

Solution and Answer Guide

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CHAPTER 1: THE NATURE OF FRAUD

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DISCUSSION QUESTIONS

1. What is fraud?

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

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

Fraud is deception that includes the following elements:

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

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

Answer: Fraud affects individuals, consumers, and organizations in various ways. Fraud usually lowers organizations' net income dollar for dollar. To recover these costs, consumers and individuals must pay more for goods and services. For example, health care fraud and insurance fraud increase premiums that individuals must pay. The cost of fraud

eventually reaches every part of the economy, including individuals, consumers, and organizations.

The 2008 study by The Association of Certified Fraud Examiners estimates that U.S. organizations lose roughly 7 percent of their annual revenues to fraud. Applied to the U.S. gross domestic product (GDP), this 7 percent figure translates to approximately \$994 billion in fraud losses.

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

Answer:

- a. **Employee embezzlement:** In this type of fraud, employees deceive their employers by taking company assets. Embezzlement can be either direct or indirect.
- b. **Management fraud:** Distinguished from other types of fraud both by the nature of the perpetrators and by the method of deception. In its most common form, management fraud is deception perpetrated by top management's manipulation of financial statements. The victims of management fraud are typically stockholders, lenders, and others who rely on financial statement information.
- c. **Investment scams or consumer scams:** A type of fraud that is perpetrated when fraudulent and usually worthless investments are sold to unsuspecting investors.
- d. **Vendor fraud:** Perpetrated by vendors; comes in two main varieties: fraud perpetrated by vendors acting alone, and fraud perpetrated through collusion between buyers and vendors. Vendor fraud usually results in an overcharge for purchased goods, the shipment of inferior goods, or the nonshipment of goods even though payment was made.
- e. **Customer fraud:** Usually involves customers not paying for goods purchased, getting something for nothing, or deceiving organizations into giving them something they should not have.

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

Answer:

- a. **Criminal law** is the branch of law that deals with offenses of a public nature. Criminal laws generally deal with offenses against society as a whole. Violators of criminal laws are prosecuted either federally or by a state for violating a statute that prohibits some type of activity.
- b. **Civil law** is the body of law that provides remedies for violations of private rights. Civil law deals with rights and duties between individuals. The purpose of a civil lawsuit is to provide

compensation for harm done to an individual. Unlike criminal cases, where juries consist of 12 jurors, juries in civil cases may have as few as six jurors, and the verdict of the jury need not be unanimous. Additionally, judges often hear civil cases instead of juries. In civil lawsuits, plaintiffs must only prove their case by the "preponderance of the evidence." In other words, there need be only slightly more evidence supporting the plaintiff than supporting the defendant.

5. For each of the following, indicate whether it is a characteristic of a civil or a criminal case:
- a. Jury may consist of fewer than 12 jurors.
 - b. Verdict must be unanimous.
 - c. Multiple claims may be joined in one action.
 - d. Proven "beyond a reasonable doubt."
 - e. Purpose is to right a public wrong.
 - f. Purpose is to obtain remedy.
 - g. Consequences of jail and/or fines.
 - h. Juries may have a less than unanimous verdict.

Answer:

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

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

Answer: Charles Ponzi was successful for several reasons. First, Charles Ponzi built confidence in his scheme by giving early investors a return on their initial investments. Second, Charles Ponzi presented his coupon scheme in a way that was easy for investors to understand. Although the coupon scheme never made any real profits, investors believed that it had. Third, Ponzi was extremely talented at manipulating victims' emotions. Ponzi was able to capitalize on individuals' greed. When people began to see their friends and family members receive dividends from investments, they too wanted in on the investment scam.