraud and error?
**2.** With all the advances in technology, why is fraud a growing problem? How would you respond to your friend?

**Answer:**

1. Unintentional errors and fraud are quite different from each other. An unintentional error is an error made by accident or without intent. Fraud, on the other hand, is intentional and most often involves trickery or deceit.
2. While advances in technology have helped to prevent and detect some fraud, these advances have opened up new ways for perpetrators to commit fraud that before were unthinkable. Computers, the Internet, and complex accounting systems have made it so easy that perpetrators need only to make a telephone call, manipulate a computer program, or press a key on the keyboard to commit fraud.

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## Case 3

For each of the following examples, identify whether the fraud is employee embezzlement, management fraud, investment scam, vendor fraud, customer fraud, or miscellaneous fraud.

1. Marcus bought a $70 basketball for only $30, simply by exchanging the price tags before purchasing the ball.
2. Craig lost $500 by investing in a multilevel marketing scam.
3. The Bank of San Felipe lost over $20,000 in 2018. One of its employees took money from a wealthy customer's account and put it into his own account. By the time the fraud was detected, the employee had spent the money and the bank was held responsible.
4. The CEO of Los Andes Real Estate was fined and sentenced to six months in prison for deceiving investors into believing that the company made a profit in 2018, when it actually lost over $150 million.
5. The government lost over $50 million in 2018 because many of its contractors and subcontractors charged for fictitious hours and equipment on a project in the Middle East.
6. A student broke into the school's computer system and changed her grade in order to be accepted into graduate school.

**Answer:**

1. Customer fraud
2. Investment scam/consumer fraud
3. Employee embezzlement
4. Management fraud
5. Vendor fraud
6. Miscellaneous fraud

## Case 4

Fellow students in your fraud examination class are having a hard time understanding why statistics on fraud are so difficult to obtain. What would you say to enlighten them?

**Answer:** Fraud statistics are hard to obtain for several reasons. First, we can never know exactly what percentage of fraud is discovered. Are there "perfect frauds" that are never discovered, or do all frauds eventually come to light? Second, the victim organizations quietly handle many frauds that are discovered, never making them public. Victim organizations often like to avoid publicity and the costs associated with investigating and prosecuting fraud. These and other factors make it very difficult to research fraud and for accurate statistics to be obtained.

## Case 5

You're telling your boyfriend about your classes for the new semester. He is very interested and intrigued by the idea of becoming a fraud detective but wants to know whether fraud detectives will have job security and the type of work that is available. How would you respond to his questions?

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**Answer:** As the number of frauds and amounts of fraud losses increase, so do the opportunities for successful fraud-fighting careers. Many believe that fraud examination and forensic accounting will be among the fastest growing and most rewarding careers in the future. Government fraud-fighters, consultant fraud-fighters, corporate employee fraud-fighters, and defense and plaintiff lawyers are just a few of the possible careers related to fraud prevention and detection.

## CASE 6

A bookkeeper in a $3 million retail company had earned the trust of her supervisor, so various functions normally reserved for management were assigned to her, including the authority to authorize and issue customer refunds. She proceeded to issue refunds to nonexistent customers and created documents with false names and addresses. She adjusted the accounting records and stole about $15,000 cash. She was caught when an auditor sent routine confirmations to customers on a mailing list and received an excessive number of "return-to-sender" replies. The investigation disclosed a telling pattern. The bookkeeper initially denied accusations but admitted the crime upon presentation of the evidence.

You are a lawyer for this retail company. Now that her fraud has been detected, would you prosecute her criminally, civilly, or both? What processes would you use to try to recover the $15,000?

**Answer:** When fraud is detected, companies should prosecute if possible, both in criminal and civil courts. By proceeding in a civil suit, the company can try to recover some of the money lost from the fraud. By pursuing a criminal suit, the company can ensure that when other companies hire the perpetrator, those companies will know that the employee has committed fraud in the past and will be able to prevent the prospective employee from being in a position that provides the opportunity to commit fraud again. Firms do not often pursue both civil and criminal remedies, and sometimes do neither because of litigation costs, time involved, or the desire to avoid negative press.

## CASE 7

You are a new summer intern working for a major professional services firm. During your lunch break each day, you and a fellow intern Bob eat at a local sandwich shop. One day, Bob's girlfriend joins you for lunch. When the bill arrives, Bob pays with a company credit card and writes the meal off as a business expense. Bob and his girlfriend continue to be "treated" to lunch for a number of days. You know Bob is well aware of a recent memo that came down from management stating casual lunches are not valid business expenses. When you ask Bob about the charges, he replies, "Hey, we're interns. Those memos don't apply to us. We can expense anything we want."

1. Is fraud being committed against the firm?
2. What responsibility, if any, do you have to report the activity?

**Answer:**

1. Fraud occurs when individuals intentionally cheat or deceive others to their advantage. In this case, Bob is committing a fraud. Regardless of the magnitude of the charges, he is intentionally charging nonbusiness lunches to his employer. This is also known as employee fraud, or occupational fraud.

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2. As an employee, you have an ethical responsibility to your employer to report Bob's fraudulent behavior. Fortunately, in this case nothing has been done that cannot be corrected easily. Since Bob is justifying his behavior by saying the recent memo pertaining to meal expenses does not apply to him because he is an intern, you should try to help Bob see the error of his logic and encourage him to correct the charges. If Bob is unwilling to change his behavior, the appropriate superior should probably be notified.

## CASE 8

After receiving an anonymous note indicating fraudulent activities in the company, XYZ Company officials discover that an employee has embezzled a total of $50,000 over the past year. Unfortunately, this employee used an assumed identity and has suddenly disappeared. The CFO at XYZ wants to know how badly this fraud has hurt the company. If XYZ has a profit margin of 7 percent, approximately how much additional revenue will XYZ have to generate to cover the loss?

**Answer:** In the worst case, the additional revenue needed will be the fraud loss divided by the profit margin, or $50,000 divided by 0.07, which equals $714,286.

## CASE 9

Your friend John works for an insurance company. John holds a business degree and has been involved in the insurance business for many years. In a recent conversation, John shares some company information with you. He has heard that the internal auditors estimate that the company has lost about $2.5 million over the last year as a result of fraud. Because you are a certified fraud examiner, John asks you how this will affect the company's profitability. John doesn't have access to the company's financial information.

**1.** Compute the additional revenues needed to make up for the lost money, assuming that the company has profit margins of 5, 10, and 15 percent.
**2.** Give examples of three types of fraud that could affect the insurance company.

**Answer:**

1. At 5%, a maximum of $50,000,000 in additional revenue is needed. At 10%, a maximum of $25,000,000 in additional revenue is needed. At 15%, a maximum of $16,666,667 in additional revenue is needed.
2. Some of the various types of fraud that can affect an insurance company are:
   **a.** Employee fraud—individuals involved in the benefits area can create false claims for nonexistent policyholders. The victim is the company, and the perpetrator is the employee.
   **b.** Management fraud—the company can create nonexistent policyholders to make their revenues appear greater. The victims are the stockholders and other financial institutions that rely on the financial statements. The perpetrators are members of management with the company.
   **c.** Customer fraud—policyholders can create false claims to collect money. The victim is the company, and the perpetrators are the customers.

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## CASE 10

You are an accounting student at the local university pursuing your master's degree. One of your friends has been intrigued by the numerous frauds that have been reported in the news. This friend knows you are going to pursue a job as an auditor with a large public accounting firm, but your friend does not understand the difference between what you will be doing and what fraud examiners do. Write a paragraph that explains the difference between auditing and fraud examination.

**Answer:** Fraud examiners investigate suspected fraudulent activity, whereas auditors are concerned about the overall fairness of the financial statements. One of the biggest differences between auditing and fraud examination is that with auditing, sampling is used to assess whether management's assertions are reasonable. The auditor uses sampling to test the account balances to make sure the accounts are not overstated or understated. Fraud examination cannot be done effectively through sampling. In fraud examination, each transaction should be reviewed and evaluated.

## CASE 11

You own a local pizza delivery store. Mary has been working for you as a manager for two years and has been a close friend of yours. Mary has the reputation of being a hard worker and has not taken vacation for the entire time she has worked for you. Last week, Mary left town to attend a family funeral. While she was gone, you received several phone calls that seemed suspicious. During these suspicious calls, a potential customer would call and ask for the manager. When you answered the phone (representing the manager), the customer would ask for the "manager's special." When informed that there was not a "manager's special" offered this weekend, the caller would quickly hang up. This occurred several times. When Mary returned, you decided to spend an evening observing the order-taking process. It became apparent that Mary was skimming cash from the business. Mary would take the order for the "manager's special" without entering the sale into the computer. Mary would then deliver the pizza and pocket the money.

**1.** Write a paragraph explaining why Mary should be terminated from employment.
**2.** Write a paragraph explaining why it is important that Mary is prosecuted for her crime.

**Answer:**

1. There are many reasons why Mary should be terminated from employment. However, one of the most apparent reasons is that organizations that do not work proactively at fraud prevention and detection find themselves as frequent targets of fraud schemes, with the fraud becoming more and more costly. A message that perpetrators will be prosecuted deters other potential fraud by reducing the perceived opportunity.
2. An individual who commits fraud and is not punished or is merely terminated suffers no significant penalty and often resumes the fraudulent behavior. If prosecuted, the individual suffers significant embarrassment when family, friends, and business associates find out about his or her offenses. Humiliation is often the strongest factor in deterring future fraud activity.

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## Case 12

Bob, who works as a credit manager for a large bank, has a reputation for being a very hard worker. His convenient downtown apartment is located near the bank, which allows him to work undisturbed late into the night. Everyone knows that Bob loves his job because he has been with the bank for many years and hardly ever takes a vacation. He is a very strict credit manager and has the reputation for asking very difficult questions to loan applicants before approving any credit. Nancy, Bob's director, noticed that Bob had not taken a mandatory week-long vacation for a number of years. Given Bob's history of being tough on approving credit for the bank, should Nancy be concerned?

**Answer:** Nancy should be concerned. First, the bank has a mandatory one-week long vacation policy. Bob should not be allowed to be an exception. Bob also fits many of the demographics for a fraud perpetrator: he has a lot of experience with the bank and is in a trusted position, he often works late into the night all by himself, everyone trusts him, and he likes to give the impression that he is tough on credit. Nancy should not assume that Bob has committed fraud; however, she should demand that Bob take a mandatory vacation, and she should be alert for additional signs of fraud.

## Case 13

Upon hearing that you are enrolled in a fraud class, a manager of a local business asks, "I don't understand what is happening with all these major scandals such as the Bernie Madoff scandal, the Goldman Sachs accusations, and the Enron fraud. There are billions of dollars being stolen and manipulated. How can any good auditor not notice when billions of dollars are missing?" How would you respond?

**Answer:** While answers may vary, the following is one possible answer: The management frauds to which your friend refers involve much more than just stealing money. They are sometimes simple, sometimes very complicated schemes that misstate financial statements and are intended to deceive the public, but that are also orchestrated so that the fraud is difficult to detect in an audit. Financial statement fraud can be very difficult to detect because of the sophistication of the perpetrators and their positions of trust and authority in the company.

## Case 14

While discussing your class schedule with a friend who is an accounting major, your friend describes why she decided not to take the fraud class you are enrolled in: "With advances in audit technology and the increased digitalization of business records, fraud detection is a dying part of a financial statement audit." How would you respond?

**Answer:** As fraud detection methods get more sophisticated, so do fraud perpetration techniques. Fraud examination is one of the fastest-growing and most financially rewarding careers. It is not part of a financial statement audit but a distinct profession.

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## CASE 15

After telling one of your parents that you want to be a fraud examiner after graduation, your father expresses concerns about your career choice. How would you explain to your father the kind of career opportunities you will have as a fraud examiner, the types of organizations that will hire you, and the kind of work you will be doing?

**Answer:** Fraud examiners are hired by many different kinds of organizations. Examples include the government, CPA firms, law firms, insurance companies, public and private corporations, universities and hospitals. Fraud examiners are hired to do a variety of tasks, and fraud examination is an exciting and intriguing career.

## CASE 16

You are a student at ABC University. You recently read in the school's daily newspaper about a terrific investment opportunity that promises to repay you a 44 percent annual return on your investment. Although you don't understand the complicated nature of the investment, several of your friends are investing money. You have an extra $5,000 that you earned last summer that you would like to invest. Should you invest your $5,000? Why or why not?

**Answer:** This is a real investment scam that was perpetrated on an American university campus a few years ago. Before it was stopped, hundreds of students had invested hundreds of thousands of dollars. There are many warning signs that would suggest this "investment opportunity" is a scam, including:

- The promised rate of 44% is too high and unreasonable. If it seems too good to be true, it probably is. This promised rate of return does not make business sense.
- The nature of the investment is complicated and can't be easily understood. Making the investment seem complicated is one way perpetrators try to conceal their frauds.
- You are excited about the investment because several of your friends have invested. Just because they didn't exercise due care doesn't mean you should also be stupid.

## CASE 17

First, you need to convince your sister that she should never send money to someone she has never met in person. She really doesn't know if the picture he sent her was really him or if he(she) is a scam artist sitting in a cubical in a foreign country. Second, she needs to find out how large the CD he says he has is and check with a credit union to see if the early withdrawal fee he told her he'd have to pay is reasonable. If she really wants to see him, she should tell him that he needs to put the airplane ticket on a credit card and she'll loan him the money to pay for it once he flies in to meet her. Finally, you could tell her the warning signs of a romance fraud. Those warning signs, which we call red flags, include, among other things:

1. They find excuses never to meet you. Usually, these scammers are actually from other countries, especially countries in Africa or Eastern Europe.
2. They quit using dating sites immediately, using personal email, text, or phone so that the dating site can't follow what they are doing.

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3. They wire money using Western Union or MoneyGram or ask you to do the same.
4. They use events that are farfetched—such as being robbed, a friend being killed, going to a foreign country, needing an airplane ticket, paying their taxes, owing property that can't be traced, and the like—as the reasons they need money from you.
5. They often know a lot about you and about the area in which you live. This is achieved through a method called social networking or social engineering, whereby they use social media sites and other Internet sites to make it sound as if they know what they are doing and have lived close to you.
6. You can never track assets they say they own, telephone numbers, and so on.
7. Their calls get more and more personal over time as they get to know you better and find out more information about you.

## Case Studies

### Case Study 1

Gus Jackson was hired away from a “Big Four” public accounting firm to start a new internal audit function for ABC Company, a newly acquired subsidiary of a large organization. His first task involved getting to know ABC’s management and supporting the public accountants in their year-end audit work.

Once the year-end work was finished, Gus started an audit of the accounts payable function. Jane Ramon, who had worked on the parent company’s internal audit staff for about four years, supported him in this activity.

The accounts payable audit went smoothly, although many employees made no effort to conceal their hostility and resentment toward anyone associated with the new parent company. One exception was Hank Duckworth, the accounts payable manager. Hank was extremely helpful and complimentary of the professional approach used by the auditors. Gus had actually met Hank four years earlier, when Hank had been an accounting supervisor for an audit client where Gus was the junior accountant.

As the audit neared completion, Gus reviewed an audit comment Jane had written—a statement concerning some accounts payable checks that lacked complete endorsement by the payees. Both Gus and Jane recognized that in some situations and in some organizations less than perfect endorsements were not a critical concern, but these checks were payable to dual payees, and the endorsement of each payee was required. Gus asked Jane to make some photocopies of the examples so the evidence would be available for the audit closeout meeting with management.

Jane returned 20 minutes later with a puzzled expression. “I pulled the examples,” she said, “but look at these!” Jane placed five checks on the desk in front of Gus. “What do you make of these?” she asked.

“Make of what?” asked Gus.

“Don’t you see it? The handwriting on all the endorsements looks the same, even though the names are different! And these are manual checks, which in this system usually means they were pushed through the system as rush payments.”

“They do look similar,” Gus replied, “but a lot of people have similar handwriting.”

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It hit Jane and Gus at the same time. All five checks had been cashed at the same convenience store less than 5 miles from the home office, even though the mailing address of the payee on one of the checks was over 200 miles away!

Jane decided to pull the supporting documentation for the payments but found there was none! She then identified other payments to the same payees and retrieved the paid checks. The endorsements did not look at all like the endorsements on the suspicious checks. To determine which of the endorsements were authentic, Jane located other examples of the payees' signatures in the lease, correspondence, and personnel files. The checks with supporting documentation matched other signatures on file for the payees.

Gus and Jane decided to assess the extent of the problem while investigating quietly. They wanted to avoid prematurely alerting perpetrators or management that an investigation was underway. With the help of other internal auditors from the parent company, they worked after normal business hours and reviewed endorsements on 60,000 paid checks in three nights. Ninety-five checks that had been cashed at the convenience store were identified.

Still, all Gus and Jane had were suspicions—no proof. They decided to alert executive management at the subsidiary and get their help for their next step.

***The Follow-Through***

Because the subsidiary had little experience with dishonest and fraudulent activity, it had no formalized approach or written fraud policy. Gus and Jane, therefore, maintained control of the investigation all the way to conclusion. With the help of operating management, the auditors contacted carefully selected payees. As is often the case involving fictitious payments to real payees, the real payees had no knowledge of the payments and had no money due to them. The auditors obtained affidavits of forgery.

In order to identify the perpetrator, the auditors documented the processing in more detail than had been done in the original preliminary survey for the routine audit. There were seven people who had access, opportunity, and knowledge to commit the fraud. The auditors then prepared a personnel spreadsheet detailing information about every employee in the department. The spreadsheet revealed that one employee had evidence of severe financial problems in his personnel file. It also showed that Hank Duckworth's former residence was three blocks from the convenience store.

Armed with the affidavits of forgery, the auditors advised management that the case was no longer merely based on suspicions. Along with members of operating management, the auditors confronted the convenience store owners to learn why they had cashed the checks and who had cashed them.

The convenience store manager had a ready answer. "We cash those for Hank Duckworth. He brings in several checks a month to be cashed. He used to live down the street. Never had one of those checks come back!"

The rest is history. Hank was confronted and confessed. The fully documented case was turned over to law enforcement. Hank pled guilty and received a probated sentence in return for full restitution, which he paid.

**Questions**

1. What clues caused Jane to suspect that fraud was involved?
2. Why is it important for fraud examiners to follow up on even the smallest inconsistencies?

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3. In an attempt to identify possible suspects, the auditors researched the personnel files of every employee in the department. What things might they have been looking for to help them identify possible suspects?

**Answer:**

1. Jane had suspicions of fraud for several reasons. First, she noticed that the accounts payable checks, which were payable to dual payees, lacked the required endorsement of both payees. Next, Jane observed that several different people wrote all the checks in similar handwriting. Then, both Jane and Gus realized that each of the five checks had been cashed at the same convenience store less than 5 miles from the home office, even though the mailing address of one of the payees was over 200 miles away. Finally, after beginning investigation, Jane and Gus found that there were no existing documents to support the payments made from the checks.
2. Fraud is often caught through inconsistencies in financial data. Therefore, any discrepancy, however small it seems, may have the potential of assisting the auditor in discovering fraud.
3. There is always motivation for a fraud perpetrator's dishonest actions. Some of these motivations might include, but are not limited to, financial pressures, income-consuming addictions (e.g., gambling, drugs, alcohol, and extramarital relationships), family struggles, work-related strains, tax liens, garnishment of wages, or other pressures. While researching the personnel files of employees, the auditors would be looking for any patterns, characteristics, or past occurrences in the lives of the employees that would indicate any possible motivations for committing fraud.

## CASE STUDY 2: SWEEPSTAKES—LEGITIMATE OR DECEPTIVE?

**Sweepstakes Company Agrees to Pay Up**

A recent newspaper contained the following story:

*Publishers Clearing House agreed to pay $34 million in a deal with 26 states to settle allegations the sweepstakes company employed deceptive marketing practices. The $34 million will cover customer refunds, legal expenses, and administrative cost to the states. Each state's share has yet to be determined. In the lawsuits, state attorney generals accused Publishers Clearing House of deceptive marketing for its sweepstakes promotions. The suit alleged that the company was misleading consumers by making them believe they had won prizes or would win if they bought magazines from Publishers Clearing House.*

*As part of the settlement, the company will no longer use phrases like "guaranteed winner." "This will in fact revolutionize the sweepstakes industry," Michigan Attorney General Jennifer Granholm stated. "We listened to the states' concerns and have agreed to responsive and significant changes that will make our promotions the clearest, most reliable and trustworthy in the industry," said Robin Smith, chairman and CEO of the Port Washington, N.Y.–based company.*

*Publishers Clearing House reached an $18 million settlement last August with 24 states and the District 24 Part 1: Introduction to Fraud of Columbia. The states involved in the latest settlement are Arizona, Arkansas, Colorado, Connecticut, Delaware, Florida, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota,*

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*Missouri, New Jersey, North Carolina, Oregon, Pennsylvania, Rhode Island, Tennessee, Texas, Vermont, West Virginia, and Wisconsin.*

**Questions**

1. Based on this information, do you believe Publishers Clearing House has committed fraud?
2. Why or why not?

**Answer:**

1. Fraud occurs when someone deceives someone else through confidence and trickery in order to get gain. This appears to be fraud.
2. By using phrases like "guaranteed winner," Publishers Clearing House deceived many individuals into believing that they had won when in reality they hadn't. By doing so, prosecutors believed that Publishers Clearing House committed fraud.

## Case Study 3: Trading after Hours

Several years ago, Prudential Securities was charged with fraud for late trading. This was the first major brokerage house to be charged with the illegal practice of buying mutual funds after hours.

The regulators who accused Prudential Securities charged them with carrying out a large-scale, late trading scheme that involved more than 1,212 trades that were valued at a remarkable $162.4 million. These trades were placed after hours in order to benefit favored hedge funds. The complaint did not contain information regarding any profits that were protected by the scandal.

The regulators who accused Prudential stated that Prudential should have noticed the considerable number of trades that were being placed after 4 p.m. and should have begun an internal inquiry. However, the complaint stated that Prudential possessed "no internal supervisory procedures" to detect trades placed after hours.

Market timing, often done in conjunction with late trading, involves rapid in and out trading of a mutual fund designed to take advantage of delays in marking up prices of securities in the funds. By buying before the markups and selling quickly after them, Prudential traders realized quick profits for the firm's clients at the expense of others. A group of managers and top-producing brokers were charged by the SEC and/or state in separate civil actions related to market timing. The firm denied all wrongdoing.

Normally, orders to buy funds after 4 p.m. should be filled at the price set the next day. In late trading, which is illegal, orders instead get the same day's 4 p.m. price, enabling investors to react to news a day ahead of other investors.

In order to accomplish late trading, the complaint stated that Prudential clients would engage in the following activities: Prudential clients would submit a list of potential trades to brokers before the 4 p.m. deadline by fax, email, or telephone. After 4 p.m., clients notified Prudential which of the long list of trades it wished to execute. Prudential brokers would take the original order, cross out the trades the client didn't want to execute, and then forward the order to the firm's New York trading desk. The time stamp on the fax would often deceptively reflect the time it was received originally, not the time that the client confirmed the order. For example, in just one afternoon, at 4:58 p.m., Prudential's New York office executed more than 65 mutual fund trades, for a total of $12.98 million.

According to the complaint, Prudential did nothing to substantiate the orders that were received before 4 p.m. In early 2003, the brokerage firm issued a policy change

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requiring branch managers to initial a cover sheet for trades before faxing them to New York. Lists of trades could be received at Prudential's New York trading desk as late as 4:45 p.m. Accusations against the firm state that, "The orders were never rejected and were always executed at same-day prices."

The complaint further stated that Prudential also allowed the brokers involved in the market-timing and late-trading scheme to have dedicated wire-room personnel to execute trades. It has been suggested that the brokers compensated the wire-room employees for their efforts by sharing year-end bonuses. The state alleged that Prudential also authorized one broker to obtain special software that gave the employee "electronic capacity to enter bulk mutual fund exchanges after 4 p.m."

**Questions**

1. Determine whether this case would be prosecuted as a criminal or civil offense, and state reasons to support your conclusion.
2. Who are the victims of this late-trading scheme, and what losses do they incur?

**Answer:**

1. Those involved in the late-trading scheme have committed both a civil and a criminal offense. By performing trades after approved trading hours, the perpetrators have allowed certain traders to trade with perfect information and have prevented other traders and brokers from trading equities at a price at which they normally would. Therefore, this case is in violation of civil law. If proven guilty, the perpetrators will be forced to compensate monetarily for the damages they caused to others. They have also committed a criminal offense by breaking the law that regulates approved trading hours. If proven guilty, the perpetrators could be sent to jail.
2. While the Prudential traders involved in the late-trading scheme realized quick and easy profits, other stock and mutual fund traders were hurt. They had an apparent disadvantage to those traders and brokers who practiced late trading. The other traders were forced to buy stocks and invest in mutual funds at a higher price and then sell them at a lower price than they would have if there were no fraud involved. Eventually, however, the perpetrators will incur the most damage as they are forced to fulfill their civil obligations and endure tarnished reputations.

## Case Study 4

You serve on the board of directors of a multinational manufacturing company. You have just received a whistle-blower complaint that one of the managers in another country, where a large production facility is located, has been understating manufacturing costs to make his production results look better than other facilities. Answer the following questions:

1. What should you do with this information?
2. As a board member, can you immediately involve the top management of the corporation in your actions, whatever they may be?
3. What are the risks to the company if this fraud is material (significant) to the company's financial statements?

**Answer:**

This is a real case that happened to a U.S. company. The answers to the questions are as follows:

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1. In this case, you must do whatever is necessary to determine if there is any validity to the whistleblower complaint. You must discover the truth and then do the right thing, whatever that is. In this case, that probably means that you hire an investigative law or forensic firm to perform interviews, image hard drives and servers, and gather other evidence to determine if, in fact, costs are being understated. You would do as much of this as possible without arousing suspicion.
2. Unfortunately, because top management of the company may be involved, you cannot initially involve them in the investigation. Only after you are certain they are not involved can you bring them "over the wall" and let them know and even participate in the investigation. If this problem is limited to one country it is one thing; if it also involves the top management of the company, you have a much bigger problem.
3. If the fraud is real and is material to the financial statements, then the company will probably have to restate its financial statements. Restatements usually result in a drop in the company's stock price and shareholder class action lawsuits against the company. Regardless of the cost, as a board member, you must take the high road and get to the bottom of this issue. You must find the truth and then do the right thing.

## DEBATE

For the past year, you have been working as a secretary/processor for a local construction company, Midwest Homes, which specializes in the building of low-cost, limited-option homes. You left a comfortable, good-paying job to work for Midwest because it was family owned and operated by longtime friends.

Soon after you began working for XYZ, you noticed questionable behavior on the part of Mr. and Mrs. Midwest's two sons, who are company salesmen. In fact, you are positive that they are falsifying documents to increase their commissions and to trick local banks into approving mortgages to customers who don't meet credit standards.

You are trying to decide how to handle the situation when one of the sons approaches you and asks you to produce and sign a memo to a bank, falsely stating that a certain potential home buyer is creditworthy. You refuse to do so and, after much consideration, approach Mr. Midwest about the situation. To your surprise, he simply brushes off your comments as unimportant and laughingly states that "boys will be boys."

What would you do in this situation? Is the fact that you correctly refused to produce and sign a false memo enough, or are you obligated to report these crimes to the banks and proper authorities? Discuss the options, responsibilities, and implications you are facing.

**Answer:**
Due to the subjective nature of this ethics case, no exact solution is provided. However, the authors do believe that in this situation, students have a proactive responsibility to at least terminate employment. (You may later be sued if you do not).

# ANSWERS TO STOP AND THINK QUESTIONS:

1. Why is it more difficult to tell if someone can be trusted on the Internet than in person?

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**a.** When you are dealing with someone in person, you can learn much from their personality, body language, and mannerisms. You can also get to know them better. You can see the person you are dealing with. On the Internet, you have no idea who you are dealing with or whether the person or organization is an imposter. Because Internet perpetrators cannot see their victims, such frauds seem more like a victimless crime.

2. Why do you think it is easier for top management to manipulate the financial statements than for other individuals in an organization?
   **a.** Top management can more easily override internal controls than others can in an organization. Also, it is easier for others to follow the instructions of top management than others because employees will say, "it doesn't make sense to me but if the boss is asking me to do it, he or she probably knows what is right or wrong, so I better do it." The combination of deference to executives and the ease of overriding controls make it easier for top management to manipulate financial statements than it is for others. They also see the entire financial picture of an organization whereas others only see parts.

3. O. J. Simpson was tried for murder both criminally and civilly. He was found innocent in the criminal trial but guilty in the civil trial. Why do you think that is the case?
   **a.** In a criminal case, the jury must reach a unanimous verdict—even one person who feels differently can cause a hung jury or an innocent verdict. In a civil case, only the majority of the jurors must believe that the person was guilty. The conviction standard is lower in civil cases.

## INTERNET ASSIGNMENT

1. Your best friend wants to know why "on earth" you are taking a fraud examination class. He is curious about what careers this class prepares you for. Go to the Internet and find information about two different careers that you could pursue in the field of fraud examination.
   Write two or three brief paragraphs about what you found. Remember to include the websites where your information came from so that your friend can do some investigating of his or her own.

   **Answer:**
   One solution is to search the home page of the Association of Certified Fraud Examiners at **www.acfe.com** for more information about careers. There, you will find several links to companies and government agencies that are involved in combating fraud and other white-collar crime. You will also find a tab at the top of their web page entitled "careers." That would be a great place to look.

   The Federal Bureau of Investigation (FBI) is probably the largest government agency that employs fraud-fighters. The FBI's Web site can be found at **www.fbi.gov**. By clicking on "employment" and "special agent vacancy" links, students can see what an FBI agent actually does.

   The Internal Revenue Service (IRS) is another government agency that offers careers in fraud examination. Their employment Web site contains a page giving a description of and qualifications needed to become a criminal investigator. Search **www.jobs.irs.gov** and then click on the link entitled Criminal Investigation "Special Agent" opportunities.

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2. Go to the Internet and read about the ACFE. See what kind of training they offer, how many members there are, where their headquarters is located, and how to become a CFE.
   **Answer:**
   The internet site is **www.acfe.com**. There is a tab entitled "Training, Events, and Products" that will give you a list of the kinds of training they have. If you scroll down the page, you will see that they have over 90,000 members. Their headquarters are in Austin, Texas. And there is a heading entitled "CFE credential" that explains how to become a CFE or Certified Fraud Examiner.

3. There have been hundreds of articles about the FTX fraud and Sam Bankman-Fried. Many of those articles state that Sam's parents are both law professors at Stanford University. The articles state that his net worth before the collapse of FTX was $16 billion, almost all of which disappeared in one day. Alameda Research was a crypto-currency trading firm founded in 2017 by Sam Bankman-Fried and a co-partner. It had many dealings with FTX.

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# Instructor Manual

W. Steve Albrecht, Chad O. Albrecht, Conan C. Albrecht, and Mark F. Zimbelman, Fraud Examination, 7e ©2025, 9780357721759; Chapter 1: The Nature of Fraud

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## Purpose and Perspective of the Chapter

The purpose of this chapter is to define fraud and to communicate the seriousness of fraud's effects on individuals and society using both historical and recent examples. The chapter includes the different types of fraud and how they are perpetrated, as well as the difference between criminal and civil fraud laws and prosecution processes. Finally, the chapter summarizes strategies for study, training, and certification necessary to become a fraud-fighting professional as well as the types of careers available in fraud prevention, detection, and investigation.

## Chapter Objectives

The following objectives are addressed in this chapter:

- Understand the seriousness of fraud and how fraud affects individuals, consumers, organizations, and society.
- Define fraud.
- Understand different types of fraud.
- Understand the difference between fraud committed *against* an organization and fraud committed *on behalf of* an organization.
- Understand the difference between criminal and civil fraud laws.
- Understand the types of fraud-fighting careers available today.

## What's New in This Chapter

Refer to the Transition Guide for improvements in this edition from the previous edition.

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## Chapter Outline

The following outline organizes activities and assessments (including any existing ones in the PowerPoint or the textbook) by chapter (and therefore by topic), so that you can see how all the content relates to the topics covered in the textbook. #-# refers to the objective related to the content.

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I. Introduction to Fraud Impact (01-01 PPT Slides 4-5)
   a. Annecdote demonstrating fraud impact on an individual
   b. Anecdote demonstrating fraud impact on society

II. Serious of the Fraud Problem (01-01, PPT Slides 6-10)
   a. Fraud sources and limitations
      I. Government agencies: limited scope
      II. Researchers: not comprehensive
      III. Insurance companies: limited to specific cases
      IV. Victims of fraud: many victims choose *not* to make their fraud losses public.
   b. Association of Certified Fraud Examiners (ACFE)
      I. World's largest anti-fraud organization
      II. Regularly conducts one of most comprehensive fraud studies in the U.S.
         (1) Based on actual fraud cases reported by certified fraud examiners.
   c. Magnitude and seriousness of the fraud problem
      I. Organizations lose 5% of annual revenues to fraud.
      II. Fraud increases what we pay for goods and services
      III. Fraud losses reduce a firm's income on a dollar-for-dollar basis.
         (1) For every $1 of fraud, **net income** is reduced by $1.
         (2) More **revenue** is required to recover from the effects of the fraud.
      IV. Example: A large U.S. automobile manufacturer recently experienced $436 million fraud losses.
         (1) If the manufacturer's **profit margin** (net income as % of revenues) is 10%, the company must generate $43.6 million additional revenue restore net income.
      V. Fraud strain adversely impacts national economies.
         (1) High-corruption countries must overcome corruption losses.
         (2) Low-corruption countries increase GDP and move ahead.
   d. **Knowledge Check #1: 10 minutes** (PPT Slides 10-11)
      I. Present the scenario of country A which has a GDP of $100 billion and a profit margin of 10%.
         (1) If country A loses $1 billion annually to fraud, how much additional revenue must country A generate to account for the fraud?
         (2) What percentage of country A's GDP must be used to offset the fraud?

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II. Present the scenario of country B which has a GDP of $10 billion and a profit margin of 5%.
(1) If country B loses $1 million annually to fraud, how much additional revenue must country B generate to account for the fraud?
(2) What percentage of country B's GDP must be used to offset the fraud?
III. Ask the class which country is more likely to attract international investment and why.

III. What is Fraud? (01-02, PPT Slides 12-13)
a. Fraud: generic term that includes all ways one individual can gain advantage over another by false representation.
I. No definite and invariable rules
II. Typically includes surprise, trickery, cunning, and unfair ways another is cheated
b. Differs from robbery in that no physical force is involved
c. Fraud is different from unintentional error.
d. Elements of Fraud:
I. A *representation*
II. About a *material point*
III. Which is *false*
IV. And *intentionally or recklessly* so
V. Which is *believed*
VI. And *acted upon* by the victim
VII. To the victim's *damage*

IV. Charles Ponzi and the Famous Ponzi Scheme (01-02, PPT Slides 14-17)
a. Carlo "Charles" Ponzi, emigrated from Italy to the U.S. in 1903.
b. Started a scheme involving postal coupons and currency exchange with cited 400% profit.
I. Bragged about success
II. Promise to investors—double your money in 90 days
c. Questions raised about legitimacy of Ponzi's scheme
I. Paid returns to original investors
II. Unable to pay returns without new investments
III. Legal action against Ponzi
d. Role of greed, deception, and confidence:
I. Ponzi's scam is extremely helpful in understanding fraud because it involved:
(1) Greed by the perpetrator and greed by the investors
(2) Deception on the part of the perpetrator

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(3) Confidence of the investors in the perpetrator

II. Victims of fraud often have so much confidence in the perpetrator that they deny the fact that they were defrauded.

III. Confidence is the single most critical element for fraud to be successful.

(1) By paying early "returns," Ponzi gained investors' confidence and convinced them that he had a legitimate business.

(2) The word "con," which means to deceive, comes from the word "confidence."

IV. It is difficult to con anyone out of anything unless the deceived has confidence in the deceiver.

e. **Discussion #1: 10 minutes** (PPT Slide 17)

I. Present the following scenario and questions to the class: Suppose you wanted to con a bank teller. Which of the two outfits would you wear when entering the bank to perpetrate the con? Why?

(1) Outfit #1: A business suit similar to the ones worn by the bank's typical successful clients.

(2) Outfit #2: Well-worn coveralls and boots typically worn by manual laborers.

V. Types of Fraud (01-03, 01-04 PPT Slides 18-32)

a. Two main distinctions:

I. Fraud committed *against* organizations

II. Fraud committed *on behalf of* organizations

b. ACFE's definition of "occupational fraud."

c. ACFE's Categories of Occupational Fraud

I. Asset misappropriations:

II. Corruption

III. Fraudulent financial statements:

d. Classifying fraud according to victims

I. Frauds where a company or organization is the victim

(1) Employee embezzlement

(2) Vendor fraud

(3) Customer fraud

II. Management fraud—victims are shareholders or debt holders of the organization

III. Investment scams and other consumer frauds— victims are individuals.

IV. Miscellaneous frauds

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e. Employee embezzlement
   I. **Direct embezzlement**: employee directly steals company assets
   II. **Indirect embezzlement**: employee takes kickbacks from vendors or customers in return for business advantage.

f. **Discussion #2: 10 minutes** (PPT Slide 23)
   I. In each of the following cases, determine whether the embezzlement was direct or indirect.
      (1) CVC construction specializes in new home construction and older home remodeling. In spite of having a large market share, CVC struggles to make a profit. Investigation showed that CVC employees were using company supplies and equipment to do their own remodeling jobs.
      (2) In his role as a purchase agent, Mark paid a contractor nearly $100,000 for work that should have cost about $50,000. The contractor then paid Mark a kickback of nearly $30,000.

g. Types of Vendor Fraud
   I. Fraud perpetrated by vendors acting alone
   II. Fraud perpetrated through collusion between buyers and vendors

h. Types of Customer Fraud
   I. Customers do not pay for goods
   II. Customers pay too little
   III. Customers get something for nothing
   IV. Customers deceive organizations into giving them something they should not have
   V. Example: Fraud involving a bank in Chicago

i. Management Fraud
   I. Also known as *financial statement fraud*
   II. Top management deceptively misstates financial statements

j. Types of investment and other consumer fraud
   I. Fraudulent or worthless investments are sold to unsuspecting investors.
   II. Customers are sold worthless assets.
   III. Money is taken from unsuspecting individuals using a fictitious pretense.
   IV. Common Internet scams in 2023:
      (1) Romance and payday loan scams
      (2) One-time-password bot scams
      (3) Student loan forgiveness scams
      (4) Free-gift scams

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(5) Ransomware attacks
(6) Phishing attacks

k. Common consumer fraud schemes
   I. Ponzi schemes
   II. Pyramid schemes
   III. Telemarketing fraud
   IV. Nigerian letter or money scam
   V. Identity Theft
   VI. Advance fee scams
   VII. Redemption/strawman/bond fraud
   VIII. Letter of credit fraud
   IX. Internet fraud

l. **Knowledge Check #2: 5 minutes** (PPT Slides 31-32)
   I. For the following three scenarios, ask the class to determine whether or not fraud is likely and, if so, what type:
      (1) A friend tells you about a business opportunity with a startup company in a foreign country. A 200% annual rate of return is promised if you invest immediately.
      (2) You read an advertisement in a local paper in which the seller is offering a piece of used furniture for 50% off the comparable new price.
      (3) You receive an email regarding a business deal involving a money transfer of about $22,000,000 from a dormant bank account.

m. Impact on National Economies
   I. Fraudulent speculation on Wall Street during 1920s caused the Great Depression of the 1930s.
   II. Excessive and fraudulent speculation caused the U.S. Savings and Loan crisis of the 1980s and early 1990s.
   III. Widespread industry fraud led to subprime mortgage crisis of 2008 and subsequent U.S. recession.

VI. Criminal and Civil Prosecution of Fraud (01-05, PPT Slides 34-39)
   a. Fraud perpetrators can be prosecuted criminally and/or civilly.
   b. Successful prosecution requires that the perpetrator acted with intent to defraud the victim.
   c. Criminal law:
      I. deals with offenses of a public nature
      II. Deal with offenses against society as a whole
      III. Prosecuted either federally or by a state
   d. Conviction requires proof of guilt “beyond a reasonable doubt.”

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I. Convicts usually serve jail sentences and/or pay fines.

e. Examples of recent, noteablecriminal fraud prosecutions:

f. Civil law: body of law provides remedies for violation of private rights
   I. Deals with rights of individuals

g. Civil claims begin when one party files a complaint against another
   I. Usually for the purpose of financial restitution
   II. Gain compensation for harm an individual or organization believes has been done to them

h. Unanimous verdict not required for conviction, often heard by judges rather than juries

i. Plaintiffs must only prove cases by "preponderance of the evidence."

j. **Knowledge Check #3: 5 minutes** (PPT Slides 39-40)
   I. Which of the following statements is true?
      (1) When fraud is committed, civil litigation proceeds first followed by criminal prosecution.
      (2) The purpose of a civil case is to right a wrong.
      (3) The burden of proof in a criminal case must be "beyond a reasonable doubt".
      (4) In criminal cases, various claims may be joined in one action.
      (5) Civil cases are initiated by a plaintiff filing an claim.

VII. How to Prepare to Be a Fraud-Fighting Professional (01-06, PPT Slides 41-42)

a. Few universities have "fraud prevention" majors; closest applicable degrees are cybersecurity and forensic accounting.

b. Where forensic degrees do not exist, students should choose courses and majors to provide essential fraud-fighting skills:
   I. Analytical skills: fraud investigation requires diagnostic, exploratory work, and troubleshooting.
   II. Communication skills: essential for effective witness interviewing, report-writing, and presentation
   III. Technological skills: search for fraud symptoms, profiles, and perpetrators using database analysis

c. Specific skills useful for future fraud examiners:
   I. Some understanding of accounting and business
   II. Knowledge of law, criminology, privacy issues, employee rights, and fraud statutes
   III. foreign language fluency
   IV. Human behavior and motivation

VIII. Certified Fraud Examiners (01-06, PPT Slides 43-46)

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a. The Association of Certified Examiners (ACFE) provides the opportunity for an individual to become a Certified Fraud Examiner (CFE).
b. Requirements to become a CFE
    I. Be an associate member of the ACFE in good standing
    II. Meet the specified academic and professional requirements
    III. Be of high moral character
    IV. Pass the CFE Examination
    V. Agree to abide by ACFEbylaws and Code of Professional Ethics
c. CFE Academic Requirements
    I. Generally, applicants for CFE certification have a minimum of a bachelor's degree (or equivalent).
        (1) May substitute two years of fraud-related professional experience for each year of academic study
    II. No specific field of study is required
d. CFE Professional Requirements
    I. CFE designation requires at least two years of professional experience in a field either directly or indirectly related to the detection or deterrence of fraud.
    II. The following categories are deemed acceptable as fraud-related experience:
        (1) Accounting and Auditing
        (2) Criminology and Sociology
        (3) Fraud Investigation
        (4) Loss Prevention
        (5) Law
e. CFE Examination
    I. Covers four primary areas of fraud examination:
        (1) Financial transactions and fraud schemes
        (2) Law
        (3) Investigation
        (4) Fraud prevention and deterrence
    II. Exam format: 500 objective questions and taken online
        (1) Requires approximately 10 hours to complete
        (2) Divided into four sections of 125 questions each
            (a) Each section can be completed in a different sitting.
            (b) You must complete all four sections of the exam and submit it to AFCE for grading within 30 days.

IX. Fraud-Related Careers (01-06, PPT Slide 47)

a. Increasing fraud losses is driving an increase in fraud-fighting career opportunities, especially in the following industries:

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I. Government and law enforcement
II. CPA firms
III. Corporations
IV. Consulting
V. Law firms

X. End-of-Chapter Book Activities (All objectives)
   a. Review of learning objectives
   b. Key terms
   c. Questions
   d. Short cases
   e. Case studies
   f. Debates
   g. Internet assignments

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## Additional Activities and Assignments

The following are additional activities and assignments not included in the textbook or PPTs – they are for you to use if you wish. #-# refers to the objective related to the content.

1. **Anti-Fraud Statues** (Learning Objective 01-05)
   a. For each of the following scenarios, use Table 1.2 of the textbook (shown below) to determine which federal fraud statute (or statutes) were violated.

**Tabel 1.2 Principal Federal Fraud Statutes**

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| Statute | Title and Code | Description |
|---|---|---|
| Bribery of Public Officials and Witnesses | Title 18, US. Code §201 | Bribery is punishable by up to 15 years in prison, a fine of up to three times the thing of value given or received, and disqualification of officer. |
| Anti-Kickback Act of 1986 | Title 41, US. Code §51 to 58 | This act outlaws the giving or receiving of anything of value by a subcontractor to a prime contractor in U.S. government contracts. Willful violations are punished by a fine and up to 10 years in prison. |
| Mail Fraud | Title 18, US. Code §1341 | "Whoever, having devised or intending to devise any scheme or artifice to defraud, or for obtaining money or property by means of false or fraudulent pretenses, representations, or promises, for the purpose of executing such scheme or artifice or attempting so to do, places in any post office or authorized deposits or causes to be deposited any matter or thing whatever to be sent or delivered by any private or commercial interstate carrier, ... shall be fined under this title ... or imprisoned." |
| Bank Fraud | Title 18, US. Code §1344 | Any scheme to defraud federally insured financial institutions by customers, officers, employees, and owners. Covers banks, savings and loans, credit unions, and other financial institutions insured by government agencies. |
| Racketeer Influenced and Corrupt Organizations (RICO) Statute | Title 18, US. Code §1961 | This statute makes it an offense for any person associated with an "enterprise" engaged in interstate commerce to conduct the affairs of the enterprise through a "pattern of racketeering activity" A pattern is defined as two or more enumerated criminal violations. |
| Computer Fraud | Title 18, US. Code §1030 | Section 1030 punishes any intentional, unauthorized access to a "protected computer" for the purpose of obtaining restricted data regarding national security, obtaining confidential financial information, using a computer that is intended for use by the U.S. |

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| | | |
|---|---|---|
| | | government, committing a fraud, or damaging or destroying information contained in the computer. |
| Securities Fraud | Rule 10(b)5 Securities Act of 1934, $17(a) | It is unlawful for an insider who has material inside information to purchase or sell the company's securities, irrespective of whether the insider deals directly or through an exchange. The anti-fraud provisions impose civil liability on those who perpetrate or who aid and abet any fraud in connection with any offer and sale of securities. |
| Foreign Corrupt Practices Act (FCPA) | Title 15, US. Code §78m, 78a(b), 78dd-1, 78dd-2, 78ff | This law outlaws bribery of foreign officials by U.S. companies for business purposes. The FCPA also requires that SEC-regulated companies keep accurate books and records and have sufficient internal controls to assure that "access to assets is permitted only in accordance with management's authorization," to prevent slush funds and bribe payments. |
| Tax Evasion | Title 26, US. Code §7201 | Failure to report income from fraud or bribes may be prosecuted as tax evasion, or for filing a false return. Also, bribes may not lawfully be deducted as business expenses. |

b. Scenario #1: A construction firm is working on a federal project to install a new storm water control system. The project is running late and the firm's CEO asks the superintendent to bribe inspectors to sign off on substandard work that requires repair.
    i. Answer #1: Bribery of Public Officials and Witnesses Title 18, U.S. Code §201
c. Scenario #2: A junior engineer working for a prime contractor on a federally funded project is working on a research project with a senior engineer employed by a subcontractor. The senior engineer offers to pay for the junior engineer to attend a conference where their collaborative results will be presented.
    i. Answer: #2: Anti-Kickback Act of 1986 Title 41, U.S. Code §51-58
d. Scenario #3: A manager at a start-up firm just learned that a newly developed product will be ready for go to market within three months. The manager purchases $100,000 of shares in start-up firm and sells them for $800,000 after the new product release is publicized.

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i. Answer #3: Securities Fraud Rule 10(b)5 Securities Act of 1934, $17(a)

2. **Preparing for a Fraud-Fighting Career** (Learning Objective 01-06)
   a. Suppose you're an undergraduate studying engineering. Your program of study will provide you with strong analytical and technology skills. Could you consider a career as a fraud-fighting professional? Why or why not?
      i. Answer: Yes, you could consider a career as a fraud-fighting progressional since your analytical and technology skills are key skills needed by fraud-fighting professionals.
   b. Suppose you're an investigative journalist specializing in employee rights. Do you have skills useful for a fraud-fighting professional? Why or why not?
      i. Answer: Yes you do. As a journalist you have strong communication skills. As anemployee rig;hts investigator, you also have knowledge of human behavior.
   c. Suppose you're an experienced, trilingual computer programmer. What skills do you have that are essential for a fraud-fighting professional?
      i. Answer: As a polyglot computer programmer, you have technology skills as well as the ability to communicate with professionals in multiple countries.Additional Resources

## Internet Resources

- Association of Certified Fraud Examiners (ACFE): **ACFE website**
- Utica University Financial Crime and Compliance Degree Program: **Utica financial crime website**
- Colorado State University Fraud and Financial Crimes Degree Specializations: **CSU website**
- Federal Bureau of Investigation (FBI) Scams and Safety (Public Education) : **FBI Crime Smart Website**

## Primary Resources

- G. Strober and D. Strober, *Catastrophe: The Story of Bernard L. Madoff, the Man Who Swindled the World* (Beverly Hills, CA: Phoenix Books, 2009).
- I. Hamilton and I. Francis, *The Enron Collapse, IMD Case Study* (Wellesley, MA: ECCH, 2003).

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# CASE 2.6

# CBI HOLDING COMPANY, INC.

## Synopsis

Ernst & Young audited the pharmaceutical wholesaler CBI Holding Company, Inc., in the early 1990s. In 1991, Robert Castello, CBI's owner and chief executive, sold a 48% stake in his company to TCW, an investment firm. The purchase agreement between Castello and TCW identified certain "control-triggering" events. If one such event occurred, TCW had the right to take control of CBI.

In CBI's fiscal 1992 and 1993, Castello orchestrated a fraudulent scheme that embellished the company's reported financial condition and operating results. The scheme resulted in Castello receiving bonuses for 1992 and 1993 to which he was not entitled. A major feature of the fraud involved the understatement of CBI's year-end accounts payable. Castello and several of his subordinates took steps to conceal the fraud from CBI's Ernst & Young auditors and from TCW (two of CBI's directors were TCW officials). Concealing the fraud was "necessary" to ensure that Castello did not have to forfeit his bonuses. Likewise, the fraud had to be concealed because it qualified as a "control-triggering" event.

This case examines the audit procedures that Ernst & Young applied to CBI's year-end accounts payable for fiscal 1992 and 1993. The principal audit test that Ernst & Young used in auditing CBI's accounts payable was a search for unrecorded liabilities. Although Ernst & Young auditors discovered unrecorded liabilities each year that resulted from Castello's fraudulent scheme, they did not properly investigate those items and, as a result, failed to require CBI to prepare appropriate adjusting entries for them. A subsequent civil lawsuit focused on the deficiencies in Ernst & Young's accounts payable-related audit procedures during the 1992 and 1993 CBI audits. Following a 17-day trial, a federal judge ruled that Ernst & Young's deficient audits were the proximate cause of CBI's bankruptcy and the resulting losses suffered by TCW and CBI's creditors.

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## CBI Holding Company, Inc.--Key Facts

1. In 1991, TCW purchased a 48 percent ownership interest in CBI from Robert Castello, the company's owner and chief executive.

2. The TCW-CBI agreement identified certain "control-triggering events;" if one of these events occurred, TCW would take control of CBI.

3. During CBI's fiscal 1992 and 1993, Castello oversaw a fraudulent scheme that resulted in him receiving year-end bonuses to which he was not entitled.

4. A major feature of the fraud was the understatement of CBI's year-end accounts payable.

5. Castello realized that the fraudulent scheme qualified as a control-triggering event.

6. Castello and his subordinates attempted to conceal the unrecorded liabilities by labeling the payments of them early in each fiscal year as "advances" to the given vendors.

7. Ernst & Young auditors identified many of the alleged advances during their search for unrecorded liabilities.

8. Because the auditors accepted the "advances" explanation provided to them by client personnel, they failed to require CBI to record adjusting entries for millions of dollars of unrecorded liabilities at the end of fiscal 1992 and 1993.

9. The federal judge who presided over the lawsuit triggered by Castello's fraudulent scheme ruled that Ernst & Young's deficient audits were ultimately the cause of the losses suffered by TCW and CBI's creditors.

10. The federal judge also charged that several circumstances that arose during Ernst & Young's tenure as CBI's auditor suggested that the audit firm's independence had been impaired.

## Instructional Objectives

1. To illustrate methods that client management may use to understate accounts payable.

2. To examine the audit objectives related to accounts payable and the specific audit tests that may be used to accomplish those objectives.

3. To illustrate the need for auditors to rigorously investigate questionable items discovered during an audit.

4. To examine circumstances arising during an audit that can jeopardize auditors' independence.

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## Suggestions for Use

This case focuses on accounts payable and, consequently, is best suited for coverage during classroom discussion of the audit tests appropriate for that account. Alternatively, the case could be integrated with coverage of audit evidence issues. Finally, the case also raises several interesting auditor independence issues.

As a point of information, you will find that this case doesn't fully examine all facets of the fraudulent scheme perpetrated by CBI's management. The cases in this section purposefully focus on high-risk accounts and auditing issues related to those accounts. If I fully developed all of the issues posed by the cases in this text, each case would qualify as a "comprehensive" case. [I make this point because many adopters have raised this issue with me. By the way, I greatly appreciate such comments and concerns!]

## Suggested Solutions to Case Questions

1. "Completeness" is typically the management assertion of most concern to auditors when investigating the material accuracy of a client's accounts payable. Generally, clients have a much stronger incentive to violate the completeness assertion for liability and expense accounts than the other management assertions relevant to those accounts. Unfortunately for auditors, a client's financial controls for accounts payable are typically not as comprehensive or as sophisticated as the controls established in accounting for the analogous asset account, accounts receivable. Clients have a strong economic incentive to maintain a reliable tracking system for amounts owed to them by their customers. This same incentive does not exist for payables since the onus for keeping track of these amounts and ensuring that they are ultimately paid rests with a company's creditors. Granted, a company needs sufficient records to ensure that their vendors are not overcharging them. Nevertheless, the relatively weak accounting and control procedures for payables often complicate auditors' efforts to corroborate the completeness assertion for this account.

In my view, the two primary audit procedures that Ernst & Young applied to CBI's accounts payable would likely have yielded sufficient appropriate evidence to corroborate the completeness assertion—if those procedures had been properly applied. The search for unrecorded liabilities is almost universally applied to accounts payable. This search procedure provides strong evidence supporting the completeness assertion because audit clients in most cases have to pay year-end liabilities during the first few weeks of the new fiscal year. [Of course, one feature of the search procedure is examining the unpaid voucher file to uncover any year-end liabilities that remain unpaid late in the audit.] The reconciliation procedure included in Ernst & Young's audit programs for accounts payable provides additional evidence pertinent to the completeness assertion. In particular, that audit test helps auditors nail down the "timing" issue for payables that arose near a client's year-end. Vendor statements should identify the shipping terms and shipment dates for specific invoice items and thus allow auditors to determine whether those items should have been recorded as liabilities at the client's year-end.

2. Before answering the explicit question posed by this item, let me first address the "explanation" matter. In most circumstances, auditors are required to use confirmation procedures in auditing a

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client's accounts receivable. Exceptions to this general rule are discussed in AS 2310, "The Confirmation Process," of the PCAOB's auditing standards and include cases in which the client's accounts receivable are immaterial in amount and when the use of confirmation procedures would likely be ineffective. On the other hand, confirmation procedures are not generally required when auditing a client's accounts payable. Accounts receivable confirmation procedures typically yield evidence supporting the existence, valuation/allocation, and rights & obligations assertions related to period-ending accounts receivable balances. However, the key assertion corroborated most directly by these tests is existence. When performing confirmation procedures on a client's accounts payable, the auditor is most often concerned with the completeness assertion (as pointed out in the answer to the prior question). [Note: AU-C Section 505, "External Confirmations," is the section in the AICPA Professional Standards that corresponds with AS 2310.]

The differing objectives of accounts payable and accounts receivable confirmation procedures require an auditor to use different sampling strategies for these two types of tests. For instance, an auditor will generally confirm a disproportionate number of a client's large receivables. Conversely, because completeness is the primary concern in a payables confirmation procedure, the auditor may send out confirmations on a disproportionate number of accounts that have relatively small balances or even zero balances. Likewise, an auditor may send out accounts payable confirmations to inactive vendor accounts and send out confirmations to vendors with which the client has recently established a relationship even though the client's records indicate no outstanding balance owed to such vendors.

A final technical difference between accounts payable and accounts receivable confirmation procedures is the nature of the confirmation document used in the two types of tests. A receivable confirmation discloses the amount reportedly owed by the customer to the client, while a payable confirmation typically does not provide an account balance but rather asks vendors to report the amount owed to them by the client. Auditors use blank confirmation forms in an effort to identify any unrecorded payables owed by the client.

Should the Ernst & Young auditors have applied an accounts payable confirmation procedure to CBI's payables? No doubt, doing so would have yielded additional evidence regarding the completeness assertion and, in fact, likely have led to the discovery of Castello's fraudulent scheme. One could certainly suggest that given the fact that the 1992 and 1993 audits were labeled by Ernst & Young as high-risk engagements, the audit firm should have considered erring on the conservative side by mailing confirmations—at least to CBI's major vendors. On the other hand, since payable confirmations are seldom used and since the two procedures that Ernst & Young applied to CBI's accounts payable would yield, in most circumstances, sufficient appropriate evidence to support the completeness assertion, most auditors would likely not criticize Ernst & Young for not using payable confirmations.

3. AS 2905 of the PCAOB's auditing standards discusses auditors' responsibilities regarding the "subsequent discovery of facts" existing at the date of an audit report. That section of the professional standards suggests that, as a general rule, when an auditor discovers information that would have affected a previously issued audit report, the auditor has a responsibility to take appropriate measures to ensure that the information is relayed to parties who are still relying on that report. In this particular case, AS 2905 almost certainly required Ernst & Young to inform CBI's management, TCW officials, and other parties of the advances ruse orchestrated by Castello that was not uncovered by Ernst & Young during the 1992 and 1993 audits. In my view, the obligation to

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inform CBI management (including the TCW representatives sitting on CBI's board) of the oversights in the prior audits was compounded by the fact that Ernst & Young was actively seeking to obtain the reaudit engagement. (Note: AU-C Section 560, "Subsequent Events and Subsequently Discovered Facts," of the AICPA Professional Standards corresponds with AS 2905.)

Generally, auditors do not have a responsibility to inform client management of "mistakes" made on earlier audits. On practically every audit engagement, simple mistakes or oversights are likely to be made. However, if such mistakes trigger auditors' responsibilities under AS 2905—for example, the mistakes involve gaffes by auditors that resulted in an improper audit opinion being issued—certainly the given audit firm has a responsibility to comply with AS 2905 and ensure that the appropriate disclosures are made to the relevant parties.

4. The key criterion in assigning auditors to audit engagements should be the personnel needs of each specific engagement. Certainly, client management has the right to complain regarding the assignment of a particular individual to an audit engagement if that complaint is predicated on the individual's lack of technical competence, poor interpersonal skills, or other skills deficiencies. On the other hand, a client request to remove a member of an audit team simply because he or she is too "inquisitive" is certainly not a valid request. Castello's request was particularly problematic because it involved the audit manager assigned to the engagement. The audit manager on an engagement team often has considerable client-specific experience and expertise that will be forfeited if he or she is removed from the engagement.

5. Determining whether high-risk audit clients should be accepted is a matter of professional judgment. Clearly, "economics" is the overriding issue for audit firms to consider in such circumstances. An audit firm must weigh the economic benefits (audit fees and fees for ancillary services, if any) against the potential economic costs (future litigation losses, harm to reputation, etc.) in deciding whether to accept a high-risk client. Complicating this assessment is the fact that many of the economic benefits and the economic disincentives related to such decisions are difficult to quantify. For example, quite often one of the best ways for an audit firm to establish a foothold in a new industry is to accept high-risk audit clients in those industries (such clients are the ones most likely to be "available" in a given industry). Likewise, audit firms must consider the important "utilization" issue. An audit firm will be more prone to accept a high-risk audit client if rejecting that client would result in considerable "down time" for members of the given office's audit staff. In any case, the decision of whether to accept or reject a high-risk audit client should be addressed deliberately, reached with the input of multiple audit partners, and ultimately reviewed at a higher level than the practice office. (Most large accounting firms have a "risk management" group that reviews each client acceptance/rejection decision.)

As a point of information, after Ernst & Young issued an unqualified opinion on CBI's 1993 financial statements, the audit engagement partner recommended that Ernst & Young dissociate itself from CBI. In the partner's view, the audit risk posed by CBI was simply too high. Despite this recommendation, the audit partner was overruled by his fellow partners in his practice office. (The decision to retain CBI as an audit client proved inconsequential since the company went "belly up" before the 1994 audit was commenced.)

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