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Part of an auditor's job is to ensure that their clients' financial statements are free of fraud. But, what is fraud? It is a universally understood term, however, most people are unable to truly define what it means. Depending on the source from which it is obtained, there are a number of definitions for the term. For example, the definition in Webster's dictionary is going to be different from the definition of fraud that the AICPA has. Also, to make things a bit more complicated, some definitions, such as the one given by the ACFE, are broken down into categories based on the types of fraud that can occur, each of which having its own definition of course. One would think that a simple word like fraud would be easily definable, but in reality, it has multiple meanings and can be interpreted differently depending to whom or where it is being referenced.

Definitions of Fraud

Mirriam-Webster's online dictionary defines fraud as "an intentional perversion of truth in order to induce another to part with something of value or to surrender a legal right."¹ Similarly, **Black's Law Dictionary** defines fraud as "a knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment."² **Black's Law Dictionary** also defines the various types of fraud that can occur, such as actual fraud, bank fraud, bankruptcy fraud, criminal fraud, and what constitutes a fraudulent act:

¹ <http://www.m-w.com/>. 2006., s.v., "fraud."

² Bryan Garner, ed., *Black's Law Dictionary*. 8th Ed. (2004), s.v., "fraud."

- *Actual fraud* – A concealment or false misrepresentation through a statement or conduct that injures another who relies on it in acting.
- *Bank fraud* – The criminal offense of knowingly executing, or attempting to execute, a scheme or artifice to defraud a financial institution, or to obtain property owned by or under the control of a financial institution, by means of false or fraudulent pretenses, representations, or promises.
- *Bankruptcy fraud* – A fraudulent act connected to a bankruptcy case; esp., any of several proscribed acts performed knowingly and fraudulently in a bankruptcy case, such as concealing assets or destroying, withholding, or falsifying documents in an effort to defeat bankruptcy-code provisions.
- *Criminal fraud* – Fraud that has been made illegal by statute and that subjects the offender to criminal penalties such as fines and imprisonment.
- *Fraudulent act*- Conduct involving bad faith, dishonesty, a lack of integrity, or moral turpitude.

Likewise, the **United States Government Accountability Office (GAO)** defines fraud as “a type of illegal act involving the obtaining of something of value through willful misrepresentation.”³

U.S. Department of Justice Definition

The United States Delegation responded in a questionnaire to the United States Department of Justice, Criminal Division, that U.S. federal law does not have a precise

³ www.gao.gov.

definition of the term “fraud,” although it does provide various federal criminal offenses that pertain directly to fraud, such as accounting fraud and securities and other investment fraud. Accounting fraud involves “officers of publicly traded companies seeking to manipulate accounting data and corporate reports to make the financial soundness of their companies appear better than it is” and securities and other investment fraud consists of “market-manipulation schemes, fraudulent offers of stock in nonexistent or bankrupt companies, fraudulent foreign-currency transactions, ‘prime bank’ schemes, offshore trusts and investments, and insider trading.” Another common type of fraud that occurs in the United States that was cited in the questionnaire was that of financial institution fraud, which “this offense criminalizes any execution, or attempt to execute, a scheme or artifice to defraud a federally insured financial institution, or to obtain any money under the control or custody of a federally insured financial institution by using false or fraudulent pretenses, representations, or promises.”⁴ The United States Department of Justice, Criminal Division, defines corporate fraud to “include falsification of corporate financial information, self-dealing by corporate insiders, and obstruction of justice, perjury, witness tampering and other obstructive behavior relating to falsification or self-dealing activities.”⁵

The Association of Certified Fraud Examiners (ACFE) Definition

The ACFE does not have a specific definition of the term “fraud,” but rather classifies fraud into main categories:

⁴ www.usdoj.gov/criminal/fraud/UNODCQuestionnaireUSGResponseFinal.pdf. May 2006.

⁵ www.usdoj.gov/criminal/fraud.html. Activities Report (2004-2005).

1. *Misrepresentation of material facts* – the elements constituting misrepresentation normally include:
 - A material false statement;
 - Knowledge of its falsity;
 - Reliance on the false statement by the victim; and
 - Damages suffered

2. *Concealment of material facts* – The essential elements of fraud based on failure to disclose materials facts are:
 - that the defendant had knowledge ...
 - of a material fact ...
 - that the defendant had a duty to disclose ...
 - and failed to do so ...
 - with the intent to mislead or deceive the other party.

3. *Bribery* – Includes official bribery, which refers to the corruption of a public official, and commercial bribery, which refers to the corruption of a private individual to gain a commercial or business advantage.

4. *Conflicts of Interest* – Engaging in conduct that involves a conflict of interest is prohibited. Elements of a typical civil claim for conflict of interest include:
 - an agent* taking an interest in a transaction ...
 - that is actually or potentially adverse to the principal ...
 - without full and timely disclosure to and approval by the principal.
 - An agent includes any person who, under the law, owes a duty of loyalty to another, including officers, directors, and employees of a corporation, public officials, trustees, brokers, independent contractors, attorneys, and accountants.

5. *Theft of money and property*- Includes embezzlement, larceny, and misappropriation of trade secrets and proprietary information.
- *Embezzlement* – The wrongful appropriation of money or property by a person to whom it has been lawfully entrusted.
 - *Larceny* – The wrongful taking of money or property of another with the intent to convert or to deprive the owner of its possession and use.
 - *Theft or misappropriation of trade secrets* – Include not only secret formulas and processes, but also proprietary information, such as customer and price lists, sales figures, business plans, or any other confidential information that has a value to the business and would be potentially harmful if disclosed.
6. *Breach of Fiduciary Duty* – Not abiding by the duty of loyalty or the duty of care that exist in a fiduciary relationship, such as officers, directors, high-level employees of a corporation or business, and agents and brokers.
- *Duty of loyalty* – Requires the employee/agent act solely in the best interest of the employer/principal, free of any self-dealing, conflicts of interest, or other abuse of the principal for personal advantage.
 - *Duty of care* – Requires the employee/agent to conduct business affairs prudently with the skill and attention normally exercised by people in similar positions.

The American Institute of Certified Public Accountants (AICPA) Definition

The AICPA contains both a clear definition of “fraud” as well as categorizes fraud into internal fraud and external fraud, each having a distinct definition of its own. The AICPA defines fraud according the definition given by *Black’s Law Dictionary* 6th Edition, 1990:

“An intentional perversion of truth for the purpose of inducing another in reliance upon it to part with some valuable thing belonging to him or to surrender a legal right. A false representation of a matter of fact, whether by words or by conduct, by false or misleading allegations, or by concealment of that which should have been disclosed, which deceives and is intended to deceive another so that he shall act upon it to his legal injury... A generic term, embracing all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get advantage over another by false suggestions or by suppression of truth, and includes all surprise, trick, cunning, dissembling, and any unfair way by which another is cheated.”⁶

The AICPA further classifies fraud into internal and external fraud:

- *Internal fraud* – Activities perpetrated within the organization such as intentional misrepresentation of financial statements or financial statement transactions, theft, embezzlement, or improper use of the organization’s resources. Includes both employee and management fraud.

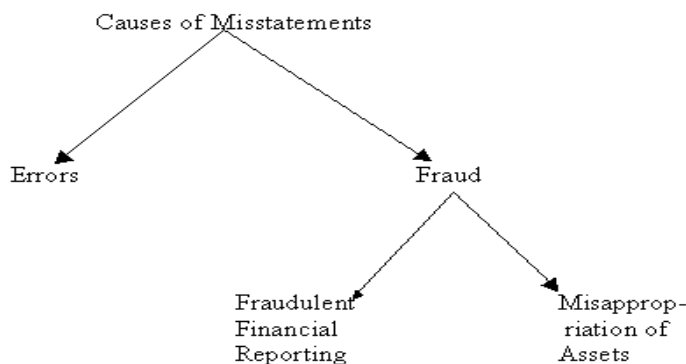
⁶ “Fraud Basics: The Many Faces of Fraud,” *Fraud Examiners Manual*. ACFE, 2000.
<http://www.acfe.com/fraud/view.asp?ArticleID=183>

- *External fraud* – Involves theft of improper use of the organization’s resources perpetrated by individuals outside the organization.

SAS No. 99 Definition

The AICPA also implemented SAS No. 99, which provides definitions and characteristics of fraud to assist auditors in making sure that financial statements are free of material misstatement, whether caused by error or fraud, in the audit process. SAS No. 99 distinguishes errors as “unintentional misstatements or omissions of amounts or disclosures in financial statements” and fraud as “intentional misstatements or omissions of amounts or disclosures in financial statements.” In conducting an audit, misstatements are said to arise from two distinct types of acts:

1. *Fraudulent financial reporting* – Intentional misstatements in financial statements to deceive financial statement users.
2. *Misappropriation of assets* – Theft of company’s assets the effect of which has not been appropriately reflected in the financial statements.



SAS No. 99 also identifies that in order for fraud to occur, three conditions must be present:

1. *Incentive/pressure* - a reason to commit fraud.
2. *Opportunity* - e.g., ineffective controls, override of controls.
3. *Attitude/rationalization* - ability to justify the fraud to oneself.

The Institute of Internal Auditors (IIA) Definition

The IIA describes fraud as “any illegal acts characterized by deceit, concealment or violation of trust. These acts are not dependent upon the application of threat of violence or of physical force. Frauds are perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage.”⁷ The IIA further clarifies fraud and misconduct into categories:

Financial Reporting Risk:

- Financial misconduct by member(s) of senior management or the board, such as charging improper fees
- Fraudulent financial reporting
 - Earnings management arising from improper revenue recognition, overstatement of assets, or understatement of liabilities

Operational Risk:

- Costs and expenses avoided by fraud such as tax fraud
- Revenues and assets obtained by fraud (committed against employees and third parties)

Compliance Risk:

- Expenditures and liabilities for an improper purpose
 - Cash kickbacks and public corruption

⁷ www.theiia.org.

- Misappropriation of assets
 - Embezzlement, payroll fraud, physical theft

International Definition

Lastly, to give an international perspective on what constitutes as fraud, the European Parliament defines fraud as “consisting in the use of false documents, non-disclosure of information, and the misapplication of funds or of a legally obtained benefit. A criminal offense.”⁸

In conclusion, there are many faces of fraud. The definition or clarification of what fraud actually is depends entirely on the reference from which it is being examined. As was shown, each source has its own definition of fraud and what categories of fraud do in fact exist. In order to fully understand how to look for and identify fraud in financial statements of clients, auditors need to understand what fraud is and what characteristics constitute fraud.

End of Document

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Prepared on December 21, 2006

⁸ http://www.europarl.europa.eu/comparl/libe/elsj/zoom_in/37_en.htm.