

No longer business as usual: Employee fraud and ethical issues

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ABSTRACT

Studies conducted by the Association of Certified Fraud Examiners (ACFE) estimated that a typical U.S. organization loses about 5% of their annual revenues to fraud. The size and number of frauds are increasing, which will lead to a great demand for fraud-fighting professionals in the future. This case tells the story of a pharmacy technician, at a retail pharmacy, who was taking advantage of the pharmacy's poor internal control framework and defrauding the pharmacy. The case is based on an actual situation, and names have been changed for privacy purposes.

The purpose of the case is to provide accounting/business students with an opportunity to apply textbook knowledge on fraud to real world issues and decision making. The case will enable students to understand the importance of business ethics and allow them to develop their critical and analytical skills. It will also help students identify and address internal control deficiency issues within a business environment.

Keywords: Employee fraud, internal control, business ethics, decision-making, analytical skills

INTRODUCTION

It was a cold Monday morning in December and snow had just stopped falling. Offices were closed until noon to give the snow trucks time to clear the roads. Just before noon, Mark Wright, the owner of Wright Pharmacy, drove out of his garage and headed to the pharmacy. On arrival, he stood outside and watched as a few people walked into the pharmacy to fill their prescriptions, recalling when he started out as a pharmacist. The pharmacy then had a large customer base and was profitable. Many changes had occurred since he first started in the business. The customer base and profits were declining as a result of an increase in customer out-of-pocket co-payments and the introduction of additional new co-payments for certain health insurance plans. Another change was the introduction of medication therapy management (MTM), a new system of drug prescription and dispensing. In an effort to prevent drug interactions, MTM was introduced to reduce the number of medications being taken concurrently. Also, the insurance companies responsible for part of the cost of most drug purchases reduced their percentage reimbursement to pharmacies.

Mark's thoughts were interrupted by some commotion inside the pharmacy. On entering the pharmacy, he saw his two pharmacy technicians in a heated argument. They were shouting at each other so loud that the few customers in the pharmacy were taken aback. Apparently they were arguing because there was a discrepancy between the physical cash received from sales from the previous business day and the amount that was recorded in the sales ledger. The cash in the register totaled \$475.00 while the sales ledger had a record of \$575.00. First, Mark was disappointed that his employees were arguing in the presence of customers. But it was also imperative that the discrepancy was resolved so he called Tony Lowe, the head pharmacist, and instructed him to review the sales and purchase ledgers. Tony subsequently noted with curiosity that, on average, the pharmacy's monthly payments to its drug distributors (i.e. suppliers) were far in excess of the monthly sales figures. Further investigation into inventory showed a shortage of drugs in stocks.

WRIGHT PHARMACY

Wright Pharmacy is an independent retail pharmacy located in downtown Baltimore, Maryland. The pharmacy has been in existence for thirty years retailing prescription drugs and over-the-counter medications. It is affiliated with K-medical, a clinic that caters mostly to the elderly. The pharmacy has six employees i.e. two each of pharmacists, pharmacy technicians and interns. The position of pharmacy technician plays a supporting role to that of the pharmacist, but it pays almost five times less. Employee relations are cordial at the pharmacy.

The pharmacy has no internal auditor but has a business code of conduct which covers a wide range of business practices and procedures. The code sets out basic principles to guide employees and they include the following:

- Employees should report to duty on time, perform their duties in a fair and honest manner and keep the pharmacy ahead of its competitors.
- Employees should obey the law and adhere to the pharmacy's business and ethical standards.
- Employees should not conduct direct or indirect personal business with customers, suppliers or competitors; except as required by the pharmacy.
- All employees should ensure the efficient use of the pharmacy's assets.

- Employees are encouraged to talk to supervisors, and to report any observed illegal behavior.

To help ensure compliance with the code of business conduct, all employees of the pharmacy are required to review the code of conduct and acknowledge their understanding and adherence in writing on an annual basis.

Exhibit 1 (Appendix) shows the pharmacy's patient service process that shows a sequence of operations performed by employees and Exhibit 2 (Appendix) displays the key players involved in the day-to-day activities of the pharmacy. The chart of key players shows the key agencies and establishments the pharmacy regularly relates to in its operations. The pharmacy receives drug prescriptions from physicians and refill orders from customers and orders the drugs from distributors. The pharmacy also relates with insurance providers. The insurance companies reimburse the pharmacy for the drugs dispensed to customers who are covered under the insurance providers' health plans. The government agencies such as the DEA and the State Board of Pharmacy oversee the operations of the pharmacy to ensure that they comply with set laws. Lastly, the technology support company maintains and updates the software used by the pharmacy, resolves any software errors and also maintains the electronic signature capture device used by the pharmacy. There is no particular pattern to the layout of the chart, and the pharmacy's relationship with these establishments and agencies depicted on the chart are all two-way relationships.

REGULATION AND CONTROLS

The DEA oversees compliance inspection of controlled substances. The DEA's Office of Diversion Control prepares manuals to assist pharmacists in understanding the Federal Controlled Substances Act and implementing policies and regulations as it applies to pharmacies. Every pharmacy must maintain accurate records of controlled substances, honor only valid prescriptions, and carefully dispense such substances.

In addition, the State Board of Pharmacy conducts regular inspection of the pharmacy to ensure that they adhere to policies and regulations. The Board also carries out licensing and disciplinary activities when required. A citation was issued to the pharmacy at the last compliance visit because some medications were missing. This led the pharmacy to install cameras on its premises. The cameras capture the activities in the pharmacy hall from different angles during business hours. They serve as a low cost way to reduce employee theft.

TONY LOWE

The head pharmacist, a native of Baltimore, is a married man with three children. He joined the pharmacy six years ago. Tony obtained his Doctor of Pharmacy degree from Ohio State University and graduated top of his class. Afterward, he started his career as a clinical pharmacist at a hospital in Baltimore. He left clinical pharmacy to work as a retail pharmacist because he was offered a better benefit package at retail. Retail also afforded him flexible working hours, allowing him to work part-time hours when he needed to so as to spend more time with his family. At Wright Pharmacy, he is in charge of the operations of the pharmacy, the supervision of employees, and the hiring of pharmacy technicians and interns. His colleagues describe him as a fair and disciplined person. Tony hired Stan George when a previous pharmacy technician got married and moved overseas with her husband.

STAN GEORGE

Stan George is a single father of three boys aged three, five and ten years old, respectively. A few years ago, he lost his wife to cancer. He could not afford to pay for a babysitter so he moved his family from Virginia to Baltimore to be closer to his relatives, who were willing to help look after his boys. Stan came highly recommended, having started out as a cashier at a wholesale food store in Virginia. Stan had studied hard toward his goal of completing the Pharmacy Technician Examination. After passing the examination, he moved from the food section to the pharmacy section within the same store. Over the two years since starting at Wright Pharmacy, his job duties as a pharmacy technician involved serving patients and healthcare providers, ordering and taking delivery of products and maintaining records of inventory, expenses, and sales. While working at Wright Pharmacy, Stan kept to himself a lot of the time, did not get along with other employees, and was often quick tempered. However, what he lacked in social skills, he made up for with hard work and was awarded employee-of-the-month for a number of consecutive months.

THE INCIDENT

After the initial review of the sales and purchase ledgers by Tony, he went back to his office and decided on an action plan for further investigation of the discrepancy and any possible links to the overall decline in the pharmacy's profit. He started by reviewing entries in the computer.

The pharmacy had three computers for ordering drugs from wholesalers and for billing insurance companies. Employees did not have unique log-in names and passwords for accessing the system. There was just one general log-in name and password. This created a situation that made it difficult to discern who ordered what drug at what time. Also, Tony could not rely on the order history because it was possible for an employee to order products and delete the order history afterwards. So he needed the physical invoices which the distributor gives to the pharmacy once the ordered drugs are delivered. He headed to the store to check the copy of invoices. He decided to do a random check and picked the invoices for last November. The invoices seemed intact. Tony called the distributor to find out if the distributor could make copies of invoices submitted to Wright Pharmacy for the same month. He planned to compare the distributor's invoice copies to what the pharmacy had in storage. The distributor promised to make the copies available to him before the end of that week.

Tony was tired and noticed it was already time for lunch, so he took his lunch break. Upon returning from lunch, he went to the main pharmacy hall and noticed Stan was alone looking into one of the drug cabinets. His behavior was suspicious so Tony decided to check the video recordings for that day. He also did a random check of the recordings for some days in November. Tony recalled that he had noticed some changes with Stan's behavior earlier in the year, but he did not read any meaning into it. Stan was always tired and sleepy. He also seemed to be more friendly toward other workers and jovial with the customers. Tony's findings from the recordings are in the incident report (see Exhibit 3 in the Appendix).

At the end of the week, the distributor brought the copies of the invoices as requested. Tony was grateful and spent the better part of that day comparing the distributor's copies to the pharmacy's invoices. He noticed the pharmacy had some missing invoices. A spot inventory check of medications also revealed that some medications were missing. Tony decided to have a

meeting with Stan but also asked Sam, an intern, to sit in as a witness. The following ensued during the meeting:

Tony: “Stan, I notice you have been acting strangely of late. Is everything alright with you?”

Stan: “I am doing fine.”

Tony: “I just reviewed the recordings from the video camera and noticed some inappropriate behavior on your part.”

Stan: “That is impossible!!!!!!”

Tony: “Last week, on Monday afternoon, you went into the drug cabinet a couple of times, took some pills out and placed them in your pocket.”

Stan: “Everybody else is probably doing it. Why are you picking on me?”

Tony: “There is no need to raise your voice and get all worked up. The pharmacy also has some missing invoices for the month of November. The information I gathered from the distributor indicates that you signed for them. There is really no need for us to argue. As you can see from the video recordings of the days in question, you are putting some medication into your pocket.”

Stan: “I was just taking something out of the refrigerator. Everybody takes prescriptions out of the refrigerator for customers.”

Stan later confessed. He admitted that the death of his wife affected his finances and made him depressed. Therefore, he resorted to taking medication to help him sleep better at night. This explained the tiredness and sleepiness he exhibited. He also sold some of the drugs to customers at discounted prices to earn extra income.

DISCUSSION QUESTIONS

1. Characterize the elements of the fraud triangle present in the case.
2. Explain how the pharmacy can improve its internal control.
3. What decisions does the owner face, and what alternative actions are available? Evaluate the alternatives and explain the choice you recommend.

CASE TEACHING NOTES FOR FACULTY

Case Overview

The owner of Wright Pharmacy, Mark Wright, realized that his business was not as profitable as it used to be in the early years. A heated argument between two employees regarding cash discrepancies from sales led Mark to assign the head pharmacist, Tony Lowe, the task of investigating the discrepancies in the sales and purchases ledgers. The investigation revealed that one of the pharmacy technicians, George Stan, was stealing medication from the pharmacy and destroying invoices. The investigation also revealed that the pharmacy did not have a good internal control framework. An incident report of the investigation was drafted by Tony and given to Mark, who will decide the appropriate course of action to take to resolve the issues. This case helps students to apply the elements of the fraud triangle to recognize when individuals are apt to initiate fraudulent schemes. The case also enables students to analyze the shortfalls that result from a poor internal control framework. Many studies focus on fraud that occurs in big companies but small companies also lose a lot of revenue due to employee fraud.

Broad Learning Goals

1. Students will be able to understand fraud in auditing.
2. Students will be able to increase their decision-making skills.

Specific Teaching Objectives

The students should be able to:

1. List and describe the main elements of the fraud triangle.
2. Explain how internal control weakness promotes fraudulent behavior.
3. Analyze alternative approaches to minimize fraud.
4. Capture/evaluate an environment that fosters honesty and high ethical behavior.

Suggested Teaching Approach

This case is designed to expose undergraduate and graduate students in accounting and other business classes to the fraud triangle concept, the importance of good internal control framework within organizations, business ethics and strategic decision making. The case can be introduced at the beginning or the middle of the first semester session.

The case has a medium level of difficulty and an analytical dimension difficulty level of two because the students will be required to analyze the situation, recommend additional alternatives, evaluate the alternatives and make decisions. The conceptual dimension difficulty is level one because the concepts are not difficult to understand and a presentation dimension difficulty level of two because the students will have to sift through the case to recognize relevant issues. The case is designed for a fifty minute class period and may require approximately one hour of pre-class student preparation.

It is recommended that the instructor uses the case only after giving a lecture on the fraud triangle and internal control framework concepts. Students should master the material in Exhibit 4 (Appendix) before tackling the case. The instructor should note that the potential responses to the case questions are not an exhaustive list. Prior student reading can also include relevant sections of Chapters 2, 4 and 5 of *Fraud Examination* by Albrecht, W. S., et al. (2013); Chapter 10 of *Auditing and Assurance Services* by Arens, A. A., Elder, R. J., and Beasley, M. S. (2014).

Suggested Answers to Case Question 1

The fraud triangle illustrates the following three key elements that are common to fraud, namely:

1. Perceived pressure/motivation,
2. Perceived opportunity, and,
3. Rationalization.

Perceived Pressure/Motivation:

- Work-related pressures: Afraid that he would not be able to function at work, Stan felt pressed to take drugs that would allow him to sleep believing it would keep him functioning well while at work.
- Financial pressure: Selling of the drugs created a new source of income for Stan who was a single father of three children. He could not afford to hire a baby-sitter to look after his children and even had to accept the help of relatives.

- Vice pressure: Stan claimed that he was depressed after the death of his wife and he needed medication to help him sleep. The need for drugs motivated him to commit fraud.

Perceived Opportunity:

- Wright Pharmacy did not have a good control framework. The pharmacy did not have an internal auditor to review daily activities. It only relied on the inspection conducted by external auditors.
- The pharmacy lacked a good accounting system to ensure that transactions were recorded properly. They did not have a proper system of authorization, independent checks and segregation of duty or dual custody. The person who ordered drugs also took delivery of drugs and dispensed drugs to customers. Also, employees were not assigned unique passwords to the computer.
- There were no physical safeguards of medications, documents and records.
- The hiring process was not rigorous. Only one person, the head pharmacist made hiring decisions. The best controls will fail to prevent fraud when deceitful people are hired.
- Stan was able to interact with customers who became his market.

Rationalization:

- Initially, when Stan was accused of taking medication from the fridge while no one was present, he argued that other employees did the same. So he may have rationalized his fraudulent act based on the reasoning that since everyone else was doing it, it was alright for him to also do it.
- Stan was very hard working, but the wage for his position was not commensurate with his job duties. Feeling underpaid could have triggered his behavior. He may have thought that it was only fair because he was working very hard.
- Stan may have rationalized his actions by thinking that it is the company's own fault for not having better security on all of these drugs.

These three elements do not have to be present for employee fraud to occur. The presence of some of the three elements does suffice to enable fraud.

Suggested Answers to Case Question 2

Weak internal control framework provided the opportunity for Stan to perpetrate fraud. Given that Wright Pharmacy is a small company, the owner will have to evaluate the trade-offs of implementing extremely costly controls versus relying on individuals. Improving internal control will involve some or all of the following:

- The pharmacy should hire an internal auditor if the benefit of hiring an internal auditor outweighs the cost. The absence of an audit trail enabled Stan's fraudulent behavior. Tony only conducted an investigation at the prodding of the owner who had a suspicion that the decline in profit was not mainly due to a decrease in customer base.
- Separate usernames and passwords should be created for employees and duties should be segregated. Tasks should be divided so that no one employee has complete control of any task. The pharmacy should introduce a system of authorization.
- An efficient accounting system should be introduced that keeps track of inventory. Proper documentation and record keeping procedures should be introduced. Measures should be taken to safeguard drugs.

Suggested Answers to Case Question 3

A. What should be done about the employee's theft?

- Do nothing, issue a verbal warning or suspend Stan with/without pay.
 - Pros: Retain a hard working employee.
 - Cons: The action may be perceived as an encouragement of fraudulent behavior.
- Terminate his employment.
 - Pros: This will discourage other employees from stealing and committing other fraudulent acts.
 - Cons: Lose a hardworking employee.

The situation in the case creates an ethical dilemma for the owner. It is not easy to terminate the employment of a hardworking employee faced with personal problems. This can also send a bad signal to other employees. Some decisions are not black and white for small company owners with few employees relative to large company owners.

B. How should the internal control structure be changed?

- Hire an internal auditor. This may be costly, but more thorough.
- Segregate duties and change systems. This will be less costly, but the owner has to be sure of its adequacy and employee-proof in terms of circumvention.

C. What other measures might be needed?

- The owner should review pay differentials. Either the pharmacy technicians' pay should be reviewed upwards or fewer duties should be delegated to the technicians.
- The pharmacy needs to introduce more rigorous hiring practices.
- Though the pharmacy has a business code of conduct which sets out basic principles to guide employees, it does not have training procedures for ethical actions. Training procedures could make employees comply with set policy and procedures.

REFERENCES

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APPENDIX

Exhibit 1
Wright Pharmacy
Patient Service Process

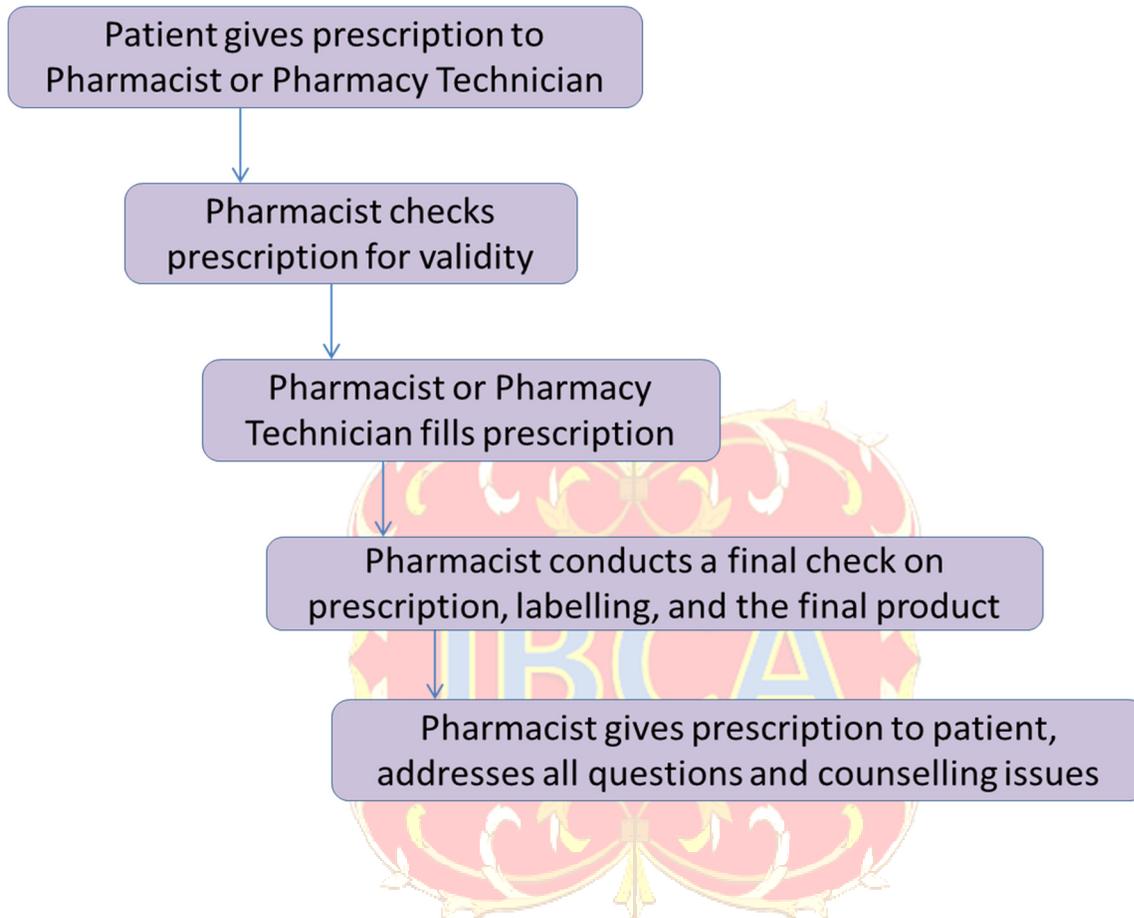


Exhibit 2
Wright Pharmacy
Chart of Key Players

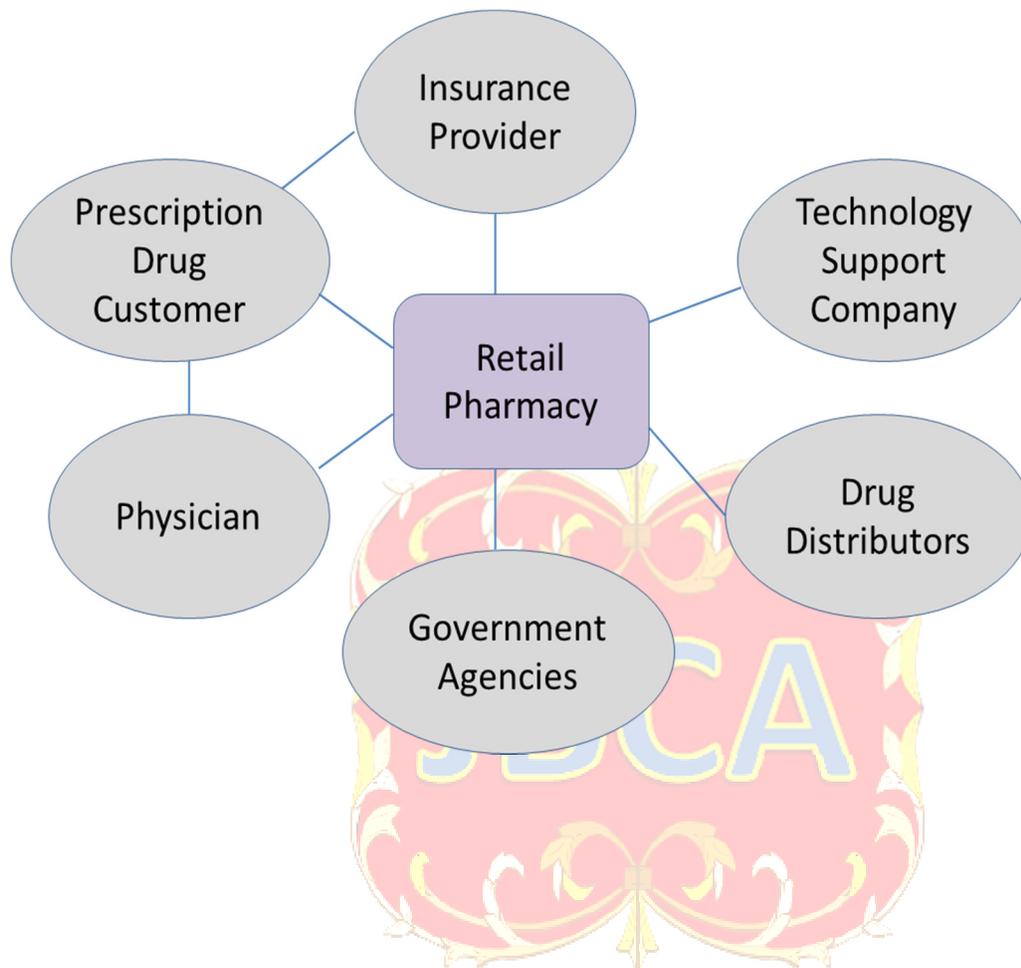


Exhibit 3
The Incident Report



Wright Pharmacy

5100 Sawyer Road, Baltimore, MD
12/14/20XX

The Incident Report

Location: Wright pharmacy – Main pharmacy hall
Employee name: Stan George
Head pharmacist: Tony Lowe
Date: Monday, 12/14/20xx

Details of event: On Monday, 12/07/20XX, at approximately 1:00pm, I, Tony Lowe on returning from lunch break saw Mr. Stan George close to the medication cabinet for schedule II and certain prescription medications. Since I was not completely sure of what was going on, I did not confront him but waited for an opportunity to review the video recording of the event that led to the moment. The video recording revealed that Mr. Stan George did actually open the said cabinet a couple of times and put some medication into his pocket while making conscious efforts not to be seen by anyone. I also discovered that Mr. Stan George has been tampering with the pharmacy's invoices in order to conceal order history of drugs.

Action taken: I called Mr. Stan George to take a look at the video recording with me in the presence of a witness, Sam, an intern. When confronted with the video recordings, he initially responded that "...he was just taking something out of the refrigerator" but later admitted to taking some medication which he returned in a vial.

Conclusion: I spoke with the owner, Mr. Wright who said he was going to have a discussion with Mr. Stan George and other employees.

All the undersigned affirm the above incident report.

Tony Lowe
Staff Pharmacist

Stan George
Pharmacy Technician

Sam Choice
Witness

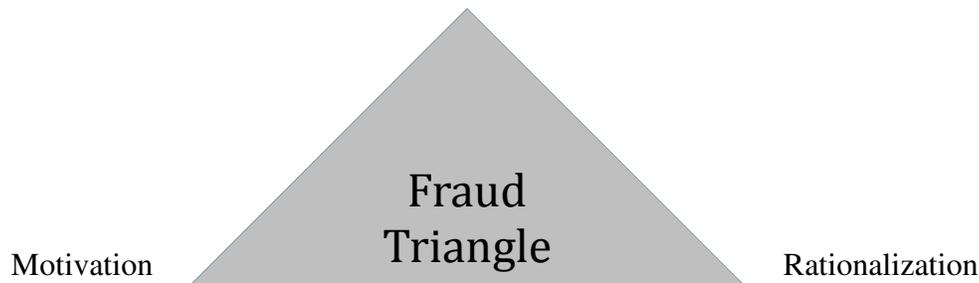
Exhibit 4

(Material that students must master before tackling the case)

Elements of the Fraud Triangle

Why People Commit Fraud

Opportunity



Even the best systems of control cannot provide absolute safeguards against irregular activities
By Donald R Creasy.

Adapted from: http://controls.ucmerced.edu/Data/Sites/9/media/images/fraud_triangle.png

Though there are several ways to perpetrate fraud, the fraud triangle illustrates the three key elements common to all of them:

1. Perceived pressure/motivation
2. Perceived opportunity
3. Rationalization

All these elements do not have to be present for fraud to take place.

1. The element of pressure: This can be attributed to financial pressures that arise due to personal debt, greed, financial losses; vice pressures such as gambling, drugs, alcohol, and expensive extramarital relationships; work-related pressures such as getting little recognition for job performance, having a feeling of job dissatisfaction, fearing losing one's job, being overlooked for a promotion, feeling underpaid; other pressures (Albrecht et al., 2013).

2. The element of opportunity: The absence of a control framework: this may include the control environment such as management's role and example, management communication, appropriate hiring, clear organizational culture, effective internal audit department; the accounting system: a good accounting system that ensures that transactions are recorded properly; control activities such as segregation of duties, or dual custody, system of authorizations, independent checks, physical safeguards of documents and records (Albrecht et al., 2013).

3. Rationalization: People find ways to justify inappropriate behavior such as: no one is hurt by their action, or it is their right considering the compensation they receive for their hard work, or others are also committing the same crime (Albrecht et al., 2013).