Employee fraud: A tale of greed and temptations

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ABSTRACT

Occupational fraud—schemes in which an employee defrauds his or her employer for personal enrichment through the deliberate misappropriation of the employer's assets—has been around as long as organizations have had to employ individuals to perform their business functions. A typical organization loses an estimated five percent of its annual revenues to occupational fraud, according to a study conducted by the Association of Certified Fraud Examiners. Occupational fraud is increasing in both amount and frequency signifying that companies need to improve their internal controls and other preventive methods. This case tells the story of how a once trusted administrative assistant colluded with ten other employees, including a former external-audit-manager-turned-internal-audit-director, in a $1.5 million scheme to defraud her company. This auditor worked at Talbot & Associates for over seven years and served on the Leeds Medical Center audit engagement team before joining Leeds as director of internal audit. The case is based on an actual event and the names of those involved and other facts have been modified to preserve anonymity. The situation presented in this case is intended to provide students with the opportunity to think critically, analytically, and creatively, drawing upon their knowledge of fraud, internal control principles, and the Independence Standards Board Standard No. 3 - Employment with Audit Clients, in their analysis of the case.

Keywords: Asset misappropriation, audit engagement, collusion, Independence Standards Board Standard No. 3, internal controls, occupational fraud

INTRODUCTION

The management of Holy Cross Health System is at a crossroads. Declining reimbursements, shrinking operating margins, and rapidly increasing operating costs are forcing the Health System to rethink its business strategy. In an effort to improve operational efficiencies, create corporate transparency, and streamline healthcare delivery processes across all of its fourteen member hospitals, the management of Holy Cross Health System summoned Josh Davis, its Chief Financial Officer, for an urgent discussion. At the meeting, Josh was charged with creating an integrated health delivery system that would enable all member hospitals to have a single point of access to critical patient medical and financial information. Josh hired Ernst and Young Corporation to audit the financial statements and employee referral bonus programs of all fourteen member hospitals. The audit was completed with the finding that in the last three years, Leeds Medical Center paid about $1.5 million in employee referral bonuses, of which about $700,000 was obtained fraudulently.

Holy Cross Health System (HCHS)

HCHS is a private, nonprofit corporation established in 1820 to provide patients with access to quality and affordable health care through cutting-edge research, leading edge technology, medical education, and integrated clinical practice. As a well-known regional and national referral healthcare group, it provides primary and highly specialized care for people in the state of New York and beyond. HCHS comprises of fourteen (14) member hospitals and health care facilities, including the Leeds Medical Center (LMC) based in New York City.

Leeds Medical Center (LMC)

With a 65% market share and annual revenue of over 4.5 billion dollars, LMC is the second largest medical center in the Mid-Atlantic States. It offers acute and sub-acute care facilities and has 1,450 beds, over 4,000 employees, five urgent care centers, two home health agencies, and a quality network of specialists and physicians with 50,000 inpatients and 350,000 outpatients annually. It is a level one trauma and tertiary-care teaching facility acclaimed both locally and internationally for its excellence in clinical care, patient care, research, and education across a wide range of specialties. LMC provides care to members of the community while servicing most of the emergency medical care population for the region. It has achieved most of its wealth through numerous acquisitions. It prides itself on treating complex and research based medical/surgical cases. Since its founding in New York City in 1820, Leeds Medical Center's accomplishments have distinguished the center from other medical centers both locally and nationally. LMC receives various grants from individuals and agencies of federal and state governments for its commitment to providing quality and affordable patient care.

KEY PLAYERS

Debby Smith has been with LMC for about six years as vice president of human resources. Prior to joining LMC, Debby was director of human resources at Holy Trinity Hospital. An industry veteran with more than 25 years of experience in human resources, she oversees the center's human resources functions including recruitment, organizational and policy development, orientation and retention of employees, employee and labor relations, retirement plans, health and welfare benefits, compensation and benefits programs, and training and development programs. She received her Master's degree in Human Resource Management from Purdue University and her Bachelor of Science degree in Communications from Cornell University. She has been nationally recognized for her work at LMC on Work/Life Balance and Workplace Flexibility. In her capacity as the vice president of human resources, she developed state-of-the-art employee policies and benefits that allowed LMC to retain world-class talent, improve employee morale, and increase productivity. Debby is a member of the American Society of Healthcare Human Resources Administrators and a Certified Professional Specialist in Organizational Development.

Josh Davis, CFO of HCHS, is a certified public accountant and a financial management expert with more than 40 years of experience in the health care sector. He joined HCHS 6 years ago. He oversees the financial operations, financial management, financial and capital planning, debt management, and operations support including budgeting. Josh received his MBA from Stanford University and his Bachelor of Science degree in Finance from Northwestern University. He has a reputation for meeting performance goals, as well as completing projects ahead of schedule and within budget. Under his leadership, HCHS achieved rapid growth in market share and the highest operating margins in its history. He is actively working to deploy a system that will establish a centralized financial database stored on dedicated servers that will be accessible from every member hospital and provide a platform to standardize financial reporting processes across all member hospitals and health care facilities. This centralized platform is expected to serve as a springboard for undertaking various operational analyses that are beyond traditional financial reporting. Moreover, it will improve communication and provide more accurate cross-platform comparisons and reporting of financial information across all member hospitals and health care facilities. Josh has acquired SAP solutions (Patient Management, Clinical Practice Management, and Healthcare Operations Management solutions) and other technology to integrate the transfer of financial and patient information and clinical data from all facilities to a centralized data hub.

Linda Larson joined the LMC team eight years ago as the administrative assistant in the human resources department. With over twelve years of experience in the health care field, she is responsible for the administration of the hospital's compensation and benefits program and for coordinating the recruitment and hiring process which includes opening recruitments, placing ads, screening applications, contacting applicants, arranging interviews, maintaining all relevant documentation and correspondence, and properly archiving job files. Linda also oversees the administration of the Employee Referral Bonus Program (ERBP). She is popularly known in her office as "Larson la frugalist" from her sixteen-year-old, beat-up Chevrolet car, oversize purses and hats, and long flowing skirts in dull colors like dark brown and tan. Having grown up in a poor household, Linda's whole life revolves around saving every penny she earns and clipping coupons. Over the years, Linda developed a reputation for being diligent, trustworthy, and hardworking. Five years after joining LMC, Linda married David Larson, a seasoned and lavish real estate agent at Regents Realty, Inc. Soon after her marriage to David, Linda's lifestyle and spending habits changed drastically. Linda began to live a lavish lifestyle with a great desire for expensive jewelries, designer clothes, elaborate homes, and luxury cars. The "luxury queen," as Linda is now called in the office, paid over $300,000 for a beachfront property in Florida, in celebration of her wedding anniversary. She also bought a new Mercedes-Benz CL55 AMG Coupe car, at a cost of over $100,000 and spent over $50,000 for a birthday party she organized for her husband in Paris. Prior to working with LMC, Linda worked as a human resource clerk at Holy Trinity Hospital. She received her Associate's degree in Business Administration from Austin Community College.

Nick Cooper, C.P.A., a former audit manager who worked at Talbot & Associates for seven years, served on the LMC audit engagement team before joining LMC as director of internal audit four years ago. He resigned from his position at Talbot & Associates just one year prior to starting with LMC. Nick is charged with planning and performing system-wide audits of LMC's business processes and other audits including revenues, expenditures, payroll, grants and contracts, accounts payable, and human resources. Nick received a Bachelor of Science degree in Accounting from the University of Richmond, and a Master of Business Administration degree from George Washington University. Nick has over twelve years of public accounting experience.

EMPLOYEE REFERRAL BONUS PROGRAM (ERBP)

LMC, in an effort to reward the recruitment efforts of all employees, developed the ERBP. Under the program, any paid employee who successfully recruits a new employee for any of the full-time and part-time hard-to-fill positions such as registered nurses, physical/occupational therapists, employed physicians, and all other positions will receive an employee referral bonus that ranges from $500 to $7,000 per hire. The employee referral bonus eligibility, guidelines, and procedures are as follow:

- All paid employees of LMC are eligible to participate in the referral bonus program regardless of status except for employees in management positions and employees in the human resources department;
- The referring employee must be employed at the time of referral and at the time of hire of the referred applicant to receive the referral bonus payout;
- Once the referral is submitted to the human resources department through the ERBP website, the referring employee will be sent an electronic confirmation. The referral system will automatically send an "Apply Now" email to the potential employee at the email address specified by the employee making the referral;
- The referral bonus program administrator reviews all new hires against the system referrals to identify any referral hires. If a referral hire is found, an eligibility audit on each referral hire is performed;
- The referral bonus program administrator and the human resource manager must electronically sign the referral forms before sending them to the vice president of human resources for final authorization;
- The vice president of human resources must authorize and electronically sign the referral forms before forwarding them for payment processing;
- The referral bonus program administrator accesses the Process Employee Referral Program page to submit monetary awards to PeopleSoft Payroll for North America for processing;
- The payroll system pays the cash awards and posts the amounts to the appropriate general ledger account;
- The referring employee is sent an email notification of the referral status; and

- The payout process begins after the hire date and after the successful completion of a 90-day evaluation period including any extension period.

PRE-AUDIT STATUS

Prior to the audit, each medical facility operated independently of the HCHS. However, it is desired that in the near future a uniform approach to data collection and centralized financial reporting and monitoring would be put in place to achieve economies of scale and scope. Josh had assured management that by the end of the fiscal period, financial reporting would be consistent across all member hospitals and health care facilities, and a shared service site would be established to accommodate all hospital entities within the network.

THE AUDIT

Ernst and Young conducted the audit of LMC. The audits were done by an audit senior and two staff assistants. The engagement team audited the financial statements of LMC, which comprise the balance sheet, statements of income, changes in stockholders' equity, cash flows, and the related notes to the financial statements as of December 31 of the previous year. The auditors compared the amounts to the prior year and conducted a thorough review of all referral bonus submissions for the last three years. A closer evaluation of all referral submissions within the three year period revealed the following:

- About 800 referral bonuses were processed;
- More than 60% of the 800 referral bonuses were processed by Linda;
- Several submissions were processed for payment by Linda without Debby's authorization and signature affixed to them;
- There were ten instances where the newly hired employees failed to complete the probationary period and payments to the referring employees were processed;
- Significant deficiencies in internal control occurred that allowed Linda to process duties that are typically segregated. Linda processed most of the referral bonuses, signed the referral forms for payment processing, and accessed the Process Employee Referral Program page to submit monetary awards to PeopleSoft Payroll for North America for processing; and
- Nick failed to conduct detailed and systematic checks on the effective administration of the bonus program; routine checks were only conducted to validate payment processing.

The engagement team also uncovered major deficiencies in the office of internal audit. In recent years, LMC had invested very little in internal control systems and training and lacked a fraud hotline. Moreover, while the office of internal audit consisted of three members in addition to Nick, most internal audit testing was conducted by Nick. As a result, Nick was able to circumvent prior external audits conducted by Talbot & Associates, due to his familiarity with their audit approach and testing strategy. Also, Talbot & Associates did not implement effective safeguards to reduce to an acceptably low level the risk of independence impairment due to Leeds's hiring of their former employee.

The engagement team interrogated Linda about the unusual amount and she confessed to enlisting the help of nine of her colleagues including her mother to submit referral forms for potential employees they had never met. Linda's mother along with the other eight employees worked in other departments at Leeds Medical Center. Her mother and friends fraudulently received payments from the hospital's employee referral program, kept a portion of each referral bonus, and sent the remaining money to Linda. She also confessed to colluding with Nick to defraud the medical center after Nick confronted her, during one of his routine audits, about the unusual increase in the employee referral payables general ledger. In addition, Linda disclosed the nature of the relationship between her and Debby. Linda is married to Debby's brother and thus a personal conflict of interest may exist. Mrs. Larson had also worked under the leadership of Mrs. Smith at Holy Trinity Hospital for more than three years. Linda confessed to facing financial pressure early in her marriage. She admitted that her husband despised her frugal lifestyle and she worried she would lose her husband. To protect her marriage, Linda claimed she gave up on her frugal lifestyle and adjusted quickly to her husband's lavish lifestyle. When asked why she committed the fraud, Linda said she stole because she felt entitled to the additional benefit and needed to "get even" with her employer for being overlooked for promotion and for not granting her a pay raise in years. Also, Linda claimed she needed those luxuries to please her family and win her husband's love. The engagement team also confronted Debby about the referral fraud. Debby denied she knew about Linda's fraud scheme. Her testimony painted a sad story of a dedicated and honest boss who lost the career she worked so hard to build for relying carelessly on the trust she had built with a longtime colleague and sister-in-law. The day after the fraud was uncovered, Nick committed suicide.

ACTION

Linda, her mother, and friends involved in this scandal were immediately terminated. The criminal scheme was reported to federal authorities because LMC receives more than half of its revenue in public money from Medicaid and Medicare, criminal charges were filed against all parties, and legal sanctions were imposed.

DISCUSSION QUESTIONS

1. Differentiate between "red flags" and "red herrings" Identify some red flags that indicate the possible incidence of fraud and the major "red herring" in the case.
2. Having read the case, propose to the management of Leeds Medical Center internal control improvements and other deterrent measures that could effectively reduce the risks of fraud.
3. Research on fraud identifies three key conditions or factors that must exist before a fraud occurs: (1) Perceived nonsharable financial pressure/Incentive, (2) Perceived opportunity, and (3) Rationalization. In your opinion, what do you think were Linda's incentives (pressure) for fraud, her rationalization to commit fraud, and what created the opportunity to commit fraud?
4. Should Debby be terminated? Why or why not?
5. Was Talbot & Associates' independence impaired with respect to Leeds Medical Center's employment of their former employee, Nick? If so, how?
6. Should Leeds Medical Center have hired Nick, who formerly served as one of its former engagement professionals? If so, why?

CASE TEACHING NOTES FOR FACULTY

Case Overview

The issue of detecting and preventing fraud in organizations worldwide is gaining greater momentum than in past years due to the alarming number of fraud cases reported in a survey conducted by the Association of Certified Fraud Examiners. A typical organization loses an estimated five percent of its annual revenues to fraud. As a result, exposing accounting and business students early in their career to the issue of fraud, its detection, and prevention, will go a long way to better prepare them for the daunting task of assisting their employers in making sound business decisions, especially as they relate to fraud and other financial mismanagement.

Three separate but interrelated topics, namely occupational fraud, auditor independence, and internal controls, taught in principles of accounting and auditing underlie this case. The case outlines the problem of poor internal controls at Leeds Medical Center, a member of Holy Cross Health System. The management of Holy Cross Health System is at a crossroads. Declining reimbursements, shrinking operating margins, and rapidly increasing operating costs are forcing the Health System to rethink its business strategy. In an effort to improve operational efficiencies, create corporate transparency, and streamline healthcare delivery processes across all of its fourteen member hospitals, the management of Holy Cross Health System summoned Josh Davis, its Chief Financial Officer, for an urgent discussion. At the meeting, Josh was charged with creating an integrated health delivery system that would enable all member hospitals to have a single point of access to critical patient medical and financial information. Josh hired Ernst and Young Corporation to audit the financial statements and employee referral bonus programs of all fourteen member hospitals. The audit was completed with the finding that in the last three years, Leeds Medical Center paid about $1.5 million in employee referral bonuses, of which about $700,000 was obtained fraudulently.

The case is intended to expose students to the issue of employee fraud and the importance of ensuring auditor independence especially in situations when an audit client employs a former audit engagement team member of an accounting firm. Students must draw upon their knowledge of fraud, internal control principles, and the Independence Standards Board Standard No. 3 - Employment with Audit Clients in their analysis of this case. This will ensure that students uncover and gain a deeper understanding of the facts underpinning the case and subject areas taught in class. By providing answers to discussion questions that have been carefully crafted following a set of predetermined learning goals and objectives, students will improve their understanding of occupational fraud and the importance of early fraud detection and prevention.

Broad Learning Goals

1. Students will be able to demonstrate critical thinking, problem-solving, and analytical skills by suggesting and implementing solutions to identified problems.
2. Students will be able to explain how frauds are perpetrated and the impact they may have on their victims.
3. Students will be able to discuss the best practices of internal controls within an organization.

Specific Teaching Objectives

The students should be able to:
1. Assess the role of internal controls in reducing both the likelihood of fraud and the magnitude of loss when fraud does occur.
2. Recognize and evaluate “red flags” that indicate the possible incidence of fraud.
3. Generate efficient internal control recommendations that will effectively and efficiently reduce the potential for fraud.
4. Develop an understanding of why and how fraud is committed.

Suggested Teaching Approach

This case is designed to expose undergraduate and graduate accounting and business students to the risks of fraud, how fraud can be detected and prevented, and the importance of developing a system of internal controls to address a firm’s fraud risks. Students can be introduced to the case at the beginning or the middle of the semester after the instructor has given a lecture on fraud, the fraud triangle, and internal control framework. The case is intended to be used in a 50-minute lecture class though students may require an additional one-hour of pre-class reading and preparation.

The case has a medium level of difficulty. The analytical dimension difficulty level is two because students are required to analyze the situations presented in the case, suggest relevant alternative solutions to problems identified in the case, and make decisions. The conceptual dimension difficulty level is one because the concepts can be easily understood. Finally, the presentation dimension difficulty level is two because students will have to sift through the information presented in the case to glean the facts needed to make decisions and identify and separate the central issues from the trivial issues.

In order to ensure the analytical quality of solutions suggested by students, the instructor should encourage students to read the following materials in exhibit 2 (Appendix): Independence Standards Board Standard No. 3 - Employment with Audit Clients (Paragraph Number 1, 2, 7, 10, 11, 12, 13, and 14), chapter seven of the Accounting textbook, fifth edition by Paul Kimmel, Jerry Weygandt, and Donald Kieso, chapters one through five of the Fraud Examination textbook, fourth edition by W. Steve Albrecht, Chad O. Albrecht, Conan C. Albrecht, and Mark F. Zimbelman and chapters ten and eleven of the Auditing and Assurance Services textbook, fifteenth edition by Alvin A. Arens, Randal J. Elder, and Mark S. Beasley (exhibit 2). In addition, students should study the material in exhibit 1 (Appendix) before working on this case. A list of acronyms used in the case is provided in exhibit 3 (Appendix).

There is no one correct answer to all the questions provided in this case; they are open-ended questions structured in a way that would prompt students to furnish answers that depict general concepts and principles related to fraud, auditor independence, and internal controls. Providing students with open-ended questions will improve their thinking process and sharpen their analytical and problem-solving skills. Hence, the instructor should expect students to give numerous answers and with different levels of details. Because the majority of the answers to the case questions can be found in the recommended textbooks, students are likely to give similar answers. However, the instructor should guide students who may provide irrelevant answers; clues can be provided to help steer students in the right direction when answering these questions.

Suggested Answers to Question 1

A red flag is a signal that something is not exactly as it should be, and should be investigated further. Also, a red flag is a set of circumstances that are unusual in nature and a possible warning sign of fraud (DiNapoli, 2008, p. 3; Lundstrom, 2009, p. 1). On the other hand, a red herring, named after the false signals used occasionally in the investment industry, is a false indicator or false-positive signal for which there is a logical explanation (Lundstrom, 2009, p. 2). Some of the red flags that indicate the possible incidence of fraud at Leeds Medical Center are:

(a) Employee referral bonus payables general ledger increased to $1.5 million in the last three years;

(b) Linda processed more than 60% of the 800 referral bonuses;

(c) Linda processed several bonus submissions for payment without Debby's authorization and signature affixed to them;

(d) There were ten instances where the newly hired employees failed to complete the probationary period and payments to the referring employees were processed;

(e) Significant deficiencies in internal control occurred that allowed Linda to process duties that are typically segregated. Linda processed most of the referral bonuses, signed the referral forms for payment processing, and accessed the Process Employee Referral Program page to submit monetary awards to PeopleSoft Payroll for North America for processing;

(f) Nick failed to conduct detailed and systematic checks on the effective administration of the bonus program; routine checks were only conducted to validate payment processing;

(g) Linda is married to Debby's brother and thus a personal conflict of interest may exist;

(h) Linda showed a sudden display of wealth and a lifestyle upgrade. For example, Linda paid over $300,000 for a beachfront property in Florida, in celebration of her wedding anniversary. She also bought a new Mercedes-Benz CL55 AMG Coupe car, at a cost of over $100,000 and spent over $50,000 for a birthday party she organized for her husband in Paris; little wonder further investigation into Linda's personal life revealed she used the kickback to upgrade her lifestyle;

(i) Major deficiencies existed in the office of internal audit. In recent years, Leeds Medical Center had invested very little in internal control systems and training and lacked a fraud hotline. Moreover, while the office of internal audit consisted of three members in addition to Nick, most internal audit testing was conducted by Nick;

(j) Talbot & Associates did not implement effective safeguards to reduce to an acceptably low level the risk of independence impairment due to Leeds' hiring of their former employee; and

(k) Nick worked at Talbot & Associates as audit manager and served on the Leeds Medical Center audit engagement team before joining Leeds as director of internal audit. This constitutes a red flag as Nick's past employment at Talbot & Associates and his past involvements in the audits of Leeds before joining Leeds pose potential threats to Talbot & Associates' audit independence and to the integrity of the financial reporting process at Leeds Medical Center.

The major red herring present in the case is: Linda worked under the leadership of Debby at Holy Trinity Hospital for more than three years. This only constitutes a red herring as her past business relationship with Debby does not lead to suspicion of fraudulent activities.

Suggested Answers to Question 2

In order to reduce the risks of fraud, Leeds Medical Center should:
(a) Implement and maintain effective internal control systems and written policies and procedures that would ensure that its financial reporting practices and administrative procedures are of the highest integrity and quality (Weinstein & Walker, 1981, p. 141);
(b) Actively monitor the activities of the internal audit department and of senior management in order to ensure the adequacy and the effectiveness of the systems of internal control and to prevent employee collusion. The Audit Committee (or the board of directors if there is no audit committee) should be responsible for this task;
(c) Design an appropriate fraud-risk management program and effective management review controls that are used to monitor the results of operations across the various departments at Leeds (Public Company Accounting Oversight Board [PCAOB], 2013, p. 5);
(d) Launch a new verification process that ensures that appropriate authorization policies for the employee referral bonus program are maintained;
(e) Train new employees, especially employees with financial reporting duties, at the time of hiring and periodically about the Center's code of conduct and values (PCAOB, 2002); and
(f) Launch an anti-fraud hotline and a well-designed whistleblower program. This might have encouraged a whistleblower to step forward sooner.

Suggested Answers to Question 3

The fraud triangle is a widely used model for explaining why otherwise honest people commit fraud. This model was developed by Dr. Donald R. Cressey (1919–1987), a criminologist whose research focused on embezzlers, whom he called "trust violators." According to Cressey, three factors must be present in order for a person to commit fraud. They are: perceived nonsharable financial pressure, opportunity, and rationalization (Association of Certified Fraud Examiners [ACFE], 2004, pp. 6-8).
(a) Perceived Nonsharable Financial Pressure/Incentive: Soon after her marriage to David Larson, Linda faced pressure from her spouse who demanded a higher standard of living. The "luxury queen," as Linda is now called in her office, paid over $500,000 for a beachfront property in Florida, in celebration of her wedding anniversary. She also bought a new Mercedes-Benz CL55 AMG Coupe car, at a cost of over $120,000 and spent over $50,000 for a birthday party she organized for her husband in Paris.
(b) Perceived Opportunity: Linda perceived the opportunity to commit fraud due to:

- Significant deficiencies in internal control that allowed her to perform duties that are typically segregated. For example, Linda was able to process most of the referral bonuses, sign the referral forms, and access the Process Employee Referral Program page.
- Failure to conduct detailed and systematic checks on the effective administration of the bonus program by Nick. For example, routine checks were only conducted to validate payment processing.

(c) Rationalization: Linda rationalized her behavior by believing that she had genuine reasons for perpetrating fraud. For example, Linda said she stole because she felt entitled to the additional benefit. She claimed she wanted to "get even" with her employer for being overlooked for promotion and for not granting her a pay raise in years. Finally, Linda claimed she needed those luxuries to please her husband.

Suggested Answer to Question 4

Yes, Debby should be terminated for gross incompetence on the basis of her grave failure to carry out her obligations as the vice president of human resources. As a supervisor to Linda, Debby was expected to have notified management of her relationship with Linda at the time of hire (or post hire, if the relationship was established post hire). Providing this vital information would help Leeds Medical Center to take formal steps to modify Debby's duties to eliminate any possibility of nepotism and conflict of interest. For instance, management should reassign Linda to a new supervisor who would oversee her daily operations and conduct annual evaluations.

Suggested Answer to Question 5

Yes, Talbot & Associates' independence was impaired with respect to Leeds Medical Center's employment of one of their former engagement professionals, Nick. By reason of his knowledge of the audit firm and his familiarity with the audit approach and testing strategy, he was able to circumvent audits to conceal fraudulently recorded transactions (Independence Standards Board [ISB] Standards No. 3, 2000).

Suggested Answers to Question 6

There is no definitive answer to this question. Some students may argue that the answer is yes. Some of the reasons for their response could be:
Leeds Medical Center could hire Nick as long as it implements appropriate safeguards. Some of these safeguards are:

- Performs a review of prior audits performed by Nick upon the commencement of employment negotiations between Nick and Leeds Medical Center.
- Performs an additional review of subsequent annual audits following Nick's acceptance of employment at Leeds Medical Center. Because Nick has been involved with prior audits conducted by the audit team from Talbot & Associates after his employment by Leeds Medical Center, conducting an additional review will ensure that the audit team exercised an appropriate level of professional skepticism towards the judgments and decisions now being made by Nick.

Some students may argue that the answer is no. Some of the reasons for their response could be:

- Leeds Medical Center should not have hired Nick because he could by reason of his familiarity with the audit approach and testing strategy of his former employer, circumvent subsequent audits that may be performed after his employment with the medical center whenever the opportunity to do so arises (ISB, 2000).
- Leeds Medical Center should not have hired Nick because the potential hiring of Nick could impair Talbot & Associates' independence both before and after Nick is hired. Moreover, any impairment of Talbot & Associates' independence may likely increase the potential that financial reporting irregularities may be undetected by Talbot & Associates as was the situation in the case.

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APPENDIX

Exhibit 1 (Case material to help students in their analysis of the case)

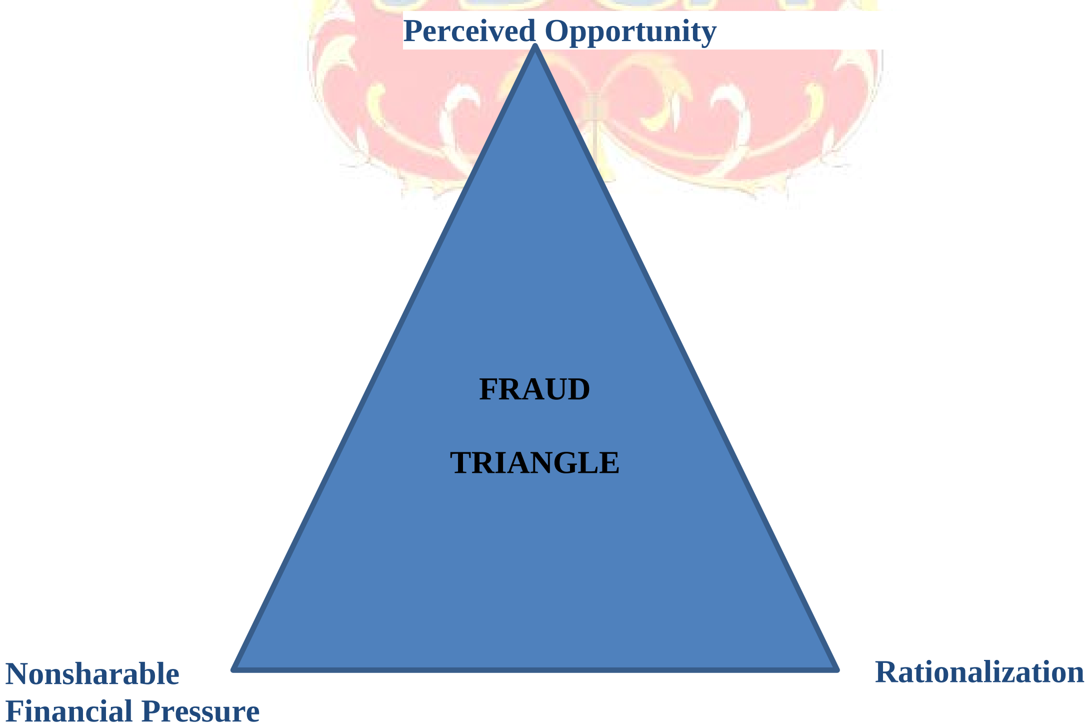
Telling the Difference between Red flags or Red Herrings in Situations of Fraud

A red flag is a signal that something is not exactly as it should be, and should be investigated further. Also, a red flag is a set of circumstances that are unusual in nature and a possible warning sign of fraud (DiNapoli, 2008, p. 3; Lundstrom, 2009, p. 1).

A red herring, named after the false signals used occasionally in the investment industry, is a false indicator or false-positive signal for which there is a logical explanation (Lundstrom, 2009, p. 2).

The Fraud Triangle

The fraud triangle is a widely used model for explaining why otherwise honest people commit fraud. This model was developed by Dr. Donald R. Cressey (1919–1987), a criminologist whose research focused on embezzlers, whom he called "trust violators." According to Cressey, three factors must be present in order for a person to commit fraud. They are: Perceived nonsharable financial pressure/incentive, perceived opportunity, and rationalization (Association of Certified Fraud Examiners [ACFE], 2004, pp. 6-10). Although Cressey's classic fraud triangle does not explain the nature of all occupational fraudsters, it provides a framework to explain why majority of occupational offenders commit crimes.



1. Nonsharable Financial Pressure: An otherwise honest person starts committing fraud when faced with some great financial pressure. Generally, nonsharable financial problems carry some sort of stigma or shame in the subject's mind. As a result, the subject feels the need to keep his problem a secret and resort to illegal means to rectify the problem (ACFE, 2004).
2. Perceived Opportunity: In order for a person to start committing fraud, that person must believe (or perceive) there is an opportunity to resolve the problem in secret without being caught (ACFE, 2004).
3. Rationalization: In order for a person to take the next step toward committing fraud, it is crucial that he develops some excuse to rationalize or justify his unacceptable conduct, avoid feelings of guilt, and maintain his image as a moral person (ACFE, 2004).

Exhibit 2 (Additional study materials that are relevant to the case)

Supplementary Materials

1. Accounting: Tools for Business Decision Making, fifth edition (Chapter 7) by Paul Kimmel, Jerry Weygandt, and Donald Kieso.
2. Auditing and Assurance Services, fifteenth edition (Chapters 10 and 11) by Alvin A. Arens, Randal J. Elder, and Mark S. Beasley.
3. Fraud Examination, fourth edition (Chapters 1 through 5) by W. Steve Albrecht, Chad O. Albrecht, Conan C. Albrecht, and Mark F. Zimbelman.
4. Independence Standards Board Standard No. 3 - Employment with Audit Clients (Paragraph Number 1, 2, 7, 10, 11, 12, 13, and 14).

Exhibit 3

Acronyms (Are used in the case to maximize clarity)

1. ACFE — Association of Certified Fraud Examiners
2. CFO — Chief Financial Officer
3. ERBP — Employee Referral Bonus Program
4. HCHS — Holy Cross Health System
5. ISB — Independence Standards Board
6. LMC/Leeds — Leeds Medical Center
7. PCAOB — Public Company Accounting Oversight Board