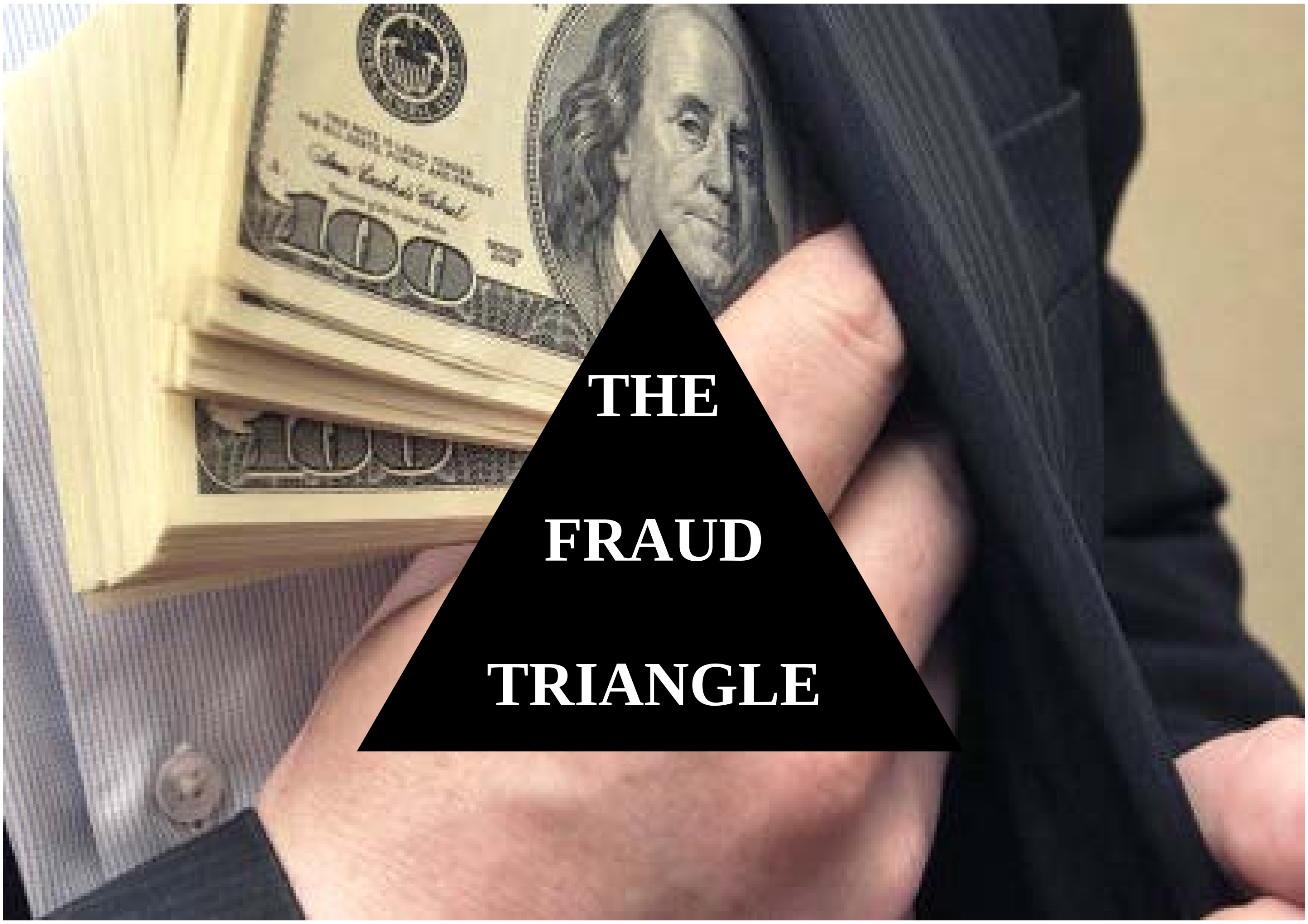
Accountants, Consultants & Business Valuators



<u>Things you will learn from this whitepaper:</u>

1. What is The Fraud Triangle?
2. What are the tenants of fraud?
3. How is fraud detected?

<u>This whitepaper will have special interest to:</u>

1. Judges presiding over fraud litigation cases.
2. Attorneys representing litigants in fraud cases.
3. Business owners wishing to safeguard its corporate assets.

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Introduction

Fraud comes in many different forms, from tax evasion to overstatement of corporate income. Take for example the now legendary case of Enron Corporation in 2001. That company's reported revenues of over $100 billion ended up being nothing more than a fiction. But fraud also occurs in smaller doses. In September 2014, Matthew Wada and Jennifer York were indicted on multiple counts of fraud for renting out already occupied apartments, swindling dozens of victims out of more than $60,000.

Whatever the intensity or scope of a fraudulent activity, the elements behind a person's decision to commit fraud remain universal.

The Fraud Triangle, developed and refined over sixty years by academics, researchers, and professionals, has become the standard tool for diagnosing the causes behind fraud. Forensic accountants, in particular, utilize this tool in their investigation of fraudulent activities.

History of the Triangle

Criminology researchers, Edwin Sutherland and Donald Cressey, provided the seeds of the Fraud Triangle. Sutherland developed the "Differential Association" to explain why people commit crime. It defined criminal activity as a learned activity, influenced by ones environment, and consisting of learned motives, drives, attitudes, and rationalizations. Cressey, when researching into embezzlement, extended Sutherland's findings, pinning down three elements which must be present for embezzlement to occur:

1. *A non-sharable problem,*
2. *An opportunity for trust violation, and*
3. *A set of rationalizations that define the behavior as appropriate.*

However, it wasn't until a 1979 study, conducted by Romney, Cherrington, Payne, Roe, and Albrecht, that the variables leading to fraud were directly investigated. These researchers refined and broadened Cressey's three points further:

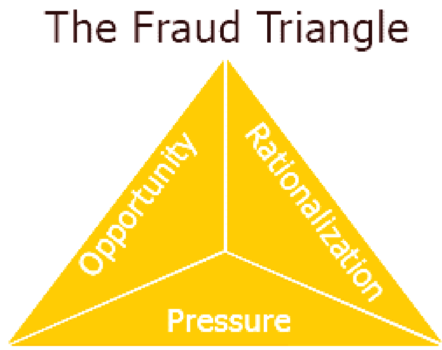
1. *Situational pressures,*
2. *Opportunities to commit fraud, and*
3. *Personal integrity (character).*

Not only this, but the researchers also showed that these aspects were interactive, showing that if more of one element is present, less of the other two are needed.

This list would be further refined by one of the study's authors, W. Steve Albrecht. He included ideas of perception into the elements, as well as finding that a return to one of Cressey's original points was a better fit. He came up with the final sides of the triangle:

1. *Perceived Pressure,*
2. *Perceived Opportunity, and*
3. *Rationalization.*

The Aspects of the Triangle



1From The University of Indiana. http://www.usi.edu/internalaudit/what-is-fraud

Albrecht's three elements work together to prepare the conditions for a person to compromise the values of honesty and fair-dealing.

Perceived Pressure

People often feel they are being forced into the actions they take, regardless whether these actions exist in reality, or are simply a matter of perception. In the instance of fraud, these pressures can come in the form of an enormous amount of real debt, or the perceived threat of a possible divorce. Either of these examples, either real or imaginary or anticipated, are one element that can lead a person into feeling they are being pressured into committing fraud.

Perceived Opportunity

In many fraud cases people wonder, "Why did they think they could get away with it?" The reason behind this is that, like pressure, the opportunities to commit fraud can also be simply perceived rather than real. If someone feels both pressured and can rationalize fraud, it is not too hard for them to create an available opportunity. However, opportunities can be, and often are, very real. Many are surrounded every day with opportunities to commit fraud, but more often than not, they don't. This is because a perceived opportunity alone will not lead a person into fraudulent activity.

Rationalization

Perhaps of all the elements of the Fraud Triangle, rationalization is the most easy to understand. We have seen it in the news, in movies, and in books: the person about to commit a crime, or in the midst of committing one, rationalizes their action. This ability to rationalize an action which would normally go against one's moral code must also be present.

The Triangle at Work: An Example

As the 1979 study pointed at, each element of the fraud triangle will not work alone, but must act with the other two elements to lead to fraud. However, if one element—such as perceived opportunity—is very strong, the other two elements don't have to be as strong for a fraud to occur.

Enron

In the case of Enron the elements of the triangle are reflected clearly. The company's executives saw a *perceived opportunity* in the deregulated energy industry, therefore, under *perceived pressure* to keep their stock price rising, they *rationalized* illegal accounting practices to follow through on that opportunity.

Here, it seems, the perceived opportunity, which would make more money, outweighed the other considerations, though all three elements were present. Yet, one could easily see how the perceived pressure could have been the prime cause of the fraud as well.

How is Fraud Detected?	According to the global survey by the Association of Certified Fraud Examiners (ACFE), the typical organization loses at least 5% of revenues each year to fraud. Globally this amounts to over $3 trillion dollars lost to fraud.

While it is hard for a company to control the *pressure* or the *rationalization* sides of the triangle, the *opportunity* side can be. There are several steps that can be taken to detect and limit fraud, such as:

- *Regular risk assessments,*
- *Frequent staff training and evaluations,*
- *Create a fraud reporting system within your organization,*
- *Use data mining to identify fraud "red flags,"*
- *Create manual checks and balances, and*
- *Consistent external audits.*

As can be seen, the best way to detect fraud is to have a thorough system in place and to stay vigilant in finding it.

Conclusion

Fraud, sadly, occurs every day in many different spheres of business and life. However, tools such as the Fraud Triangle can help investigators of fraud, such as forensic accountants, analyze the causes behind potential fraud and bring any wrongdoing to light.

For more information on this topic please feel free to contact our office for assistance.

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