

Pressure to Commit Fraud in the Workplace: Two Teaching Cases Addressing Fraud and Whistleblower Protection

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Introduction

With the emphasis on our global economy, employees of organizations face unprecedented challenges in the workplace when they encounter an ethical dilemma. For example, the Ernst and Young (2016) Global Fraud Survey noted that one third of the respondents would justify giving illegal payments to increase business during an economic downturn or would justify this behavior under pressure to meet financial targets. The 2016 PWC Global Economic Crimes survey (U.S.) results suggest that the tone at the top and the “menace in the middle” contribute to the internal pressures perform, leading to more economic crimes committed by middle managers (fifty-three percent) and senior management (eighteen percent) during the survey period. Accounting students need preparation to face these ethical challenges. As they enter the workforce as employees, they have the potential to combat corruption by reporting wrongdoing. The Association of Certified Fraud Examiners’ (ACFE) latest survey reports that fraud is most often detected through tips from employees, vendors, and customers (ACFE, 2016).

To prepare students to recognize red flags for fraudulent behavior, these cases provide a tool to help students recognize behavior that could indicate fraudulent activities, as well as increase their awareness of protections and rewards available to whistleblowers. These cases are based on real events currently in the court system and are meant to provoke class discussion about identifying potential “red flags” for fraud and the legislative protection available to employees who recognize and report misconduct in the workplace.

Several issues can cause employees to be reluctant to report potential fraud. Fear of retaliation is one of the main factors inhibiting employee reporting of wrongdoing. Consequently, methods for reporting tips and suspicious behavior through tools such as anonymous “whistleblower” tip lines are an important deterrent to fraud. The presence of these tip lines increases the perception of detection and gives employees (and involved third parties) a way to report misconduct while helping reduce fear of retaliation or retribution. As a result of retaliation to whistleblowers, and in view of the large number of high-profile frauds over the past decade and a half, legislators passed additional laws to help combat fraud by including additional protections to those individuals who assist the U.S. Government in identifying fraud perpetrators.

Two major regulatory acts that shape the legal environment surrounding the reporting of fraud in the U.S. are the Sarbanes Oxley-Act of 2002 (hereafter, SOX) and the Dodd-Frank Act of 2010 (hereafter, Dodd-Frank). It is important for students to understand the whistleblower provisions of SOX and Dodd-Frank because they may someday be whistleblowers themselves, and/or they may be designing, administering, or evaluating a control system, which ideally should include a fraud hotline. If students are not familiar with the protections guaranteed by these laws, they might be reluctant, or worse yet, be unwilling to report their suspicions. In addition to providing an exercise in red flag identification, these cases expose students to the whistleblower provisions of SOX and Dodd-Frank through the analysis of realistic cases.

Case Materials

Case 1: Rural and Urban Home Mortgage Corporation

Rural and Urban Home Mortgage Corporation (R&U) was founded in 1969 as a local provider of home loans in the Northeastern United States. The company grew quickly as a result of its use of a branch system. These locations

provided mortgage application, processing, and servicing functions, and eliminated the sales force in the branch offices. By eliminating sales commissions, the company was able to focus on delivering a product to customers with low overhead. R&U worked closely with realtors and potential buyers through telemarketing and mailings.

By 1985, the company had branches in eight states, and by 1990, had successfully integrated computer technology into its loan application process and stood poised to be a leader in the mortgage industry nationwide. The company benefited from the savings and loan crisis of the 1980s and 1990s by being able to provide loan services in a market that no longer included their largest competitors. As loan rates dropped, the company cashed in on the mortgage refinancing boom and grew even larger. By 1992, R&U was originating over thirty billion dollars in mortgages, while increasing its profits by 170 percent.

The company provided home mortgages to those who might otherwise not be able to afford a home by developing innovative financing arrangements. R&U kept costs low by using technology for servicing and processing applications, while offering the most competitive combination of loan fees and interest rates available at the time. To assist customers who might have difficulty securing financing, the company worked with the Federal Housing Authority, Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation—all government agencies that provided a source of funds for companies offering mortgages to qualified buyers.

R&U also streamlined its mortgage processing function by developing and using an artificial intelligence system that handled the approval and underwriting process for routine mortgages. This allowed underwriters and processors to spend their time working with difficult or borderline mortgages. Later, the company was able to produce an additional \$500 billion in mortgages by loosening some of its lending guidelines so that it could offer mortgages to home buyers who had minimum resources and might have to borrow money for a down payment.

The CEO (one of the original founders of the company) was also the president and the chairman of the board for the company, which is a significant amount of power vested in one individual. Indeed, press reports indicated that the CEO was determined to make R&U a leading company in the mortgage industry. From 2000–2006, the CEO received over \$400 million in compensation and seventy percent of that amount was the result of exercising stock options (management compensation was linked to stock prices). During this same timeframe, R&U's net income increased from \$385 million to almost \$2,750 million.

With the exponential growth of R&U, several individuals involved with the company started to notice things amiss:

- Henry, an appraiser working for a subsidiary, noticed that one of R&U's largest home builder clients insisted on using his own appraiser, an individual who supposedly could process more than 400 appraisals a month by himself. Other appraisers were appraising similar homes at lower values. Henry became concerned because many of the homes in question were guaranteed by the government. When he brought his concerns to the attention of his supervisors, he was ignored and eventually fired.
- Marie, an internal auditor who was head of the Mortgage Fraud Investigations Group, also noticed irregularities and discussed her concerns in reports to the Audit Committee. She pleaded with her superiors to investigate what she felt constituted ongoing forgery of documents by loan officers. She was terminated shortly thereafter for inappropriate behavior.
- Martin, the CFO, was instructed to falsify documents to a bond-rating agency, but he refused. In addition, he reported other financial concerns to the CEO. Martin was fired shortly thereafter because some of the financial programs he developed were considered unimpressive by the CEO.
- Sandra, the senior vice president for Culture and Diversification, worked for a year and a half for the company developing programs to diffuse employee dissatisfaction with executive management. Her supervisor accused her of having a bad attitude and fired Sandra.

Problems started to emerge at R&U. When the real estate market collapsed in late 2007, R&U suddenly lacked customers—mortgages for home loans disappeared, and there was a dramatic increase in individuals defaulting on their mortgage loans. A large national bank purchased the company in 2008 for four billion dollars, and R&U was able to avoid bankruptcy.

However, the purchase price was only about fifteen percent of R&U's market value, which raised concerns about the accuracy of R&U's financial statements. In addition, from October 2006 through September 2007, the CEO exercised more than five million stock options and sold the underlying shares for total proceeds of nearly \$150 million. These actions alerted the Securities and Exchange Commission (SEC), and in July 2009, the SEC filed civil fraud and insider-trading charges against the owners of R&U as well as several other top executives.

Case 1: Questions

1. In the 1950's, Donald Cressey developed a model for predicting fraudulent behavior based on interviews of people who had been caught committing fraud.¹ His Fraud Triangle model suggests that there are three components of fraudulent behavior: 1) Pressure (e.g., such as financial pressures, employer-caused pressures, or pressure related to supporting an addiction or vice), 2) Perceived Opportunity (e.g., the ability to bypass controls, or a desire to “see what I can get away with”) and 3) Rationalization (i.e., many fraudsters have their own “personal code of ethics” and rationalize their behavior for any number of reasons that make sense to them, such as “I deserve this after all my hard work” or “I am doing this for the greater good”). Albrecht et al., (2012) suggest behavioral red flags, such as a coworker living beyond their means or a coworker with a gambling problem, are also signals of a situation that might “encourage” fraudulent behavior. Huber (2017) argues the Fraud Triangle does not explain fraud (nor was it meant to), as there could be other factors involved that affect the likelihood of fraud, such as capability through one's position to commit fraud, sociological elements (e.g., personal background), or a national or organizational culture more “accepting” of corruption. Although Huber (2017) correctly notes that the Fraud Triangle can only explain fraud committed as a breach of trust, Cressey's Fraud Triangle components are a starting point to evaluate a situation where fraudulent behavior is suspected.

Based on the information provided above, discuss the “red flags” for fraud in this case in terms of the opportunity, pressure, or rationalization (or a combination of) components of the Fraud Triangle. Include in your discussion other individual and organizational “behavioral red flags” that might also be present in the situation.

2. Discuss the control environment at R&U following the COSO 2013 framework (refer to <https://www.coso.org/Documents/990025P-Executive-Summary-final-may20.pdf> for components and principles of the framework).
3. Under the provisions of SOX that relate to whistleblower protections, would any of the terminated employees in the case above be entitled to financial compensation? If these individuals were able to prove retaliation by their former employer, what would their potential financial awards include?
4. Discuss the whistleblowing provisions of the Dodd-Frank Act. Do you think any of the employees of R&U would be able to prove retaliation by their former employer? Explain.
5. Assuming the Dodd-Frank provisions protecting whistleblowers were in place during the time the allegations above occurred and that all of the individuals separately reported their concerns to the SEC, who among the above former employees would be eligible to collect ten to thirty percent of any fines over one million dollars imposed on R&U as a result of these violations? Which of the above former employees would not be able to collect these payments? Why?

Case 2: WebUni

The UniEducation Group is a private education provider with wholly-owned subsidiaries offering both face-to-face and online degree and vocational programs throughout the United States. The UniEducation Group includes WebUni, an online degree program that offers bachelors, masters, and doctoral degrees in a variety of disciplines, including: business administration, information technology, education, nursing, and criminal justice. WebUni is a for-profit institution with

¹ Cressey, D.R. (1950). The criminal violation of financial trust. *American Sociological Review*, 15 (6), pp. 738–743, December, pp. 1–15.

open enrollment, requiring only a General Education Development² (GED) certification for admission, and represents over ninety percent of the total revenues for the UniEducation Group.

The UniEducation Group was founded in 1973, with the goal of providing lifelong learning opportunities to a population who would work in various jobs throughout their careers. In the early 1980s, WebUni started expanding from its home state into other metropolitan areas and began offering college courses online in 1989. At one point, enrollment totaled over 600,000 students. Recently, there have been complaints about retention rates, accreditation, and problems with graduates finding jobs. Some critics called the MBA program a “light” MBA because of the number of hours spent working with an instructor (an average of twenty to twenty-four hours per course as compared to the traditional forty hours per course) and a perceived lack of academic rigor in the course materials.

Many employers do not reimburse students for tuition expenses incurred at WebUni because its business degree programs are not accredited by the AACSB, the premier accrediting body for business schools. The reasons underlying WebUni’s lack of AACSB accreditation include: (1) most of the faculty are part-time, (2) most of the faculty lack appropriate academic qualifications (e.g., some faculty without PhD degrees are teaching graduate courses), and (3) course materials are not comprehensive enough.

In 2002, in response to falling enrollment numbers, WebUni began an incentive plan to pay bonuses to enrollment counselors based on target student enrollment levels. The bonuses and gifts paid to the counselors were based solely on the number of students recruited, not whether the students finished their degree plans. A complaint brought by the Taxpayers Against Fraud in 2003 suggested that because of low graduation rates at WebUni, taxpayers often had to pick up the tab when these non-graduates did not repay their student loans. Nevertheless, WebUni continued to claim that they were in compliance with Title IV of the Higher Education Act in order to qualify for federal funding through PELL grants, student loans, and other government-supported funding.³ The majority of students that the counselors enrolled qualified for federal funding to pay tuition, which amounted to \$1.7 billion per year.

As part of the enrollment incentive program, the counselors were not required to review transcripts to determine if students were ready for college-level work. The head of the enrollment department (John) often bragged that the administration was “all about the numbers” and that they would show the Department of Education “what they wanted to see” so that WebUni could obtain Title IV funding. When profits started to fall, administrators recommended that some of the numbers on the financial statements should be massaged to meet analysts’ expectations for the UniEducation Group. During this time, the counselors continued to follow the enrollment incentive program goals to keep their jobs and salary levels stable.

In early 2004, two enrollment counselors, Marie and Juliet, filed a complaint with the Department of Education claiming that they were required to meet goals and falsely certify that they were in compliance with Title IV. In addition, they were required to overstate their recruits’ successful completion of degrees. Although Marie and Juliet were both still employed with WebUni at the time of their filing, they were dismissed for undisclosed reasons within six months of the filing.

In late 2004, Greg, a major shareholder and director of the UniEducation Group, started to notice some strange financial disclosures on SEC filings for the UniEducation Group. Greg requested specific information from the Chief Audit Director. When he received no response, Greg filed a complaint with the SEC stating his suspicions of material misstatement of the financial statements. By December 2005, complaints filed with the Department of Education and the

² The GED test assesses the level of proficiency in science, math, writing, reading, and social science. The test certifies that the individual has United States high school level academic skills. (reference: <https://www.gedtestingservice.com/educators/home>)

³ Universities enter into a “Program Participation Agreement” with the U.S. Department of Education to receive this funding. The agreement states that the university will comply with federal regulations to start the process of receiving the funding. The funding includes Pell Grants, Stafford loans, work-study programs, and other support based on financial need for students pursuing degrees. To receive funding, an institution must meet certain eligibility requirements such as accreditation, and not have more than ninety percent of its operations funded by Title IV funds. (reference: <http://www.dpinnell.com/TitleIVAgencies.htm> and http://www.tgslc.org/pdf/HEA_Title_IV_Oct02.pdf)

SEC included information from the external auditor, Eleanor (managing partner), Tim (an attorney for UniEducation Group), and Peter (senior vice president and treasurer of the UniEducation Group).

In early 2006, UniEducation Group changed auditors. In addition, 8-K filings for 2006 indicated that the organization was under investigation for the accounting of its stock option program, violation of the tax code for the stock option program, and intentional falsification of some financial disclosures. During that time, many officers and board members resigned. Peter was demoted to a staff level position in the Treasury department, and Tim left UniEducation Group for a position in a prominent law firm. Later in the year, Jeremy, the chief compliance officer for the UniEducation Group, filed a complaint with the SEC and resigned from his position. Joh, the head of the enrollment department, filed a report with the SEC at approximately the same time. In 2012, WebUni was ordered to pay \$67.5 million (plus attorneys' fees) to resolve the allegations filed by Marie and Juliet. In addition, WebUni continues to face lawsuits and bad press due to high student loan default rates and alleged violations related to demanding tuition from students who have withdrawn from WebUni.

Case 2: Questions

1. Discuss the control environment at WebUni following the COSO 2013 framework (refer to <https://www.coso.org/Documents/990025P-Executive-Summary-final-may20.pdf> for components and principles).
2. Under the provisions of SOX that relate to whistleblower protections, would any of the terminated employees in the case above be entitled to financial compensation? If so, which individuals and why? If these individuals were able to prove retaliation by their former employer, what would their potential financial awards include?
3. Discuss the whistleblowing provisions of the Dodd-Frank Act. Do you think any of the employees of WebUni would be able to prove retaliation by their former employer? Explain.
4. Assuming the Dodd-Frank provisions protecting whistleblowers were in place during the time the allegations above occurred and that all of the individuals separately reported their concerns to the SEC, which of the above former employees would be eligible to collect ten to thirty percent of any fines over one million dollars imposed on WebUni as a result of these violations? Which of the above former employees would not be able to collect these payments? Why?

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