Fraud

'Meta-model of fraud'

Two triangles combine for better fraud case comprehension

JULY/AUGUST 2018

By Scott Fleming, Ph.D., CPA, CMA; Jonathan T. Marks, CFE, CFF, CPA; Richard Riley, Ph.D., CFE

The Fraud Triangle is tried and true, but we might need more to understand our cases. The authors describe a "meta-model of fraud" that combines the "why-based" Fraud Triangle with the "what-based" Triangle of Fraud Action to better explain fraud cases. We might never know exactly why fraudsters commit crimes, but we can always gather facts and evidence to help prevent and deter fraud.

Meridian Fleetware Inc., a multinational private organization headquartered in Warrington, Pennsylvania, began operations in 2001. It now has more than 2,000 employees, with offices in 20 cities in the U.S. and 10 countries around the world.

In response to declining sales, Meridian's vice president of sales and marketing, Jake, reviews the forecast. Over a series of meetings, he implements a plan to enhance revenue, which includes providing the sales team with rich incentives. (Meridian Fleetware is a fictitious company name, and all players' names are changed.)

Jake, during an all-hands-on-deck meeting with the global sales team, describes a new go-to-market strategy plus a new sales incentive called "Bull Rush." After the meeting, he sends the sales team an email that outlines the strategy with a closing quote he modified from the 2000 movie, "Boiler Room":

"There is no such thing as a no-sale call. A sale is made on every call you make. Either you sell the client our products and services or he sells you a reason he can't. Either way, a sale is made; the only question is who is gonna close? You or him?"

The compliance officer, Susan, gets wind of the call and reads Jake's email. She has a face-to-face meeting with Jake and reminds him about the risks of aggressive sales tactics. Susan also reviews Meridian Fleetware's policies on bribery, revenue and expenses recognition, and the importance of collection of payments from customers after sales are made.

Early in the fourth quarter, a customer service representative tips off the internal audit department that she was receiving calls from large customers who complained the company hadn't installed their "free software enhancements," and their salesperson wouldn't return their calls. Also, an accounts receivable clerk fielded a misdirected call from a competitor's customer who was inquiring about how they might qualify for the Meridian Fleetware's "payment terms." The clerk said he didn't write down any of the information, but the call seemed odd.

How should the CFE, Liz, in the internal audit department proceed with this tip? Should she focus the examination on Jake, the VP of sales and marketing, and look for signs of pressure, opportunity and rationalization? Or should Liz approach these issues from a different perspective?

Judges denying courts' admission of Fraud Triangle testimony

In a September/October 2017 *Fraud Magazine* article penned by John D. Gill, J.D., CFE, The Fraud Triangle on Trial, he examined several U.S. court opinions that reference the Fraud Triangle. Gill, the ACFE's vice president – education, wrote that he was surprised to find cases where judges denied the admission of expert testimony about the triangle because they deemed it as "unreliable" scientific theory.

Here are excerpts from Gill's summaries of three cases:

Haupt v. Heaps, 131 P.3d 252 (2005). The appellate court "failed to locate even a single case in which the 'fraud triangles' [sic] theory has been adopted as a reliable scientific method in any court of law." The (fraud triangle) evidence was rejected for that reason and because the court felt the testimony was more prejudicial than probative.

Travis v. State Farm Fire & Cas. Co., 2005 U.S. Dist. LEXIS 49957. "The trial judge excluded the (fraud triangle) testimony. In his opinion, the judge notes that applying the triangle relies more on professional judgment than 'hard science.' The judge writes, 'it is also unlikely that there is a known rate of error or specific objective controls associated with the application of the fraud triangle.' " Gill paraphrases the judge: "Expert evidence from fraud examiners is usually related to direct evidence that fraud has occurred or to descriptive evidence that will help the jury understand transactions and how they compare with or deviate from applicable standards."

Kremsky v. Kremsky, 2017 U.S. Dist. LEXIS 22794. In its opinion, the court noted that an expert witness can't speak to the subjective belief of a party because it would basically amount to unsupported speculation. The court wrote, "Uncle [Stanton Kremsky] does not cite a case where an expert touting this 'fraud triangle' has been permitted to opine as to motive." It further stated, "An expert cannot speak as to the subjective belief of a [party]."

Gill's cautionary tale is relevant to those professionals who complete fraud and forensic accounting examinations, especially those who are likely to be heard in courts of law.

Conceptually, Donald Cressey, a criminologist, developed the attributes of the Fraud Triangle (pressure, opportunity and rationalization) in the 1950s. Cressey stated that "trusted persons become trust violators when they conceive of themselves as having a financial problem that is non-sharable, are aware that this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their contacts in that situation verbalizations which enable them to adjust their conceptions of themselves as users of the entrusted funds or property." (From "Other People's Money," by Donald R. Cressey, Montclair: Patterson Smith, 1973, page 30.)

Cressey wrote that none of these elements alone would be sufficient to result in embezzlement; instead, all three elements must be present. While he identified the three elements, Cressey never drew or referred to them as a triangle nor used the term "fraud triangle."

It wasn't until 1991 that W. Steve Albrecht, Ph.D., CFE, CIA, CPA, constructed the "triangle," a staple of the anti-fraud community for years to come. "The fraud triangle," Albrecht wrote, "is very much like the 'fire triangle.' In order to have a fire, three conditions must exist: there must be oxygen, heat and fuel. If any one of these is removed, there will be no fire." (See Fraud in Government Entities: The Perpetrators and the Types of Fraud, by Albrecht, Government Finance Review, December 1991, pages 27-30, and Iconic Fraud Triangle endures, by Albrecht, *Fraud Magazine*, July/August 2014.)

Others have updated the Fraud Triangle in various permutations. In 2004, David T. Wolfe, CPA, CFF, and Dana R. Hermanson, Ph.D., added capability in the Fraud Diamond. In 2010, Jonathan T. Marks, CFE, CFF, CPA, added two constructs: arrogance and competence to form the Fraud Pentagon.

Challenges of the Fraud Triangle

Fundamentally, the Fraud Triangle poses at least two challenges: 1) Many of these characteristics are psychological in nature, and the typical anti-fraud professional, while familiar with the concepts, aren't psychologists, criminologists or experts in the scientific study of the criminal mind, which requires experience, education and training. 2) Many persons have characteristics similar to the profile of the fraudster yet choose not to commit fraud. This second issue may be more damaging and prejudicial in a court of law; the characteristics of the Fraud Triangle don't necessarily eliminate all possible suspects.

Alternatively stated, more than just the fraud perpetrator might exhibit characteristics associated with the Fraud Triangle yet not be involved in a fraud act. The Fraud Triangle, and its elements, aren't accurate predictors of fraud but rather are elements to describe and understand a fraudulent actor after the fact. Therefore, fraud examiners shouldn't be dependent upon the Fraud Triangle as the centerpiece of their analyses, but rather should make facts and evidence the foundation of cases.

Incorporating the Triangle of Fraud Action

So, what's the fraud examiner to do if they can't center their examination on the Fraud Triangle?

Going back as far as 2006, Albrecht, who crafted Cressey's concepts into the Fraud Triangle, offered the solution in the form of "the elements of fraud" or "the Triangle of Fraud Action." (See a 2012 summary in Fraud Examination, fifth edition, by Albrecht, Chad. O. Albrecht, Conan C. Albrecht and Mark F. Zimbelman.) Under either moniker, the elements of fraud include the act, the concealment and the conversion. (See Figure 1 below.)

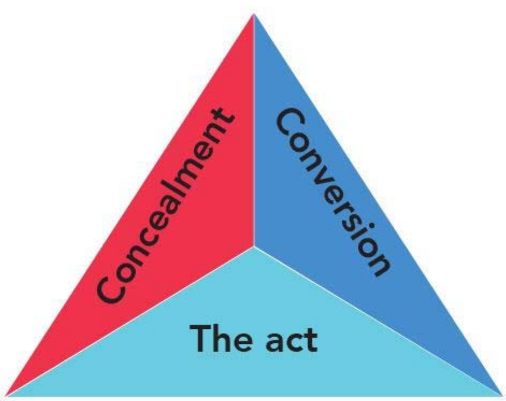

Figure 1: Elements of fraud

"While the fraud triangle identifies the conditions under which fraud may occur, the triangle of fraud action describes the activities an individual must perform to perpetrate the fraud," according to " The Evolution of Fraud Theory," by Jack Dominey, A. Scott Fleming, Mary-Jo Kranacher and Richard A. Riley Jr., Issues in Accounting Education, Volume 27, Issue 2, May 2012.

“The act represents the execution and methodology of the fraud, such as asset misappropriation, corruption, or financial statement fraud. Concealment represents deliberate effort to hide the fraud act; examples of concealment include creating fake invoices, false journal entries, falsifying reconciliations, or destroying records,” according to the “The Evolution of Fraud Theory” paper. “Conversion is the process of transferring the benefits of asset ownership and control from the victim to the perpetrator; examples include laundered money, cash deposited in perpetrator bank accounts, purchased personal cars or homes.”

As Gill notes in the *Fraud Magazine* article, the anti-fraud professional needs to “stick to the facts when you testify,” which are provided by the Triangle of Fraud Action. From this structure the professional can identify evidence that support hypotheses (a.k.a. fraud theories) and answer the important questions of who, what, when, where, how, plus how much, how concealed, how long, etc.

A model to rule them all

In 2012, Dorminey, Fleming, Kranacher and Riley in their “The Evolution of Fraud Theory” paper positioned the traditional Fraud Triangle in relation to the Triangle of Fraud Action in what has become known as the “meta-model of fraud.” The Fraud Triangle might not represent actionable theory, but when you combine it with the Triangle of Fraud Action the meta-model illustrates a flow from perpetrator to crime, and it provides a framework for examining issues associated with fraud and financially motivated crime.

In Figure 2 below, the model, on the left side, identifies the potential fraud perpetrator as they perceive it. The Fraud Triangle characterizes the perpetrator as the person who has the three requisite criteria and considers whether a fraudulent act can be successful in both 1) execution and 2) concealment.

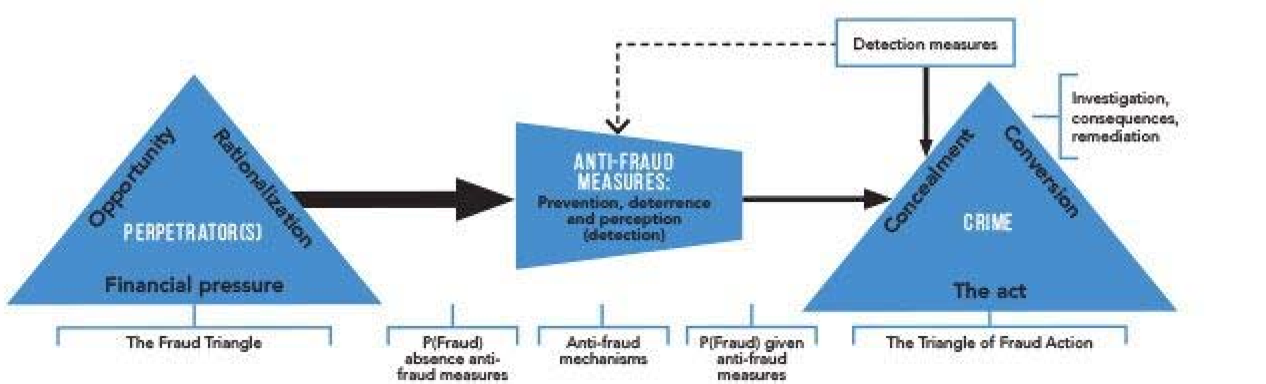

Figure 2: A meta-model of fraud and white-collar crime (adapted from [The Evolution of Fraud Theory](), by Jack Dominey, A. Scott Fleming, Mary-Jo Kranacher and Richard A. Riley Jr., “Issues in Accounting Education,” Volume 27, Issue 2, May 2012.

On the right side, captured in the Triangle of Fraud Action, the model focuses on the specific elements of the fraud or financial crime including the act, the concealment and the conversion of benefits that accrue to the perpetrator.

The meta-model also highlights the critical role of anti-fraud efforts: Between the perpetrator (the Fraud Triangle) and the criminal act (the Triangle of Fraud Action) are anti-fraud interventions such as internal controls, corporate governance, law and regulations designed to reduce the incidence and impact of fraud. The anti-fraud profession has identified these activities as prevention, deterrence and the perception of detection.

Interestingly, anti-fraud efforts are generally outside the perpetrator's direct control but likely influence the would-be fraudster's assessment of the probability of success in terms of the fraudulent act, concealment and conversion. As such, the arrow on the left side is larger, which indicates a higher probability of fraud before the anti-fraud efforts. The arrow on the right is thinner, which suggests that the probability of fraud has been reduced in light of anti-fraud efforts.

The illustration of anti-fraud measures and the impact is supported by recent data. The 2018 *ACFE Report to the Nations on Occupational Fraud and Abuse* states that the presence of anti-fraud controls was correlated with both lower fraud losses and quicker detection. The report compares organizations that had specific anti-fraud controls in place against organizations lacking those controls and found that where controls were present, fraud losses were 12 percent to 56 percent lower, and frauds were detected 33 percent to 58 percent more quickly (pages 28 and 29).

Meridian Fleetware's evidence

The case history in the opening paragraphs (and continued below) offers insight into how to apply the meta-model to case evidence. (We created this example from our experiences, but but we've disguised it to comply with professional standards and applicable disclosure agreements).

Fraud Triangle	
The Fraud Triangle offered many red flags and suppositions but no conclusive evidence about the fraud act.	
Pressure: Softening sales.	Indication: > 20 percent decline in revenue during first and second quarters.
Pressure: Management pressure from the board on strategy and capability.	Evidence: Board minutes and communications.
Pressure: Goal of eventual IPO.	Indication: Communications.
Opportunity: Weak control environment over information systems, including the input, review and approval of transactions.	Indication: Prior year audit findings, review of internal controls by forensic accountants, interviews of salespersons and accounting staff.
Opportunity (competence and capability): VP of sales and marketing guides controller and general-ledger (GL) accountant on how to record discounts.	Indication: Interview notes with VP of sales and marketing, the controller and the GL accountant.
Opportunity: VP of sales and marketing states "I'd do it again" (arrogance).	Indication: Interview.
Rationalization: VP of sales and marketing states "this company wouldn't exist without me."	Indication: Text message blasted to "A-list" sales personnel.
Rationalization: VP of sales and marketing states "they all do it."	Indication: Interview.
Rationalization: VP of sales and marketing understood that "side agreements," though against company policy, wouldn't be reflected in the accounting records.	Indication: Review of journal entries noting the lack of journal entry back-up for customer discounts (thereby a notable lack of evidence); review of sales agreements, emails and text messages.
Triangle of Fraud Action (note that the elements of fraud are grounded in evidence)	
Act: Off-contract commitments (side agreements) to install and service "free software enhancements" and undocumented payment terms.	Evidence: Obtained a listing of customers complaining about "free software enhancements."
Act: These commitments were consistent with bribes in the form of discounts and free services made to customers. Because some of the revenue in question was written with state-owned enterprises and/or organizations run by royal families, there's fear Meridian Fleetware violated the 1977 Foreign Corrupt Practices Act.	Evidence: Obtained sales agreements and Meridian Fleetware/customer correspondence, confirming no "free software enhancement" on the agreements. Examined the sales agreements for emails between the sales department and the customer laying out what they called "special benefits" as a "tribute to their loyalty." These emails were presented to the sales personnel who were interviewed, and each confirmed the nature and timing of these "free software enhancements." (strong reliability)
Concealment: Scheme consistent with bribery.	Evidence: Also interviewed the controller who was able to produce correspondence from the VP of sales and marketing on how to account for these sales — providing the controller with journal entries that should be used. (strong reliability)
Concealment: Bribes were recorded as business development expenses.	Evidence: Review of journal entries related to the sales discounts. (strong reliability)
Concealment and conversion: Bonuses to A-list salespersons.	Evidence: Counterfeit CEO signature approving the excess bonuses by the VP of sales. (strong reliability)
Conversion: VP of sales and marketing received kickbacks from the salespersons who transacted the sales.	Evidence: This was confirmed during the interview process and corroborated by obtaining copies of canceled checks made payable to the VP of sales and marketing and in one case the receipt for the purchase of gift cards. (strong reliability)
Anti-fraud environment and controls (Note that controls are measured in terms of existence or strength, and can be supported by fact and evidence, and rated in terms of quality.)	
Detection: An avenue for supplying tips to internal audit.	Evidence: A tip from a customer service representative saying, "that they were receiving calls from large customers complaining that their 'free software enhancements' were never installed." Also, their sales person wouldn't return their calls. (medium to high reliability)
Prevention: Internal controls had been overridden for sales approval.	Evidence: The investigation noted the sales sheet, which outlined that the sales manager didn't review the deal. The sales manager was the control to ensure the policies and procedures related to sales were followed. During the interview of the sales manager, he said that the VP of sales and marketing notified him that several deals didn't require his review and approval because the VP of sales and marketing had already reviewed and approved them. The sales manager confirmed this when he provided emails from the VP of sales and marketing to him. (medium reliability)
Prevention: Internal controls had been overridden for the standard sales agreement and for discounts.	Evidence: Review of the sales agreements, discounts and correspondence for the "free software enhancements" confirmed that company policies hadn't been followed, and the appropriate review and approval of all aspects of the agreements wasn't followed. (strong reliability)
	Evidence: Review of payroll paperwork signed by the VP of sales and marketing allowing select salespersons to earn bonuses that amounted to more than five times their base salaries and more than 10 times calculated bonuses. (strong reliability)
	Evidence: A tip by an accounts receivable clerk. The clerk fielded a misdirected call from a competitor's customer who was inquiring about how they might qualify for the new "payment terms." The clerk admitted they didn't write down any of the information, but the call seemed "odd." (low to medium reliability) Indication: Third-quarter cash flows from operations were slightly below expectations. (detection analytics) Evidence to obtain: Cash collections in fourth quarter by customer (new versus existing) by salesperson; interviews with customers delaying payment.

Meridian Fleetware's overarching goal was to file for an initial public offering after it had reached revenue targets. The company sells and services electronic devices and software that monitor the use and maintenance of fleet automobiles and trucks. Sales in the previous five years for Meridian Fleetware have been strong, and the company has grown remarkably. The industry has been growing at a significant pace and the company is well-positioned in the marketplace. However, new private start-ups have begun to emerge as competitors.

Entering the current year, sales orders have been soft, and in the first and second quarters revenue was down by more than 20 percent. The board is now questioning whether management's strategy is sound and has concerns regarding the capability of senior leadership to take the organization to the next level. Also, Meridian Fleetware's information infrastructure and internal controls aren't adequate to support, control or monitor operations and financial reporting. During prior audits, the external auditors have highlighted this issue with the audit committee.

The company's senior leadership developed a plan to remediate gaps in controls by hiring a new chief audit executive and compliance officer who have experience with multinational organizations that have outgrown their infrastructure.

Third-quarter revenue numbers:

- Exceeded quarterly projections, which essentially got year-to-date sales back on plan.
- Growth was accomplished through the acquisition of new customers and growing existing customers.
- A limited number of "A-list" salespersons were responsible for closing about 75 percent of new business.
- The A-list salespersons earned bonuses that amounted to more than five times their base salaries compared to bonuses that are designed to be 50 percent of base salaries.
- The VP of sales and marketing approved larger than normal discounts to the company's largest customers who signed contracts for software and services that exceeded anticipated orders.
- Cash flows from operations were slightly below expectations.

In response to the tip, the internal audit department (IA) quietly pulled several customer agreements related to the larger sales and read that they didn't include any "free software enhancements" but did have the standard net 30-day payment terms.

With initial predication, IA launched a preliminary internal investigation and briefly interviewed two of the A-list sales reps to confirm the presence of off-contract commitments (side agreements) to install and service free software enhancements and provide open-ended payment terms. IA then worked with the compliance and legal departments, and the audit committee to engage independent outside counsel, which then engaged a team of forensic accountants.

After the investigative team interviewed several sales personnel, the VP of sales and marketing and the controller, it reviewed email communications and text messages, and analyzed the books and supporting records. See the table above for what the evidence suggested.

Meridian Fleetware case outcome

With this evidence, the company restated third-quarter sales to reflect the side agreements. Meridian Fleetware terminated the vice president of sales and marketing and required all salespersons to complete organizational ethics and compliance training.

Meridian Fleetware's compliance officer developed a training program, which he administered to sales and marketing personnel, that outlined company policies and procedures for customer acceptance, sales contracts and revenue recognition.

More 'what' and less 'why'

While juries love to ask, "Why did they do that?" the evidence-based Triangle of Fraud Action doesn't require that an anti-fraud professional answer the question of "why" that's inherent in the Fraud Triangle. In the "The Evolution of Fraud Theory" paper, Dorminey, Fleming, Kranacher and Riley further note:

"The incremental value of the triangle of fraud action is that it represents specific actions that can be documented with evidence, as well as control points where the fraud or potential fraud may be prevented, detected, or remediated. That is, anti-fraud professionals may develop certain measures, controls, or structure their audits to illuminate the act, the concealment, or the conversion. The triangle of fraud action is also valuable to the investigator where proof of intent is required. While the fraud triangle points investigators to why people might commit fraud, the evidentiary trail might be weak or nonexistent. For example, the financial pressure and rationalization elements of the fraud triangle are not directly observable.

"Therefore, anti-fraud professionals need an evidenced-based approach to conduct investigations. The triangle of fraud action is helpful in this regard because the elements can be directly observed and documented. The triangle of fraud action, therefore, represents a model for detecting white-collar crimes and obtaining prosecutorial evidence. Evidence of the act, concealment, and conversion can be collected and presented during adjudication. Further, when considered in total, the triangle of fraud action makes it difficult for the perpetrator to argue that the act was accidental or to deny his/her role in the act. Evidence of concealment, in particular, provides a compelling argument that the act was intentional."

Work must be grounded in evidence

We recommend that when you investigate any allegation of fraud or financial malfeasance make sure your work is grounded in the evidence. This means that your report is supported by data or information that you carefully examine, and the technique for forming your opinion is relevant, reliable and stated with a reasonable degree of scientific certainty.

Anti-fraud professionals who don't have the proper credentials and experience should avoid commenting on motives or provide subjective beliefs associated with the purpose of illegitimate transactions. In essence, even though many have years of experience in dealing with fraudulent behavior and clearly understand the profiles of bad actors, anti-fraud professionals should tread carefully when considering the "why" behind the fraudster's alleged crime.

Anti-fraud professionals shouldn't abandon the Fraud Triangle but rather know how, why and when to use it. Understand the elements of the Triangle of Fraud Action and its relationship to the perpetrator via anti-fraud measures as noted within the meta-model. As an expert witness, provide direct evidence, and as John Gill notes, "Your time on the witness stand will be much more comfortable.

Authors-

Jonathan T. Marks, CFE, CFF, CPA, is a partner at Marcum LLP and a member of the firm's advisory services division. Contact him at jtmarks@me.com.

Richard Riley, Ph.D., CFE, is Louis F. Tanner Distinguished Professor of Public Accounting at West Virginia University. Contact him at Richard.riley@mail.wvu.edu.

Scott Fleming, Ph.D., CPA, CMA, is an associate professor of accounting and senior director of the Center for Executive Education at West Virginia University. Contact him at Scott.Fleming@mail.wvu.edu.

Original article can be found here - http://www.fraud-magazine.com/article.aspx?id=4295002447&Site=ACFEWEB