

Ethnographic Analysis Yields Fraud Insights For Auditors of Financial Institutions

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ABSTRACT

Auditors understand the fraud risk factors of incentives/pressures, opportunities, and rationalizations. This qualitative study combines ethnography and content analysis to analyze fraud risk factors in actual occurrences of fraud. Interviews with an audit partner were summarized for stories underlying situations in five fraud and five non-fraud financial institutions. The stories were separately analyzed using content analysis techniques. General content analysis was performed in an ethnographic fashion looking for recurring themes; direct quotations are provided to aid contextual understanding. Next, a grounded assessment tool analysis applied an industry checklist to the events of each story. The frequency of fraud risk factors was found to be consistent with the occurrence of fraud. The importance of informal communications and looking beyond the numbers in attempts to “know the client” and issues surrounding professional skepticism are a few insights to emerge. Several morals of the story are provided for auditors, management and perpetrators.

Key Words: *Fraud Schemes, Misappropriation of Assets,, Ethnography, Content Analysis, Financial Institutions*

INTRODUCTION

An early analysis of fraud cases that were prosecuted on federal and state levels looked at the frequency of various kinds of fraud by industry even though fraud information was difficult to find (Albrecht and Schmoltdt 1988). Similarly, a recent article focused on the use of non-financial performance measures as a tool for fraud discovery faced many of the same information collection barriers (Brazel et al. 2005). The earlier report concluded the lack of information is due to companies who do not want to deal with the bad publicity surrounding a fraud case and instead deal with it privately. It focused on several industries, including financial institutions as “only banks are required to report employee embezzlement” (Albrecht and Schmoltdt 1988, 16). Cash embezzlement was the most common type of fraud, followed by check forgery/alteration, fictitious loans and misrepresentation. Suggestions for limiting fraud opportunities included strengthening internal controls, enforcing mandatory vacations and obtaining separation of duties.

Since the introduction of SAS No. #99, auditors have been forced to consider and test for fraud during their audits; whereas before, auditors only had the mere obligation to inform management if they detected fraud during the ordinary course of the audit. Fraud as defined in SAS 99 is “... an intentional act that results in a material misstatement in financial statements that are subject of an audit” (AICPA, 2002, par. 05). One important test that auditors perform is the analysis of fraud risk factors. The analysis of fraud risk factors and the content analysis of fraud and non-fraud stories pertaining to financial institutions are the basis of this qualitative research study. The results from the fraud risk factors grounded assessment tool and the fraud stories content analysis answer the research question, what can the frequency of fraud risk factors tell us about the likelihood of fraud?

BACKGROUND

Fraud Risk Factors

Fraud risk factors are “events or conditions that indicate the presence of incentives or pressures to commit fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify fraud” (Carmichael and Griffith 2005, p. 65). Consideration of fraud risk factors has heightened due to the Sarbanes Oxley Act of 2002 and SAS No. #99. Those two regulatory actions required managers and accountants to become more aware and proactive about fraud. Consequently, the fraud triangle is a tool used by auditors to assess fraud risk factors and to study fraud perpetration. Many times auditors do not create their own fraud risk factors for each organization; however, they analyze fraud risk factors through the use of an industry guide that incorporates the red flags that were expanded in SAS No. #99. In addition, auditor must use professional judgment and maintain professional skepticism when analyzing fraud risk factors.

Incentives/ pressures are synonymous with motivation and need. Motivation is “financial pressures on employees such as medical bills, college tuition payments, gambling debts, lifestyle changes and etc.” (Grossman 2003, 40). Additionally, motivation/incentives are unfulfilled needs (Hodson 1996) or situational risks that will be fulfilled by committing fraud (Wilks and Zimbelman 2004). Incentives can be any reason whether it is personal or occupational for an employee to improve a current financial situation, appearance, or job description by committing fraud.

A 1995 financial institution seminar warned management to be aware of employees who “indicate that they have financial pressures, show personality changes, demonstrate poor personal money management, appear to be living beyond their means, have outside

business interests, show signs of drug or alcohol abuse, indicate they have a gambling problem and give inadequate answers when they are asked about missing supplies, property or funds” (Britt 1995, 46). These aspects all appear to be incentives/ pressures that employees face. A truth about the incentives/ pressures fraud risk factor is “the bad news is that for one of the factors -motivation- employers are essentially powerless” (Grossman 2003, 40). To protect against fraud employers cannot change their employees’ lifestyles but they can make fraud difficult to commit by taking away opportunities.

Opportunity is a “situational risk factor associated with circumstances which would permit management to perpetrate a dishonest or fraudulent act” (Wilks and Zimbelman 2004, 13). Opportunity occurs when controls are weak and the employee is aware of the weakness, the employee has access to company assets, and when the employee does not perceive getting caught as a risk (Grossman 2003; Hodson 1996). Consequently, opportunity is a fraud risk factor in which the organization holds responsibility.

Poor internal controls, lax management, an employee having significant control over a process, member/client complaints about shortages, and altered, missing or destroyed documents are activities making an organization vulnerable to fraud (Britt 1995). Conversely, in a more recent fraud survey, companies have stepped up to their responsibility and avoided detrimental activities, because internal control weaknesses and management override of internal controls have dropped, 19 and 5 percentage points, respectively as factors contributing to fraud (KPMG 2003).

The final leg of the fraud triangle is rationalizations/attitudes, which can be the catalyst in starting the fraud. Rationalization/attitudes are “risk factors indicative of an internal characteristic, personality trait, or set of ethical values that might lead management

to knowingly and intentionally commit a dishonest act” (Wilks and Zimbelman 2004, 13). Examples of rationalizations employees contemplate are “everybody’s doing it, business is business, I’ll pay it back, they’re not paying me enough, nobody’s going to get hurt, or it’s not for me; it’s for my ...” (Hodson 1996, 2-3). Rationalization/attitude is the turning point in the fraud scheme where the employee is convinced that such actions are necessary and acceptable for a specific reason.

With the publication of COSO’s Internal Controls Integrated Framework and the passage of the 2002 Sarbanes Oxley Act, and the increased awareness of examiners and regulators, financial institutions must implement and maintain strong internal controls. “It is incumbent upon the directors and management of every institution- not just publicly traded organizations – to analyze their internal controls and institute appropriate polices and procedures in light of the size, complexity, risk profile, and resources of the institution” (Smith and Feder, 2003, 10A). Strong internal controls become the weapons management and the board of directors can use to deter fraud.

RESEARCH METHOD

A qualitative research methodology for this study combines ethno-methodology and content analysis. Derived from ethnography, ethno-methodology is an extensive study of a specific cultural group in its natural setting (Leedy and Ormrod, 2005); in this analysis there were two groups: fraud and non-fraud institutions. A benefit of ethnography is the richness of “thick description” achieved by the researcher’s deep understanding through observation, recording, and analysis (Geertz 1973). Content analysis is the meticulous inspection of a specific body of material to identify emerging characteristics, themes, patterns or biases

(Leedy and Ormrod, 2005). The actual summarized fraud and non-fraud stories were the body of material analyzed in this study.

An audit partner (hereafter referred to as “Partner 1”) selected ten fraud and non-fraud cases that spanned his 20 years experience as a firm partner. Since Partner 1 specializes in financial institution audits, he chose ten financial institutions to reiterate the stories, which were also audio-taped for future analysis. Repeated listening of the stories was independently done by two experienced auditors, for the purpose of summarizing the stories which are presented in the next section, and for the subsequent analysis. Any italicized quotes in this study are direct quotes from Partner 1. The written stories were generally reviewed to find emerging characteristics, themes, patterns and biases, without any pre-conceived classification scheme. These results are presented in Tables 1 and 2.

Next, an industry assessment tool from the Practitioners Publishing Company (hereafter referred to as “PPC”) was used as a grounded analysis tool. PPC is a well known auditing, accounting and tax guide publisher and is commonly used by accounting and auditing practitioners. Parts of FCX-3a: Financial Institution Fraud Risk Factors, an assessment tool from PPC’s *Guide to Audits of Financial Institutions* (Carmichael and Griffith, 2005) were used in this study. The assessment tool was completed for each fraud and non-fraud financial institution from the taped interviews. Subsequently, Partner 1 reviewed the findings and added comments where necessary. The assessment tool pertained only to misappropriation of assets fraud factors. The stories are described and coded in this paper as A through E for fraud financial institutions and A1 through E1 for non-fraud. Frequency tables are presented for each fraud risk factor, as well as an overall frequency table.

FINANCIAL INSTITUTION AUDIT STORIES

The following stories of fraud and non-fraud financial institutions have the names of parties and identifying characteristics taken out to maintain client confidentiality. In addition all quotes have been kept intact to each specifically applicable story; care was taken to ensure that context was preserved for each story, rather than a general sprinkling or mix of quotes throughout the stories. General morals that conclude stories are compiled from language used in the telling of each story, although at the time of the interviews, the partner would not have known that the authors would later attempt to compile morals for each story from his words. In all cases, the reader is provided with the direct words as told by Partner 1. The story titles however are summary phrases selected by the authors, primarily for reader recall.

Story A: Initial Audit Catches Overdraft Scheme Done in the Name of Love

In financial institution A, the environment consisted of a relatively small organization and at the time the fraud was caught it was undergoing its first external audit. The financial institution had just reached an asset level between three to five million dollars, which requires an audit every three years. The institution had two full time employees and one part time. The board of directors rarely offered compensating controls for internal control weaknesses, and the president continually complained about the lack of attention she received such as not getting pay raises.

As a result, the president committed the fraud at financial institution A. The president of the institution was very experienced in the financial institution industry; however, she did not have any formal upper level education. She was married, and her husband had an addiction to having a neat and germ free home and environment. Many

times the husband had contractors at their home for improvement jobs such as re-shingling their roof every other year and taking out old carpet and re-install new carpet on a semi-annual basis. Additionally, the husband would only wear his clothing one time and then discard the clothing. *“She was bringing a new meaning to the words ‘for better for worse’.”* Due to her husband’s *“bizarre behavior”*, the perpetrator felt financial pressure. *“He didn’t do anything wrong; she’s the one that that did the action.”*

As president, the perpetrator’s main responsibility was to approve the overdraft list on a daily basis. The overdraft list consisted of the overdrawn members’ account numbers and the amount overdrawn as of the specific date being reviewed. Interestingly, the president always printed this list without names, even though there was an option for the report to be printed with names corresponding to the account numbers. First, the president determined whether or not a check/draft should be paid on the account of a member/customer whose account was or would be overdrawn. This determination was done by checking the balance in the member/customer account and the recent activity to gain reasonable assurance as to whether or not the overdrawn check would be paid back by the member. Next, an overdraft fee would be applied to all of the accounts of members/customers whose checks were paid causing them to overdraw. If the check was not paid, then it was sent back to the depositing institution and marked insufficient funds. The policy and fees were customary in the industry and were established by the board of directors. Consequently, the president’s fraud was possible due to a lack of segregation of duties in approving and paying the overdraft list, which the board should have been checking. *“The regulators had missed it, they simply had not looked at the overdraft list.”*

After the president's financial life severely suffered from her husband's addiction, the president started showing up on the overdraft list. The president started approving the payment of her own checks even though her account was overdrawn, and it was not reasonable to believe that she would be paying back her overdraft in the near future. The president was able to conceal her fraud because she was the only person looking at the overdraft list, and if anyone else saw it her name was not readily on the face of the list. In addition, the board of directors and the regulators never reviewed the overdraft list. One of the audit steps taken by the external auditors was to test the overdraft list, which had an account overdrawn approximately \$65,000. The auditors then asked for the names of the overdrawn accounts. Next, the auditors and chairman confronted the president. After confessing, the president went to her father, who repaid the fraud and fees to keep her out of jail. The president received a felony conviction, which made her not bondable and unable to ever work again in a financial institution. Additionally, she was ordered to pay \$80,000 in restitution for the money she stole and the accounting and legal fees that were incurred due to her fraud.

Moral to Auditor *"One thing an auditor should say is what kind of hat do I put on today... You have a bigger broader responsibility because you're representing the public. The public expects you to check things out."*

Moral to Management *"It's not your money, it's everyone's money. You have to be squeaky clean."*

Story B: Board Chairman's Suspicions Help Find Fraud

Financial institution B had four employees. The institution was so small that it did not offer teller operations. If a member wanted to withdraw money from his or her account,

then he or she would go to the institution and receive a check. The membership of the institution was municipal workers of a city, and many of the city's accounts were held at the institution. The board of directors was made up of active and retired city workers, who were not trained in the financial institution industry and generally, lacked understanding of internal controls. *"Opportunity was just ripe for someone to do something."* However, the supervisory committee chairman paid close attention to detail and later directed the auditors to suspicions of fraud.

Due to a lack of segregation of duties and a small staff size, the president of the institution was the only loan officer; therefore, she originated, granted and disbursed funds for loans with limited approval oversight from the board. As a result, she *"complained all the time about the board chairman and the board members because they didn't realize how hard she worked."* By having complete control of the loan duties the president had a major opportunity. Additionally, the president was the treasurer of the cemetery board for the city and that account was held at the institution. From the auditor's point of view, the president appeared to be well liked at first. Partner 1 explains that feeling by saying *"One of the things that I thought was very peculiar was that the city employees [financial institution members] would constantly stop by the credit union and she [the president] would pass out gym bags, flash lights, pens, and ice cream, all kinds of freebies ... She was everybody's buddy. She couldn't say no to anybody."* Consequently, the president started making loans to herself and relatives to cover massive medical bills generated from her husband's severe medical condition. The financial burden of her husband's medical problems was the incentive as well as the rationalization for her fraud. She rationalized that she needed the money to ensure her husband's care, and the incentive/pressure to steal was the massive medical bills. Therefore,

she would re-collateralize and re-finance her own loans without board approval. In addition, she would make loans to relatives without the relatives' knowledge and forge the loan signatures. *"How do you know this signature is not the son-in-law's?"* On one of the fraudulent relative loans, the president waited until a relative paid off a car loan and kept the title to use as collateral on a fraudulent loan. Her role as the cemetery board treasurer came into play when she would make loan payments. She would debit the account of the cemetery board for her loan payments and credit the amount outstanding on her loan. The financial institution and the city were both faced with misappropriation of assets fraud. A board member *"former military, the overzealous type"* that she had complained about a lot was how the fraud was uncovered. *"He suspected that the president had too many loans for the amount of money she was making."* Therefore, he contacted the auditors about his suspicions. The auditors came in and reviewed her loan files and found numerous exceptions. In addition, they were able to make a connection with the loan payments being made from the cemetery account.

The perpetrator did not receive any jail time, but has been forced to pay restitution on the numerous loans she had setup. A felony conviction is still pending because the auditors had difficulty getting the State's Attorney to bring proceedings against her. Currently, the financial institution is still pursuing legal action.

Moral to Auditor: *"All that free stuff she gave all the time. That should have been a signal to me. This gal's too loose. Trying to run the Board."*

Moral to Management: *"And everyone loved [the president], and that's not necessarily an attribute of an environment with good internal controls."*

Everyone loved her, and no one was watching her."

Story C: Complaints Explain the Large Deposits in Transit

Financial institution C was the most profitable of all of the fraud firms in this study for its asset size. The president was kind and very ethical, but extremely weak. He believed in hands-off managing, and could not run any of the daily duties such as making a loan or running teller operations. The president was very reliant on other employees, and *“he couldn’t balance a teller drawer if he had to and he couldn’t make a loan if he had to.”* As a result, the employees were not very willing to work hard because the president rarely did, which made the employees lose respect for him. *“There was a love hate relationship with the employees and management.”* Dissatisfaction with the president and the institution gave way to rationalization.

The perpetrator had started at the institution as a teller and through promotions moved up to being in charge of the Visa card program. The perpetrator constantly complained about the president and her salary to the auditors, which should have been a red flag to the auditors. *“When you see that much vocal disrespect for the boss, it’s probably a red flag that I [the auditor] should have paid more attention to. It’s one thing to disrespect your boss, it’s another thing to disrespect them so much and open your mouth. She did and I didn’t catch it. And those are not monetary things...”*

The perpetrator was married and had one child. Her husband never kept a stable job, which resulted in them not having very much money. This caused the perpetrator problems because she was very concerned with material items. *“The incentive was pure: I want to keep up with the Joneses.”*

As a result, the elementary nature of the visa card program became her opportunity. Members would come in to pay their visa bill and since Visa was not integrated with the

general ledger, the teller would not run anything through the drawer. The teller would collect the money from the member and paper clip the money and the visa statement stub together and put it in a basket. At the end of the day, all of the Visa stubs and payments were collected from the baskets and taken to the perpetrator. The following day the perpetrator would post the payments to member accounts, call in the payments to Visa, and then make general ledger entries. The institution would receive information a few days later via the mail and the perpetrator was told the amount to be debited from the institution's correspondent bank. The perpetrator would then take the money and deposit it into the correspondent bank, so that it would be there when Visa debited the account.

The perpetrator saw the opportunity when she found out that the general ledger was being kept open for twenty days into the following month due to the vice president's difficulty in reconciling correspondent bank accounts. As a result, the perpetrator started a lapping scheme. A lapping scheme is where the perpetrator steals today's deposits and then replaces them with tomorrow's deposits. By nature, lapping schemes fall apart as soon as the perpetrator does not have enough time or deposits to cover the scheme or if the perpetrator pays off the amount that has been stolen. Since the general ledger was open longer, the perpetrator had at most twenty days to collect enough deposits to cover her scheme. Over a ten-year period, the perpetrator would steal and lap approximately \$800 - \$1,000 per month totaling \$108,000 over this period.

For ten years, the continuing audit partner missed this fraud. He described the audit failure by saying, *“one of the auditing weaknesses that I thought had to do really with myself and is probably why I'm more of a professional skeptic today than most auditors is... familiarity breeds contentment. You trusted these people and were content with them.”*

Partner 1 allowed contentment and trust to cloud his professional skepticism. *“She was Miss Bible Study. Song leader at church. Always preaching Jesus, Jesus to me. She really put it on me.”*

The fraud had no financial measures indicating it because the institution was still very profitable, no members’ funds were ever lost, and the perpetrator was concealing her fraud. However one major red flag became more apparent as the lapping scheme progressed. At the end of each month a deposit in transit was present and it did not clear for fifteen to twenty days, which raised a red flag because *“when things don’t clear timely ... we should ask why.”*

During the audit the year before the fraud was uncovered the auditor quizzed the perpetrator about the length of time it took for the deposits in transit to clear. The auditor found the length of time to be suspicious, but the perpetrator *“ranted and raved [about the ineffective president discussed earlier] and she did it so much I [the auditor] fell for it.”* Additionally, the fraudster would always reconcile those deposits in transit to the penny with the coinciding member’s payments. As a result, the auditor trusted the perpetrator and missed discovering the fraud for another year. *“It also begs this question of partner rotation... Partner rotation on audit jobs is a disadvantage to a small firm because you can’t necessarily do that...”*

The next audit year brought to light the fraud as the perpetrator was finally unable to collect enough deposits at the end of the month to cover her lapping scheme. In addition, the month she was unable to lap enough money for was the final month of the audit year, which resulted in approximately a \$44,000 debit in the visa in transit liability account. One of the perpetrator’s family members had died at the audit year-end forcing her to go to the funeral,

which was out of state. By doing so, the perpetrator had cut numerous days out of her twenty-day window to lap. She was able to cover some of the lap, but the general ledger was closed before she could collect enough deposits to cover the lap in total. The large debit immediately set off red flags to the auditor. Once the audit started that year, the auditor made it a point to tell the perpetrator that he wanted to talk with her the following day about the large debit in the visa in transit account. The auditor never had the chance to question her the next day, because as she was walking in to work she handed off her keys to a fellow employee and told that employee to tell management that she would not be in to work. Upon hearing that news, the auditor knew he had struck a cord. Through minimal investigation the auditor found the lapping scheme that he had missed for so long.

The perpetrator received one year in prison, five months on house arrest, a felony conviction, and an order to pay restitution in the amount that was not covered by the bonding company, which was approximately \$25,000. The auditor's work papers were scrutinized by a forensic accountant from the bonding company. *"Always tell the truth in your work papers."* The forensic accountant was trying to quantify the fraud and prove the auditors' negligence, but she was unable to do so due to the auditor's documentation. *"In this case, telling the truth and my tick mark meaning exactly what it said probably saved the firm from being sued and our careers."*

Moral to Auditor: *"This was probably one of our most profitable clients. It didn't show up in the numbers."*

Moral to Management: *"Isn't this the classic thing of why mandatory vacation time? She took a day here, a day there."*

Story D: Hiding the IT Override

Much like financial institution B, financial institution D did not have physical cash at its facility. If members wanted money out of their accounts, then they would receive it through a check from the institution. The institution employed four employees; therefore, it was difficult to achieve segregation of duties. The president of the institution was by trade an accountant. She had an abrasive personality when she talked to members and the auditors, and she had no apparent passion for her work. Moreover, she was perceived as lazy by employees, which was brought on by her ongoing health problems. Her laziness and health problems enabled her to depend on others in the institution to do some of her duties. By doing so, she allowed an environment of leniency and reliance to be created. For example, the employees all knew each other's password on the computer. Additionally, she would tell employees how to make critical changes in the computer system, which is how the fraud was perpetrated. The board of directors was uninvolved and rarely went to the financial institution. Partner 1 described the board's lack of involvement as *"they had to be willing to walk up four flights of steps and come from two to four hours away."*

The financial institution controlled the printing and mailing of member statements each month, which is itself a risk because the statements can be more easily manipulated by employees. In addition, the institution's computer system allowed for transactions to be hidden on monthly statements. Not understanding the internal control weakness in revealing this information, the president told all of the employees how to hide transactions on a member statement if he or she had posted an error to a member's account. For example, if the employee had put the member's deposit in the wrong account and had done it repeatedly by accident, then the institution would hide that transaction so the member did not see the

mistake and become mad. However, by revealing this information to all employees, the president facilitated the opportunity for fraud.

Consequently, one of the employees started pilfering money from several elderly members who were in nursing homes and had more than \$75,000 in savings accounts. One of the elderly members was a past board member. The perpetrator then hid the transaction on the statement not only on her own computer but on everyone's computer, since she knew all of their passwords. *"She did this on all four employees' computers. They were all suspect. This even occurred on the president's computer."*

At the time, the perpetrator was having financial difficulties. Her husband was disabled, and he did not have disability insurance. Therefore, the perpetrator's incentive was to support her family. Additionally, she constantly complained about the institution, which helped her rationalize her actions. Over the course of less than one year, the perpetrator took in a range of \$70,000 to \$100,000 from elderly members' accounts and concealed it by hiding the transactions. This fraud could have been easily caught through member complaints; however, the perpetrator purposely picked a group of members who were less likely to study their statements due to various reasons. The statements would reflect the changes in amount, but the withdrawing transaction would not show. For example, if a member had \$100,000 in an account and she stole \$10,000, the ending balance would be \$90,000 on the statement without any activity being shown. To make sure the statements printed fraudulently with the transactions hidden, the perpetrator would change the mailing address on each of the statements she had altered to the institution's address. She received the returned statements, made sure the hidden fraudulent transaction did not print, and then re-mailed the statements herself. She checked the fraudulent statements every time she stole.

“Why did she need to see it fifteen times? ... When she confessed she said she had to see it, to have that confidence that the transaction did not print.”

By the perpetrator wanting to verify her concealment, the fraud was uncovered. One day the president walked by the perpetrator’s desk and found several member statements that had been returned to the institution, particularly a former board member, who was in the nursing home with a valid address. The president looked at the statement and called the external auditors due to her fear that fraud had occurred. All employees were sent home that day and were locked out of the institution until someone confessed to the fraud. It was difficult for the auditors to make a case since the perpetrator had done the transactions on everyone’s computer. After stringent questioning, the perpetrator confessed to the Board Chairman at three o’clock in the morning. She also agreed to explain to the auditors how she committed her fraud. The perpetrator was convicted of a felony and was forced to pay restitution to the institution and the bonding company. In addition, she filed bankruptcy as a result of her fraud being revealed. In the bankruptcy proceedings, she was forced to pay off loans she had at the institution. Currently, she is still paying on the loans and has yet to be overdue.

Moral to Auditor: “This was a fairly sophisticated method of stealing where you hide the transactions. I confronted her for the entire day...They’re not going to tell you about the fraud.”

Moral to Management: “It’s bad when you only have four people. Almost impossible. Don’t give employees override functions if you can.”

Story E: Night Deposit Allows Perpetrator to Remain Unseen

Financial institution E employed roughly fifteen to twenty people. Even though the institution had several employees, there were still instances when segregation of duties was not being enforced. At this institution, the loan officer's responsibilities were to grant and collect on loans allowing the perpetrator an opportunity, which was "*obviously a conflict of interest...you can't collect what you grant.*" The president was not educated enough to see the major internal control weakness being allowed. "*She was simply terrible...she had no idea.*" As a result, the loan officer was able to setup a fraudulent loan and collect the disbursement himself.

The perpetrator owned several rental houses, and a few of them had become vacant all around the same time. Thus, the perpetrator did not have enough income to cover the mortgage payments on the rental loans, which was the perpetrator's incentive. Since the perpetrator was a loan officer, he made a phony loan for \$20,000, when he only needed \$15,000, in the name of a randomly picked person from the phone book. He made up a phony social security number, changed the city in the address of the person in the phone book, and used that information to falsify the loan documents. He made the loan for more than he needed, so that he could make timely payments on the loan and limit his risks of being caught. Next, the perpetrator made the loan check out to himself and quit working at the institution shortly thereafter. After leaving the institution, the perpetrator went to ministry school and became a pastor at a church.

A few months later, the auditors came for the annual audit. As part of an audit procedure, the auditors controlled the mailing of the statements; so that, any statements with bad addresses would come back to their office. Ironically, a statement for a loan came back

with a bad address, which was hard to believe since the loan was current. As a result the auditors requested the institution to do a skip trace on the social security number listed on the loan to track down the correct address. A skip trace is a method of locating missing persons in which the institution inquires of the credit bureau about a specific social security number, and the credit bureau returns the geographic locations affiliated with that social security number. After doing the skip trace, the institution found out the social security number was bogus because the credit bureau had no information with the skip trace.

Coincidentally before the auditors had a chance to derive their next plan of action, a man came into the institution complaining “*I don’t owe a damn thing*” and about the phone calls and letters he was receiving from the institution. While doing the skip trace, an employee had noticed that there was a man with the same address and name as listed on the loan note, but a different city. Thinking the loan officer had mistakenly put the wrong city, the employee started to try to contact the man. The auditor overheard the man’s complaints and went and talked to him only to find out that the man did not have a loan at the institution, was not a member and had no idea why he was being contacted by the institution. After receiving a copy of the loan disbursement check, the auditor was able to see that the check was paid to the order of the former loan officer. In addition, the fraud was not detected in the payment process of the loan because the former loan officer would make the payments in cash through the night deposit box. The payments were timely, and the loan was never delinquent. The perpetrator had rationalized that he was just borrowing the money and he would eventually pay it all back even though his actions were fraudulent.

The auditor then collected his evidence and with the assistance of the institution’s attorney confronted the perpetrator. When confronted, the perpetrator “*denied it but, he*

started sweating profusely... it was obvious he was guilty.” The perpetrator was convicted of a felony and ordered to repay the loan, legal and accounting fees. The perpetrator’s father made the repayments, and the perpetrator was fired from the church.

Moral to Auditor: *“We did our confirmations. A bad address issue. Skip traces... gotta know where... He’d left in June, fiscal year end was September, we’re there in October. Statements had come back to the bank, but it was not an issue because the loan was current.”*

Moral to Management: *“He got a felony conviction. An agreed upon felony conviction - all the bonding companies can then find your name. If you’ve got a felony conviction, you can’t work in a financial institution. You’re not bondable.”*

Story A1: Commitment to the Institution

Financial institution A1 has a strong board of directors. The board consists of individuals with accounting and information systems backgrounds. They insist on having internal audits done quarterly throughout the year in conjunction with an external audit. They do not fear firing a president or other employees if that person is not doing their job. Similarly, the institution’s president is also a very strong leader. She is the only child in her family and is unmarried with no children. As a result, she spends a majority of her time on the institution. She is capable of performing all duties at the institution, and she does those duties if needed. This is illustrated with the following: *“She could do everything, and she did do everything.”* She has a take control attitude and is very organized and dominating. Finally, she was a major supporter of the credit union movement, which is to serve the underserved, and would never put her institution in danger.

Moral: *“She never had any employees that were smart enough to steal.”*

Story B1: Related Parties Not Allowed By Management to Hinder Control

Financial institution B1 is an institution where all but one or two of the employees are related. This fact would be seen as a major weakness; however, strong management compensates for this weakness. The president at institution B1 has been working in the financial institution industry for thirty years. She is very well loved and respected at her institution. She is an avid supporter of the credit union movement. Additionally, she addresses related-party work problems as well as related-party account discrepancies. *“She fixes the problems immediately or has the related party fix it immediately.”* She maintains tight controls over the related-party issues. Moreover, she takes audit exceptions or management comments seriously and follows up on them as need be.

The institution’s board has an understanding of the industry and has an employee of a financial institution insurance bonding company on its board. As a result, that board member has an extreme interest in making sure internal controls are in place and working effectively, since his employer would be subject to the claim if fraud was committed. The board is very cognizant and strict on controls. Finally, the relationship between the president and the board is positive and respect runs both ways.

Moral: *“A very strong Board membership. Not going to allow too many golf outings or conventions.”*

Story C1: Respect Creates an Internal Control

The president at financial institution C1 came out of retirement to manage the institution. He was a former accounts receivable head at a large corporation. He had served on many financial institution boards and learned a great deal. He has a passion for his work,

which shows and is emitted through his employees. The employees have a great deal of respect for the president and would not commit fraud for the simple fact they would hurt the president. Partner 1 describes this by saying, *“I’ve never seen fraud happen in an institution where management is really well respected...I’m not saying it can’t happen, but I’ve never seen it. People have so much respect for him [the president] that they wouldn’t think about committing fraud.”* The employees also work hard and are compensated fairly for their work. The branch manager of this institution carries a similar work ethic as the president. As a team, the two are highly respected and have mutual respect for each other and their staff. They can both perform any aspects of the institution and are very competent of the computer system. They both set the tone and expect others to follow. Financial institution C1 has many internal controls in place and has compensating controls. The board of directors is made up of diverse individuals who take their duties seriously. The board frequently will carry out their own internal control tests and will make recommendations. Finally, the board of directors and management create a strong internal control environment.

Moral: *“Why do they respect him? He’ll get his hands dirty. He can play teller, grant loans. He’ll return checks, repo vehicles...They’ll follow the controls; they’ll implement, they’ll even monitor them.”*

Story D1: Lack of Management Comments Equals Strong Financial Institution

The president at financial institution D1 is organized. She has a college degree and is a supporter of the credit union movement. She worked her way from a teller up to president at financial institution D1. *“Her husband is a professional and her job is viewed as a secondary income.”* She has a strong relationship with the members of the financial institution, can perform all duties at the institution, and is courteous and helpful. *“She knows*

a lot of the members' names and can play teller as well as make loans... she is very hands on." Her employees are constantly busy and rarely have downtime. The board of directors is made up of a retired doctors and hospital administrators who have high expectations. The board members are constantly in and out of the institution overseeing operations. In addition, the external auditors rarely have adjustments or management comments; however, when they do, management is quick to correct any errors or problems.

Moral: *"You get vibes...It's called auditor judgment. Of course she could be hoodwinking all of us. I am aware of that."*

Story E1: Two Management Styles Create Balance

Financial institution E1 has two different types of management. The president commands respect and is not overly liked. *"He has a bark that is bigger than his bite."* The vice president is a very technical person who is demanding of controls, and *"she could easily go play teller if she had to."* She comes down hard on employee insubordination. The institution has two CPAs on staff that can be considered compensating controls because a balance between professional employees and blue-collar employees is formed. *"Then there is Mr. X. He is a big goofus who wouldn't steal a bone from a dog. You get vibes here about what a person would or wouldn't do."* At times there can be a rift between management due to management's opposite personalities, but it is good in this case because it creates a compensating control. *"She thinks he's dumber than a post.* Management can perform many of the duties, address exceptions strongly and follows up on exceptions. The board of directors is made up of intellectuals; however, they are not very involved. A chemist, police chief, retired teachers, active teachers and a practicing accountant make up

the board. The chairman of the board is an accountant who understands the accounting and regulatory environment of the industry.

Moral: *“People don’t really like the V-P, but they respect her and know she would come down hard.”*

RESULTS

The content analysis of the fraud stories yielded several recurring characteristics that are presented in table 1. The most common recurring characteristic that occurred in each of the fraud stories was that the perpetrator was under financial pressure. Also for each there was a lack of segregation of duties, which in four of the five cases was due to a small number of employees. In addition all five fraud cases had some kind of internal control issue. In four of the stories the perpetrators had expressed dissatisfaction to the auditor either with the institution, management, or the board. Also for four stories, the spouse was a contributing factor due to medical conditions, addiction, or job stability. Weak management was found in three of the stories. Uneducated management, a weak board of directors, uneducated board of directors, and management that could not perform daily duties was found recurring in two or less of the fraud stories. These findings suggest that auditors must talk to the people in the institutions they are auditing because some of the recurring findings such as financial pressures and dissatisfaction with the institution may only be revealed through casual conversation.

(Insert Table 1 here)

The content analysis of the non-fraud stories had several recurring characteristics, which are presented in Table 2. The most common recurring characteristic specified in non-fraud stories was the presence of intelligent/qualified board. There is a compensating control

system for internal control weaknesses when the board is more aware of risk areas. Four of the five non-fraud stories shared common characteristics in which management could perform all duties and also that strong controls were seen as important. The benefits include management being able to recognize any possible discrepancies due to error or fraud, and strong internal controls to decrease the financial institution's exposure to fraud opportunities.

An active board of directors, support for the credit union movement, respect between management, employees and the board of directors, and management who follow up on audit exceptions occurred in three of the five non-fraud stories. Supporting the credit union movement was a finding that would never have been found on any grounded assessment tool, but it is logical because presidents who support the credit union movement are driven to have success in their financial institution so that they can serve the underserved. A mutual respect in the financial institution is a control strength because employees are less likely to have animosity toward the financial institution creating an environment with fewer rationalization possibilities. Management with a passion to follow up on audit exceptions is more likely to run an institution with tighter controls and fewer opportunities available for perpetrators. Finally, strong management and organization of employees' desks and vital report documents are characteristics that occurred in two of the financial institutions.

(Insert Table 2 here)

The PPC fraud risk factors assessment tool only exposed fraud risk factors that were considered misappropriation of assets, excluding fraudulent financial reporting. Due to copyright issues this tool is not reproduced here, but the checklist used was lifted directly from the published material (Carmichael and Griffith, 2005). Using the PPC assessment

tool helped support the findings that emerged through the content analysis by having a structured checklist format, so that any risk factors that were not found in the content analysis would be discovered in the grounded assessment tool analysis.

There were nine possible fraud risk factors identified in the assessment tool for analyzing incentives/pressures; the results of this analysis are included in Table 3. Four of the fraud firms had three or more incentive/pressure factors present, whereas three of the non-fraud firms had two or less factors. Incentive/pressure fraud risk factors occurred at a greater frequency in fraud settings and than in non-fraud institutions. The most common incentive/pressures risk factor for both fraud (n = 5) and non-fraud stories (n = 3) was financial pressures due to various circumstances, which validated the characteristic previously found in the general content analysis reported in Table 1. Failure to receive promotions or other rewards was one factor that occurred in three of the fraud stories and only one of the non-fraud stories. The possibility of merger was a factor for both one fraud and one non-fraud story.

(Insert Table 3 here)

There were forty-three possible fraud factors presented in the opportunity section of the PPC assessment tool; this was the most factors out of any of the three sections. The results of this analysis are included in Table 4. Each fraud story had at least eleven opportunity risk factors present, while, non-fraud stories had three or fewer identified. All instances known to have fraud present had increased frequency of opportunity fraud risk factors than non-fraud situations. Lack of screening for job applicants and enforcing mandatory vacations were risk factors found in each fraud story. Not enforcing mandatory vacations was the weakness that helped conceal the fraud in fraud financial institution C. Job

applicant screening is a good preventative fraud measure; since all of the perpetrators in the fraud stories were convicted of a felony (one conviction is still pending), those charges will surface in a background check. Lack of job screening was also present for four of the five non-fraud stories. One reason is that smaller institutions have a harder time obtaining background check information or do not want to spend the money on those measures. Lack of segregation of duties, independent statement mailing, periodic confirmation by other than a loan officer, dormant or inactive accounts, and timely reconciliation of asset accounts were risks present in four out of the five fraud financial institutions. It is very important for financial institutions to have compensating controls for small staff sizes and that board members be active in monitoring controls when possible.

(Insert Table 4 here)

There were six possible fraud risk factors identified in the assessment tool for attitudes/rationalizations section; the results of this analysis are included in Table 5. Each fraud firm illustrated between two and four attitudes/rationalization risk factors; only three of the five non-fraud firms had even a single risk factor. Consequently, fraud financial institutions have substantially more fraud risk factors in attitudes/rationalizations than non-fraud financial institutions. Employee disregard for internal controls designed for prevention/detection of misappropriation was the fraud risk factor noted in each fraud story. The next most common (4 out of 5 stories) was dissatisfied employees having access to assets susceptible to misappropriation. The non-fraud financial institutions in two separate cases also noted employees with difficulty maintaining minimum balances in their accounts; however, there were compensating controls, such as segregation of duties or board oversight to alleviate the fraud risk possibility.

(insert Table 5 here)

The summary of total frequency of all fraud risk factors is presented in Table 6. Each fraud story noted in total between eighteen and twenty fraud risk factors out of fifty-eight possible. On the other hand, each non-fraud story only noted in total three to five fraud risk factors. What can the frequency of fraud risk factors tell us about the likelihood of fraud? In all instances where fraud was found, 31 to 34% of possible fraud risk factors according to an industry assessment tool were able to be identified. Where there was no fraud known to exist, an independent verification of fraud risk factors indicated the existence of only 5 to 8% of the possible fraud risk factors.

(Insert Table 6 here)

STRENGTHS, LIMITATIONS, AND FUTURE RESEARCH

This study is the first of its kind to utilize ethnographic tools in the understanding of fraud within financial institutions. Throughout the story analysis, it was evident that knowing the client and the environment was helpful in detecting and learning from fraud occurrences. A benefit of using an ethnographic approach is that having such “thick description” enables a deeper understanding of fraud scenarios that will increase dialogue among auditors. Thus this technique of story telling and resultant findings can become a learning tool for new and experienced auditors. Indeed since the completion of this work, one author has adapted her auditing style in subtle ways. One example is comparing institution policy pertaining to vacation with institutional practices. Another was an awareness of how in just making conversation with a client about how hot it was, uncovered the fact that the worker being interviewed lives somewhere that does not have air conditioning (possible identification of risk factor of incentive or pressure). Another

strength of this study is having first-hand details explaining the perpetration activities and events surrounding the frauds. This is important, because as previously acknowledged, often such events are kept quiet within organizations. Another strength was having two colleagues review the emerging content analysis findings, as well as Partner 1 reviewing the grounded assessment findings subsequent to his telling of the stories (this was done weeks after he had been previously recorded). This increased validity, which can be a concern of interpretive differences within ethnographic research. In addition, the two analysis methods (general content analysis followed by grounded assessment) concluding similar findings thereby increasing face validity.

Admittedly, collecting the stories from a single audit partner was a study limitation, because the selection of institutions was controlled by Partner 1 and the stories were told from his point of view. However, Partner 1 has experience in fraud detection and in the financial institution area. He tried to pick fraud financial institutions with unique fraud stories and matched them with non-fraud financial institutions with similar traits such as asset size and number of employees. Another study limitation was the difficulty inherent in hearing about the stories “after the fact”. For example, if the fraud had not yet been uncovered, would the content analysis using the grounded assessment tool identify the risk factors in the same way? The answer is no, but the purpose of this research was not the same as one aim in auditing which is prevention or detection of fraud. Instead this research was undertaken to address questions of how and why fraud took place, in order to facilitate a deeper understanding of fraud risk factors.

Future research in fraud risk factors might expand the sample to include financial institutions with fraudulent financial reporting risk factors. The analysis could be done of

financial institutions with varying sizes in terms of net assets and/or number of employees to determine differing patterns and characteristics. Net assets size was not a factor in selection or analysis in this study. Analysis could consider a different industry or stay with the same industry and collect fraud and non-fraud stories from various seasoned external auditors or internal auditors. Future researchers should consider the difficulties involved with content analysis theme finding. The author chose to do a grounded assessment tool analysis to reaffirm the general content analysis findings and thinks performing both analyses helped find factors that were unable to be found in the general content analysis or vice versa. For example, one insight from the qualitative research analysis of story themes that emerged pertains to informal knowledge that a seasoned auditor can elicit. An advantage of the grounded assessment tool was increased thoroughness and consistency of potential issues.

CONCLUSION

The present study not only revealed the answer to the research question, but it also provided several morals for management, auditors, and potential fraudsters. The morals of this study for managers pertain to establishing a “*decent control environment.*” The morals can be summarized directly from the words of Partner 1. “*What does management do with your exceptions? Especially big ones. Do they come down hard on the employees? Do they establish more controls? Do they find out how the controls that existed were violated? And change those policies and procedures so it doesn’t happen again?*”

Insights for auditors are suggested in the balancing of tradeoffs inherent in maintaining professional skepticism and yet fully knowing the client. In the taped interviews Partner 1 repeatedly talked about maintaining professional skepticism. In fact, as a result of the audit failure in fraud story C, Partner 1 is more professionally skeptical today. Auditors

are required by SAS No. #99 to be professional skeptics, and this study showed the importance of asking the client again or looking at a few more source documents until the auditor is satisfied. “*Our strength will come from verification. Verify. Verify. Verify.*” In addition, auditors should not only be concerned with tying out the account balances, as “*it won’t always show up in the numbers.*” The auditor should also have casual conversations with the client and employees of the client. “*Rule 101 in auditing is know thy client.*” By doing so, the auditor can learn possible risk areas in the financial institutions and transactions that should subsequently be tested more thoroughly. Being more willing to make conversation with a client and employees helps auditors evaluate possible risk factors; for example, if the auditor hears employees complain about financial pressures. With a little conversation the auditor could learn why the employee has financial pressures and assess fraud risk factors accordingly. However, there is a Catch-22 here. On the one hand while familiarity is often associated with breeding contempt, for an auditor the risk is that professional skepticism may be compromised in the wise words of Partner 1 “*familiarity breeding contentment.*”

Is there an answer to this tradeoff? Partner 1 is a managing partner of a firm with six employees and three partners. He felt partner rotation was a major risk area for his firm because “*new eyes*” were not performing the audit; however, he also felt it was difficult to achieve due to a lack of partners to be able to rotate and the loss of client knowledge through the rotation. As a result, Partner 1 suggests small audit firms consider rotating sections of an audit so that new eyes are looking at different parts of the institution.

Finally, a moral of the stories for future perpetrators is that sooner or later synchronicity will reveal fraud. Three of the five fraud stories were partially revealed due to

synchronistic events such as the relative dying in story C, the president walking by the desk of the perpetrator in story D, and the angry person in story E complaining about not having a loan. Perpetrators will eventually be caught and then will face the consequences. Four of the five perpetrators were convicted on felony charges with one perpetrator actually serving time in prison, and one case still pending. All of the perpetrators were forced to pay restitution. In the future, perpetrators should be faced with tougher penalties, which will help deter fraudulent acts.

To sum up, financial institution boards of directors, presidents, employees, and auditors should evaluate fraud risk factors and analyze the impact of the frequency of fraud risk factors in the financial institution. In addition, auditors should keep their professional skeptic “*hat*” on during an audit and should not allow a fraudster to cloud their judgment with either complaints or seemingly religious or righteous behavior. “*The reason I had never met him [loan officer fraud perpetrator in Story E] was that Jesus had already called him back to the ministry.*”

TABLE 1 Fraud Financial Institutions Recurring Characteristics

Recurring Characteristics	# of occurrences	Fraud Financial Institutions				
Small number of Employees	4	A	B		D	E
Employee dissatisfaction/complaints	4	A	B	C	D	
Uneducated manager	1	A				
Perpetrator under financial pressure	5	A	B	C	D	E
Internal control issues	5	A	B	C	D	E
Lack of segregation of duties	5	A	B	C	D	E
Weak management	3			C	D	E
Reliant/lenient management	2			C	D	
Spouse contributing factor	4	A	B	C	D	
Weak board of directors/not performing duties	2	A			D	
Uneducated board of directors	1		B			
Management could not perform everyday duties	1			C		

TABLE 2 – Non-Fraud Financial Institutions Recurring Characteristics

Recurring Characteristics	# of occurrences	Non-Fraud Financial Institutions				
Active board of directors	3	A1	B1		D1	
Management can perform everyday duties	4	A1		C1	D1	E1
Strong controls	4	A1	B1	C1		E1
Organized*	2	A1			D1	
Supported the credit union movement	3	A1	B1		D1	
Respect between management/employees/board	3		B1	C1		E1
Strong management	2	A1		C1		
Followed up on audit exceptions	3		B1		D1	E1
Intelligent/qualified board of directors	5	A1	B1	C1	D1	E1

* clean office, desk, always ready for auditors, every report or document has its own place

TABLE 3 Incentives/Pressures Risk Factor Frequencies

(possible risk factors n = 9)

Fraud Firms	# of Risk Factors Identified	Non Fraud Firms	# of Risk Factors Identified
A	4	A1	0
B	3	B1	2
C	4	C1	1
D	3	D1	0
E	2	E1	2

TABLE 4 Opportunity Risk Factor Frequencies

(possible risk factors n = 43)

Fraud Firms	# of Risk Factors Identified	Non Fraud Firms	# of Risk Factors Identified
A	11	A1	3
B	15	B1	2
C	11	C1	2
D	13	D1	3
E	13	E1	1

TABLE 5 Attitude/Rationalization Risk Factor Frequencies

(possible risk factors n = 6)

Fraud Firms	# of Risk Factors Identified	Non Fraud Firms	# of Risk Factors Identified
A	3	A1	0
B	2	B1	1
C	4	C1	1
D	3	D1	0
E	3	E1	1

TABLE 6 Total Risk Factor Frequencies By Firm

(possible risk factors n = 58)

Fraud Firms	# of Risk Factors Identified	Non Fraud Firms	# of Risk Factors Identified
A	18	A1	3
B	20	B1	5
C	19	C1	4
D	19	D1	3
E	18	E1	4

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