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FRAUD EXAMINATION

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Conan C. Albrecht
Mark F. Zimbelman

Fraud Examination

FIFTH EDITION

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To LeAnn, Jenny, Laurel, and Karen

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About the Authors

W. Steve Albrecht is a professor of Accountancy in the Marriott School of Management and Andersen Alumni Professor at Brigham Young University (BYU). Dr. Albrecht, a certified public accountant (CPA), certified fraud examiner (CFE), and certified internal auditor (CIA), came to BYU in 1977 after teaching at Stanford and at the University of Illinois. He served as both associate dean of the Marriott School and as the director of the School of Accountancy and Information Systems at BYU.

Dr. Albrecht received a bachelor's degree in accounting from Brigham Young University and his MBA and Ph.D. degrees from the University of Wisconsin. He is past president of the American Accounting Association, the Association of Certified Fraud Examiners (ACFE), and Beta Alpha Psi. He was a former member of the Board of Regents of the Institute of Internal Auditors and served on the task force of the AICPA that wrote SAS 82, a fraud auditing standard, and on the FASAC, an advisory committee to the FASB. He was a member of the Committee of Sponsoring Organizations (COSO) from 1997 to 2000 and the AICPA Council from 2000 to 2003 and was chair of the AICPA's Pre-Certification Executive Education Committee from 2002 to 2004. He previously served as a trustee of the Financial Accounting Foundation that oversees the FASB and GASB. Dr. Albrecht has done extensive research on business fraud. His research has resulted in the publication of over 100 articles in professional and academic journals. He is the author or coauthor of over 20 books or monographs, several of which are on fraud. His financial and principles of accounting textbooks are in their 14th editions. In 1997, 2001, 2002 and 2003, and 2004 he was chosen as one of the 100 most influential accounting professionals in the United States by *Accounting Today* magazine. Because of his extensive work with the ACFE, one of the headquarters buildings in Austin, Texas, is named after him.

Dr. Albrecht has consulted with numerous organizations, including Fortune 500 companies, major financial institutions, the United Nations, FBI, and other organizations, and has been an expert witness in some of the largest fraud cases in America. He currently chairs the audit committees and serves on the boards of directors of three public companies and one private company. In 2013, he was named one of the top 50 corporate directors in the United States by the National Association of Corporate Directors.

Chad O. Albrecht is an associate professor at the Jon M. Huntsman School of Business at Utah State University. Chad has taught forensic accounting and fraud investigation at various schools both in Europe and the United States.

Chad's research focuses on international fraud and corruption. This research addresses how fraud is perceived and perpetrated across cultures. Chad's research has been published in the *Journal of Business Ethics, Business and Society, Internal Auditing, Corporate Finance Review, Cross Cultural Management: An International Journal*, and the *International Journal of Human Resource Management*, among others. Chad's research has been reporting in various news outlets including the prestigious *Times of London*. Before pursuing doctoral studies, Chad worked as a licensed stockbroker for The Harris, a subsidiary of the Bank of Montreal.

Chad received his bachelor's degree in accounting at Brigham Young University and his Ph.D. from ESADE Business School in Barcelona, Spain. *The Wall Street Journal, Business Week*, and *The Financial Times* consistently rank ESADE as one of the top 20 business schools in the world.

Conan C. Albrecht is a full professor of Information Systems at Brigham Young University. He teaches classes in enterprise development, computer-aided fraud detection, and business programming. Dr. Albrecht researches computer-based fraud detection techniques and online group dynamics. He has published articles on fraud detection and information theory in *The Journal of Forensic Accounting, The Journal of Accountancy, The Communications of the ACM, Decision Support Systems, Information and Management,* and other academic and professional outlets.

Dr. Albrecht received a bachelor's and master's degree in accounting from Brigham Young University and his Ph.D. in information systems from the University of Arizona. Dr. Albrecht is currently working on an open source framework for computer-based fraud detection. The core of this research is detectlets, which encode background and detection information for specific fraud schemes. In the next few years, he hopes the system will serve as the foundation of a large, online repository of detectlets about all types of fraud.

Mark F. Zimbelman is the Mary and Ellis Professor at Brigham Young University's (BYU) School of Accountancy. He teaches classes on auditing and fraud examination and focuses his research on the detection of financial statement fraud. His research has been published in numerous academic journals including *Journal of Accounting Research, The Accounting Review, Contemporary Accounting Research, Review of Accounting Studies, Organizational Behavior and Human Decision Processes, Auditing: A Journal of Practice and Theory, Journal of Forensic Accounting, Journal of Accounting Literature*, and *Accounting Horizons.*

Dr. Zimbelman received his doctorate in 1996 from the University of Arizona where he completed his dissertation on SAS 82. A paper from his dissertation was honored to be one of six that were presented at the 1997 *Journal of Accounting Research* Conference at the University of Chicago. In 1999, he returned to that conference to present another paper on auditor's detection of fraud. In addition to his academic research on fraud, Dr. Zimbelman has worked with the American Institute of Certified Public Accountants and the Institute of Internal Auditors in writing various publications on fraud.

After graduating from BYU's accounting program in 1984, Dr. Zimbelman received his CPA license and worked for over six years as a financial statement auditor and, later, as a controller in industry. After getting his Ph.D. and working for three years at the University of Oklahoma, he returned to BYU in 1999. In 2005, he took a leave of absence to work with KPMG in their fraud and forensics practice. This opportunity gave him hands on experience investigating violations of the Foreign Corrupt Practices Act, financial statement fraud, vendor fraud and embezzlement.

Foreword

According to the Association of Certified Fraud Examiners' 2010 Report to the Nations on Occupational Fraud and Abuse, certified fraud examiners estimate that organizations lose, on average, about 5 percent of their revenues to dishonesty from within.

If multiplied by the estimated Gross World Product, the cost of occupational fraud and abuse may run a staggering $2.9 trillion annually. By the breadth of the definition, it covers all corporate dishonesty—from the mailroom to the boardroom. While executives are "cooking" the company's earnings to show better profits, purchasing agents are getting kickbacks from suppliers, and employees are embezzling money to improve their lifestyles.

Knowing how much fraud actually costs is an impossible task. The cases we know about only represent the tip of the iceberg; those discovered tend to be greedy or careless. Executives and employees who are neither may well commit fraud throughout their entire careers and get away with it.

The huge cost of occupational fraud begs an obvious question: Why does it occur? The answers aren't always easy. Although the simple explanation is greed—a natural human trait—even greedy people don't always lie, cheat, and steal. A more complete answer for corporate dishonesty involves three factors: the individual, the workplace, and society.

Individuals likely to commit occupational fraud are often on the financial ropes. This can occur when people spend more money than they make or when there is a personal financial crisis demanding immediate resolution. Although many of us have had such difficult situations, dishonest employees are more likely to salve their consciences with rationalizations that justify fraud. In short, they lack the convictions of their own ethics.

Workplace environments also contribute to occupational fraud. Organizations that are viewed by employees as uncaring, stingy, or dishonest can run a much higher risk of being victimized from within. Many workers—in an attempt to right what they consider to be corporate wrongs—may address these perceived injustices in a variety of ways: goldbricking, excessive absences, pilferage, and dishonesty.

Moreover, some entities unwittingly contribute to the problem. By failing to establish reasonable workplace conditions, safeguards, and controls, companies might make fraud too easy, and thus too tempting. Organizations have a duty to help keep the workforce honest. Societal conditions also influence the rate of occupational fraud. If dishonesty is easily accepted and goes largely unpunished, we can only expect it to thrive.

It was my own search for answers to occupational fraud 20 years ago that led me to W. Steve Albrecht. In the early 1980s, after 10 years with the FBI, I practiced as a fraud examiner. Increasingly, my corporate clients were referring me cases of embezzlement, corruption, and other misdeeds.

One client, certainly on the cutting-edge at the time, wanted help in developing an antifraud program. That request led me to the vast libraries of the University of Texas at Austin, where I discovered one of Dr. Albrecht's first published works on the subject, *Deterring Fraud: The Internal Auditor's Perspective*.

After reading this seminal research by Steve and his colleagues, I sought him out personally. Even though Steve had never heard my name, he graciously invited me to Brigham Young University, where he was teaching. Dr. Albrecht answered my questions and volunteered his valuable time to aid on the topic of occupational fraud. After that, we've always stayed in touch.

Neither of us then could have imagined the paths our lives would take together. In 1988, Steve was a major influence in encouraging me to start the Association of Certified Fraud Examiners, and he served with distinction as its first president.

Since that time, the ACFE has grown to the world's largest antifraud organization with nearly 60,000 members in over 140 countries. Steve's lifetime of contributions to the field of fraud detection and deterrence simply cannot be overstated. The ACFE recognized the enormity of Dr. Albrecht's body of work in 1998 when it honored him with its most valued prize: the Cressey Award.

However, the many awards Steve has received do not capture the kind of man he is. A devoted father and husband, Steve lives his life by high example. Regardless of his many accomplishments, you won't hear about them from him; humility is one of his most endearing traits. I have had the pleasure of meeting the coauthors, Conan and Chad Albrecht, two of Dr. Albrecht's sons. There is no question that they will carry on his work. I am proud to call Steve my great friend.

Steve and I are of a common mind when it comes to fraud. First, the accounting community, which has the lion's share of responsibility to control occupational fraud, is ill-equipped for the job. Second, education is the cornerstone to preventing fraud. The more we know, the less likely we are to become victims.

The terms "fraud examination" and "forensic accounting" are often used interchangeably. However, they refer to different but overlapping concepts. The latter phrase, although highly popular as a euphemism for fraud investigation, actually refers to any kind of accounting work done for litigation purposes.

According to the *Fraud Examiners Manual*, fraud examination is a methodology for resolving allegations of fraud from inception to disposition. The process involves gathering evidence, taking statements, writing reports, and assisting in the detection and deterrence of fraud. Although many organizations employ fraud examiners, audit professionals and others also conduct fraud examinations on a limited, as-needed basis. The fraud examination field draws its common body of knowledge from four areas: accounting and auditing, fraud investigation techniques, the legal elements of fraud, and criminology and ethics. Steve's work in helping define this field was indispensable.

For accountants, antifraud education has been practically nonexistent for decades. One of the main reasons has been the lack of authoritative texts on the subject. Educators and students alike will find *Fraud Examination* to be a solution. Packed full of real examples, thought-provoking discussion issues and questions, this book is ideal for both undergraduate and graduate students.

Moreover, practitioners will find a great deal of guidance in resolving current cases. Managers and executives will benefit from understanding the myriad of issues that can assist them in deterring occupational fraud. And for all of us, *Fraud Examination* is simply a wonderfully engaging read.

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Preface

Fraud examination (sometimes called forensic accounting) is one of the most exciting careers for students studying accounting and business today. The AICPA has called forensic accounting one of the hot new "sizzling" career areas in accounting. It is estimated that there will be a shortage of between 25,000 and 50,000 security professionals in the next few years in the United States. Exciting opportunities for accounting and business students who become knowledgeable in fraud prevention, detection, and investigation abound in various federal agencies, such as the FBI and Postal Inspectors, major corporations, and professional service and consulting firms. Both the size and the number of frauds are increasing, which will result in an even greater demand for fraud-fighting professionals in the future.

You've probably heard about Enron, WorldCom, Madoff, and other major frauds. But, there are many other types of frauds that occur every day. Fraud is an extremely costly business problem. For example, not long ago a Fortune 500 automaker experienced a $436 million fraud. Because the fraud reduced the company's net income by $436 million from what it would have been and because the company had a profit margin (net income divided by net sales) of approximately 10 percent, the company would have to generate an additional $4.36 billion (10 times the amount lost in the fraud) in revenues to restore net income to its prefraud level. If you assume that an average car sells for $30,000, this company would have to make and sell over 145,000 additional cars ($4.36 billion divided by $30,000 sales price) to recover the effect on net income. In other words, this company faced a major business problem: it could either make and sell 145,000 more cars, or it could work hard to prevent these types of frauds from occurring in the future. When faced with the choice of generating that much additional revenue—which would have been difficult if not impossible—the company decided that reducing and eliminating future frauds was the more effective way to spend its money. As a result, it hired additional fraud and control experts and implemented extensive fraud prevention procedures throughout the organization. Eliminating fraud is a problem that every organization faces, and you can help them deal with this growing problem.

Even if you decide not to become a fraud expert, the topics you will study in this book will help you be a better professional in whatever career path you choose. The technology, interviewing, document examination, public records, and other tools and knowledge you will gain will make you a better consultant, auditor, tax professional, or manager, as well as a better and more astute investor.

As you will discover in this book, there is a very active professional organization that deals with fighting fraud called the Association of Certified Fraud Examiners (ACFE), which currently has over 40,000 members and is based in Austin, Texas. This organization, as well as others, can provide future fraud training. In addition, the ACFE will provide its educational materials free of charge to institutions of higher learning that agree to offer a three-hour course entitled "Fraud Examination." These materials include several original videos related to fraud detection and prevention. A complete listing of the ACFE's materials and other information can be found at the association's Web site at www.acfe.com.

New to This Edition

For our fourth edition, we have added enhancements and updates that will help you better understand the significance of fraud in the modern business world. In this revision, there has been a significant amount of changes to each chapter:

- *In Part 1 of the textbook, we introduce students to new frauds such as the Madoff Scandal in Chapter 1. All chapters in Part 1 have introduced new references, inserted additional learning objectives, updated all statistics (including information about the COSO report in Chapter 2), added a new section on the ACFE, added additional end-of-chapter questions, and overall increased readability and layout of each chapter in the first part of the book. Also, the Red Hat section in Chapter 3 has been moved to create Appendix A.*
- *Parts 2 and 3 of the textbook also contains new learning objectives, new references, new statistics, and increased readability and layout of the chapters. Chapter 6 contains new updates to reflect the current state of technology and software packages. The technology assignments in Chapter 6 have been revised to be compatible with the student version of ACL.*
- *Chapters 7–10 in Part 4 contain information on the most recent software for detecting fraud, updates to the public record search sites, and we updated the FBI information with the most recent data available. All chapters have also undergone significant changes to certain sections to improve readability. As with the previous chapters, additional end-of-chapter questions and references have also been added.*
- *Part 5 contains new cases and has changed the main fraud case from Rite Aid to Enron in order to present students with a more widely known financial statement fraud case. It also contains a discussion of the subprime lending crisis,*

Lehman Brothers and the Satyam frauds, and provides more current evidence of the problem of financial statement fraud. Chapter 17 contains new examples from recent events and surveys. This chapter also discusses changes in technology which present new challenges to fraud detection and prevention. New cases help students familiar with mobile platforms and social networks see fraud from these perspectives.

- *Overall, the textbook contains several new cases that detail recent frauds and many of the former cases were reworked in order to make them more understandable for students.*

Featured Topics by Chapter

In this book, we cover seven different topics:

- *Part 1, comprising Chapters 1, 2, and 3, provides an introduction to fraud and an overview of the fraud problem. Chapter 1 discusses the nature of fraud, Chapter 2 describes fraud perpetrators and their motivations for being dishonest, and Chapter 3 provides an overview of the different ways to fight and, hopefully, reduce fraud.*
- *The second and third parts of the book focus on fraud prevention (Chapter 4) and fraud detection (Chapters 5 and 6.) Chapter 5 provides an overview of and discusses traditional fraud detection methods, while Chapter 6 introduces you to the use of technology to proactively detect fraud.*
- *Part 4 covers the various elements of fraud investigation. In Chapter 7, we cover theft act investigation methods; in Chapter 8, we cover concealment investigation methods; in Chapter 9, we discuss conversion investigative methods; and in Chapter 10, we cover various types of interviewing and other query approaches to investigating fraud. The interview techniques you learn in Chapter 10 will make you a more discerning husband or wife, parent, manager, employee, or friend.*

  Parts 5 and 6 discuss the various types of fraud. In Part 5, we include three chapters on management, or financial statement, fraud. In Chapter 11, we provide an overview of financial statement fraud and introduce a proactive model for detecting fraud and errors in the financial statements. In Chapter 12, we discuss both revenue- and inventory-related frauds, the two most common ways to intentionally misstate financial statements. In Chapter 13, we discuss three other types of financial statement frauds: understating liabilities and expenses, overstating assets, and inadequate disclosures. These chapters will help you better understand and critique the financial statements of any organization.
- *In Part 6, we discuss four other types of fraud. Chapter 14 covers fraud committed against organizations by employees, vendors, and customers. Chapter 15 covers consumer fraud, a chapter that will have immediate relevance to you and will alert you to the fraud exposures you face every day. Chapter 16 introduces divorce, tax, and bankruptcy fraud, all of which are very common because people often try to hide assets from those who want to take them away—the government in the case of taxes and others in the cases of divorce and bankruptcy. Chapter 16 also covers money laundering frauds. Chapter 17 discusses e-business frauds, a growing type of fraud problem because of the increasing use of the Internet to conduct business.*
- *The final part in the book—Chapter 18—discusses options that victims have when deciding how to follow-up on frauds they experience. This chapter provides an overview of the criminal and civil statutes governing fraud legal proceedings and helps you understand the various ways organizations have to resolve dishonest acts.*

We realize that there are many other fraud-related topics that we could have included. We have tried to strike a balance between brevity and topics of general interest and detailed investigation and specific knowledge that experienced professional fraud examiners would need. We also realize that, for most of you, this book will be used in the only fraud-related course you will take in your college studies. We are certain, however, that studying fraud will be one of your most exciting courses and will spark an interest that will stimulate career-changing plans for many of you. At a minimum, after studying fraud examination, you should be a much more careful investor and business decision maker. You will never view business transactions or reports the same way, and you will be a much more careful and skeptical observer and participant in future endeavors.

We are excited to share this exciting topic with you. We wish you success and enthusiasm as you study this book, and we welcome suggestions for improvement.

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Chad O. Albrecht, D.E.A.[1]
Conan C. Albrecht, Ph.D.
Mark F. Zimbelman, Ph.D., CPA (inactive)

[1] D.E.A.—Diploma de Estudios Advanzados or First Doctoral Degree. The D.E.A. is similar to the British Master of Philosophy or the French Diploma D'etudes Approfondies.

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FRAUD
MONEY
INTERNET
ENRON
TRANSFER
LANCE ARMSTRONG
MORTGAGE FRAUD
DODD-FRANK
MOZILO
FINANCIAL STATEMENT FRAUD
ONLINE
FAKE
SCAMS
LEHMAN
MADOFF
WORLDCOM
CASH
PONZI
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FRAUDSTERS
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E-MAIL
PAY
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INSIDER TRADING
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AGENT
WEB
SELLER
INDIVIDUALS
SOON
SHIPPED
SCAMMER
POSTAL
WEBSITE
CHARGES
PICK
NOW
VICTIM
CRIMINALS
WESTERN UNION
PERSON
INTERNATIONAL
ALSO
ORDER
PRODUCTS
KNOW
DATING
PAYMENTS
PHONE
MANY
VICTIMS
TWO

CHAPTER 1

The Nature of Fraud

TO THE STUDENT

With this chapter, you are embarking on an exciting journey of the study of fraud. Many of you will find this course more interesting than any other course you have taken before. Chapter 1 will provide an overview of fraud—what is fraud, how serious is the problem, fraud-fighting careers, criminal and civil laws, and other overview topics.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- **Understand the seriousness of fraud and how fraud affects individuals, consumers, organizations, and society.**
- **Define fraud.**
- **Understand the different types of fraud.**
- **Understand the difference between fraud committed *against an* organization and fraud committed *on behalf* of an organization.**
- **Understand the difference between criminal and civil fraud laws.**
- **Understand the types of fraud-fighting careers available today.**

On December 11, 2008, the Federal Bureau of Investigation (FBI) arrested Bernard "Bernie" Madoff for perpetrating the single largest investment fraud in the history of the world. A day earlier, Madoff's own sons had turned him in, reporting to authorities that Madoff's wealth management business was not a legitimate business but was a shell company for a large scam. On March 12, 2009, Madoff pled guilty to 11 federal crimes and admitted to operating the largest Ponzi scheme in history. On June 29, 2009, he was sentenced to 150 years in prison and ordered to make restitution payments of $17 billion.

Madoff was born in Queens, New York, and later graduated from Hofstra College in 1960. After college, he dedicated himself to building his firm, Bernard L. Madoff Investment Securities, where he remained until his arrest in 2008. Throughout his career, Madoff became one of the most respected and trusted individuals on Wall Street, serving both as Chairman of the Board of Directors and on the Board of Governors of the NASD (National Association of Securities Dealers). Madoff was also actively engaged in creating the technology that eventually became the NASDAQ stock exchange.

Madoff perpetrated his scheme by consistently providing high returns for his investors. Madoff claimed that he was able to provide such returns by investing in what is known as a split-strike conversion strategy. A split-strike conversion strategy is a complicated investment where investors take a long position in equities together with a short call and a long put on an equity index to lower the volatility of the position.[1,2] While the entire split-strike conversion strategy may seem very elaborate, the strategy was nothing more than a tool employed by Madoff to attract additional investors to his large Ponzi scheme.

A Ponzi scheme is a type of fraud that lures investment funds from victims and then pays those victims a premium or interest from money that is paid by subsequent investors.[3] Without intervention, Ponzi schemes will continue to grow until new recruits become unavailable, at which time, the scam breaks down and is discovered.

Individuals throughout the world lost money in Madoff's pyramid scheme.[4] While many of the victims were blue-collared workers who came from humble backgrounds, others were extremely wealthy. For example, Prince Michel of Yugoslavia traveled across Europe to raise money for Madoff. Other victims included various royal families and even London's House of Lords. Actor Kevin Bacon and producer Steven Spielberg, as well as various other Hollywood movie stars, had invested with Madoff. Because Madoff had connections with the Jewish community, many Jewish charities and institutions lost a significant amount of money in the scam.[5]

Seriousness of the Fraud Problem

Bernard Madoff is an example of an individual who misrepresented himself and his company to commit fraud. Investment fraud, like the fraud committed by Bernard Madoff, is just one of the many types of frauds that present major problems for businesses and consumers throughout the world.

Although most people and even most researchers believe that fraud is increasing both in size and frequency, it is difficult to know for sure.[6] First, it is impossible to know what percentage of fraud **perpetrators** are caught. Are there perfect frauds that are never detected, or are all frauds eventually discovered? In addition, many frauds that are detected are quietly handled by the victims and never made public. In many cases of employee fraud, for example, companies merely hide the frauds and quietly terminate or transfer perpetrators rather than make the frauds public. Companies and individuals who have been defrauded are often more concerned about the embarrassment of making frauds public, and the costs of investigating fraud, than they are about seeking justice and punishing fraud perpetrators.

Statistics on how much fraud is occurring, whether it is increasing or decreasing, and how much the average fraud costs come from four basic sources.

1. Government agencies—Agencies such as the FBI, FDIC, IRS, and various other agencies publish fraud statistics from time to time, but these organizations only publish those statistics that are directly related to their **jurisdictions**. As a result, their statistics are not complete and do not provide a total picture of fraud—even in the areas for which they have responsibility.
2. Researchers—Researchers often conduct studies about particular types of fraud within certain industries. Unfortunately, data on actual frauds are hard to obtain and, as a result, most research only provides small insights into the magnitude of the problem, even in the specific areas being studied. Comprehensive research on the occurrence of fraud is rare and is not always based on sound scientific approaches.
3. Insurance companies—Insurance companies often provide fidelity bonding or other types of coverage against employee and other fraud. When fraud occurs, they undertake investigations and, as a result, collect some fraud statistics. Generally, however, their statistics relate only to actual cases where they provided employee bonding or other insurance. At best, their analysis of the problem is incomplete.
4. Victims of fraud—Sometimes we learn about fraud from those who have been **victims**. In almost all industries, there is no organized way for victims to report fraud and, even if there were, many companies would choose not to make their fraud losses public.

The **Association of Certified Fraud Examiners (ACFE)**, the world's largest anti-fraud organization with approximately 70,000 members (see www.acfe.com), regularly conducts one of the most comprehensive fraud studies in the United States. First conducted in 1996 and then conducted again in 2002, 2004, 2006, 2008, 2010, and 2012, the ACFE study, also known as the *Report to the Nations on Occupational Fraud & Abuse*, is based on actual fraud cases reported by certified fraud examiners (CFEs) who investigate the frauds.

The 2012 study estimates that organizations lose roughly 5 percent of their annual revenues to fraud. Applied to the 2011 Gross World Product, this 5 percent figure translates to a projected global fraud loss of $3.5 trillion. The median loss caused by the occupational fraud cases in their study was $140,000 with more than one-fifth of all cases causing losses of at least $1 million.

Even with the difficulties in measuring fraud, most people believe that fraud is a growing problem. Both the numbers of frauds committed and the total dollar amounts lost to fraud seem to be increasing.[7] In the past few years alone, we have seen huge frauds both in the form of the largest-ever investment scam committed by Bernard Madoff as well as the massive frauds in the mortgage and insurance industries that contributed to the world's economic decline.[8]

Because fraud affects how much we pay for goods and services, each of us pays not only a portion of the fraud bill but also for the detection and investigation of fraud. It is almost impossible to read a newspaper or business magazine without coming across multiple incidents of fraud.

Even more alarming than the increased number of fraud cases is the size of discovered frauds. In earlier times, if a perpetrator wanted to steal from his or her employer, he or she only had to physically remove the assets from the business premise. Because of fear of being caught with the goods, frauds tended to be small. With the advent of computers, the Internet, and complex accounting systems, perpetrators now need only to make a telephone call, misdirect purchase invoices, bribe a supplier, manipulate a computer program, or simply push a key on the keyboard to misplace company assets.[9] Because physical possession of stolen property is no longer required and because it is just as easy to program a computer to embezzle $1 million as it is $1,000, the size and number of frauds have increased tremendously.

In addition, as companies have given in to the pressures to meet Wall Street's earnings expectations and as these pressures to "meet the numbers" have intensified, some very large financial statement frauds have been committed. Hundreds of million- and even billion-dollar frauds are not unusual and, in some cases, the market value of the company's stock has declined by billions of dollars.

To understand how costly fraud is to organizations, consider what happens when fraud is committed against a company. Losses incurred from fraud reduce a firm's income on a dollar-for-dollar basis. This means that for every $1 of fraud, the **net income** of the firm is reduced by $1. Since fraud reduces net income, it takes significantly more **revenue** to recover the effect of the fraud on net income. To illustrate, consider the $436 million fraud loss that a large U.S. automobile manufacturer experienced a few years ago.[10] If the automobile manufacturer's **profit margin** (net income as a percentage of revenues) at the time was 10 percent, the company would have to generate up to $4.36 billion in additional revenue (or 10 times the amount of the fraud) to restore net income to what it would have been without the fraud. If we assume an average selling price of $20,000 per car, the company must make and sell an additional 218,000 cars to make up for the fraud. Considered this way, fighting fraud is serious business. The automobile company can spend its efforts in manufacturing and marketing additional new cars, or reducing fraud, or a combination of both. One of the authors consulted with the company after this fraud occurred. His advice to the top executives of the company (the management committee) was "You don't have a fraud problem; rather, you have a business problem. You can either stop these types of fraud from occurring or you can make and sell hundreds of thousands of additional cars. The effect on net income is the same." Viewed this way, the executives decided that, indeed, fraud was a serious business problem.

As another example, consider the case of a large bank that was the victim of several frauds that totaled approximately $100 million in one year alone. With a profit margin of 5 percent, and assuming that the bank made $100 per checking account per year, how many new checking accounts must the bank generate to compensate for the fraud losses? The answer, of course, is up to 20 million new checking accounts ($100 million fraud loss/0.05 = $2 billion in additional revenues; $2 billion/$100 per account = 20 million new accounts).

Firms are not the only victims of fraud. In the aggregate, national economies also suffer from large-scale fraud and corruption. If we use the logic described in the case of the automobile manufacturer described earlier, we can better understand how, from a macrolevel, countries suffer from fraud. Take, for example, three different economies. If Economy A, whose profit margin is 10 percent, loses $500 million to fraud, it must generate $5 billion of additional revenue to offset the loss to net income. If Economy B, whose profit margin is also 10 percent, loses $200 million to fraud, it must generate an additional $2 billion. Finally, if Economy C, whose profit margin is 5 percent, loses $100 million to fraud, it must also generate an extra $2 billion. The strain fraud imposes on economies throughout the world is tremendous. If just one fraud is prevented, billions of dollars can be saved—resources that can be reinvested in building the economy. Given this analysis, it is easy to see how difficult it is for countries with high amounts of corruption to ever compete with countries with low rates of corruption. High-corruption countries are constantly trying to overcome fraud losses, while low-corruption countries are growing and moving ahead. As a result, many honest economists, politicians, and regulators spend a considerable amount of time and resources trying to reduce fraud.

In addition to the actual reduction of a country's total GDP, the amount of fraud an economy suffers has a big impact on how willing investors are to invest in a given economy. When fraud and corruption levels are high in a country, for example, investors lose confidence in the integrity of the country and become more hesitant to invest resources. The same is true with organizations. After the revelations of corporate wrongdoing in the early 2000s in the United States, for example, foreign investors' purchases of U.S. stocks dropped to $49.5 billion, the lowest level since 1996. Whether these foreign investors' funds moved to stocks in other economies that were deemed safer or whether investors decided to stand on the sidelines and wait out the corporate scandals is not clear. What is clear is that the U.S. economy was significantly hurt by the fraudulent acts at Enron, WorldCom, and others.

Because of different cost/revenue structures, the amount of additional revenues a firm must generate to recover fraud losses varies from firm to firm, from industry to industry, and from country to country. However, it is easy to see that in order to maximize profits, eliminating fraud should be a key goal of every organization or country. The best way to minimize fraud is to prevent it from occurring. In this book, we will cover fraud prevention, as well as fraud detection and investigation.

Remember this …

Statistics about how much fraud is occurring are difficult to get. However, all signs indicate that fraud is increasing both in frequency and amount. Fraud is very costly to organizations and to economies. Because fraud reduces net income on a dollar-for-dollar basis, the amount of additional revenue needed to restore the stolen funds is many multiples of the amount of the fraud.

What Is Fraud?

There are two principal methods of getting something from others illegally. Either you physically force someone to give you what you want (using a gun, knife, or other weapon), or you trick them out of their assets. We call the first type of theft robbery or armed robbery, and the second type **fraud**. Robbery is generally more violent and more traumatic than fraud and usually attracts much more media attention, but losses from fraud far exceed losses from robbery.

Although there are many formal definitions of fraud, probably the most common is the following:

> *Fraud is a generic term, and embraces all the multifarious means which human ingenuity can devise, which are resorted to by one individual, to get an advantage over another by false representations. No definite and invariable rule can be laid down as a general proposition in defining fraud, as it includes surprise, trickery, cunning and unfair ways by which another is cheated. The only boundaries defining it are those which limit human knavery.*[11]

Fraud is deception that includes the following elements:

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

CAUTION *Who is in the best position to "con" you right now? Who is in the best position to "con" your parents? Remember, it is always those you "trust most" who are in the best position to con you or commit fraud.*

Fraud is different from unintentional errors. If, for example, someone mistakenly enters incorrect numbers on a **financial statement**, is this fraud? No, it is not fraud because it was not done with *intent* or for the purpose of gaining advantage over another through false pretense. But, if in the same situation, someone purposely enters incorrect numbers on a financial statement to trick investors, then it *is* fraud!

As was discussed in the beginning of this chapter, one of the most common types of fraud today is a scam that lures investment funds from victims and then pays those victims a premium or interest from money that is paid by subsequent investors. This popular fraud scheme, also known as a Ponzi scheme, was named after Charles Ponzi who perpetrated a large scam in the early 1900s. To better understand fraud in general, let's take a closer look at Charles Ponzi.

Charles Ponzi and the Famous Ponzi Scheme

Carlo "Charles" Ponzi was born in Parma, Italy, in 1882 and then emigrated to the United States in November 1903. Over the next 14 years, Ponzi wandered from city to city and from job to job. He worked as a dishwasher, waiter, store clerk, and even as an Italian interpreter. In 1917, he settled in Boston where he took a job typing and answering foreign mail. It was in Boston in 1919 that Ponzi discovered the mechanism that he thought would make both him and his investors very wealthy.[12]

At the time, Ponzi was considering publishing an export magazine. He had written a letter about the proposed publication to a gentleman in Spain, and when Ponzi received his reply, the man had included an international postal reply coupon. The idea behind this enclosure was quite simple. Ponzi was to take the coupon to his local post office and exchange it for American postage stamps. He would then use those American stamps to send magazines to Spain.

Ponzi noticed that the postal coupon had been purchased in Spain for about one cent in American funds. Yet, when he cashed it in, he was able to get six American one-cent stamps. Immediately, Ponzi started to consider the many possibilities to invest. Assuming this was possible, he could buy $100 worth of stamps or coupons in Spain and he could then cash in or sell the stamps to a third party. In the early 1900s, just like today, it was impossible to get this kind of interest in a bank.[13]

Ponzi's mind quickly went into overdrive and he devised a clever scheme to capitalize on his idea. He was determined to be a rich man. His first step was to convert his American money into Italian lire (or any other currency where the exchange rate was favorable). Ponzi's foreign agents would then use these funds to purchase international postal coupons in countries with weak economies. The stamp coupons were then exchanged back into a favorable foreign currency and finally back into American funds. He claimed that his net profit on all these transactions was in excess of 400 percent.

Was he really able to do this? The answer is "no." The red tape of dealing with the various postal organizations, coupled with the long delays in transferring currency, ate away at all of Ponzi's imagined profits.

However, a failed scheme couldn't keep Ponzi from bragging about his great idea. As a result, friends and family members understood what he was saying, and they wanted in on the investment.

On December 26, 1919, Ponzi filed an application with the city clerk establishing his business as The Security Exchange Company. He promised 50 percent interest in 90 days, and the world wanted in. However, personally he claimed to be able to deliver on his promise in just 45 days. This, of course, translates into doubling investors' money in just 90 days.

Word spread very quickly about Ponzi's great idea, and within a few short months, the lines outside the door of his School Street office began to grow. Thousands of people purchased Ponzi promissory notes at values ranging from $10 to $50,000. The average investment was estimated to be about $300, a large sum of money in the 1920s.

Why would so many people invest in a scheme that didn't work? The real reason was that the early investors did see the promised returns on their money. Ponzi used the money from later investors to pay off his earlier obligations. It was a new twist on the age-old pyramid scheme.

With an estimated income of $1,000,000 per week at the height of his scheme, his newly hired staff couldn't take in the money fast enough. They were literally filling all of the desk drawers, wastepaper baskets, and closets in the office with investors' cash. Branch offices opened, and copycat schemes popped up across New England.

By the summer of 1920, Ponzi had taken in millions and started living the life of a very rich man. Ponzi dressed in the finest suits, had dozens of gold-handled canes, showered his wife in fine jewelry, and purchased a 20-room Lexington mansion.

Any get-rich scheme is certain to attract the attention of the law, and Ponzi's was no exception. From the start, federal, state, and local authorities investigated him. Yet, no one could pin Ponzi with a single charge of wrongdoing. Ponzi had managed to pay off all of his notes in the promised 45 days and, since everyone was happy to get their earnings, not a single complaint had ever been filed.

On July 26, 1920, Ponzi's house of cards began to collapse. The *Boston Post* headlined a story on the front page questioning the legitimacy of Ponzi's scheme. Later that day, the district somehow convinced Ponzi to suspend taking in new investments until an auditor examined his books. Within hours, crowds of people lined up outside Ponzi's door demanding that they get their investment back. Ponzi obliged and assured the public that his organization was financially stable and that he could meet all obligations. He returned the money to those who requested it. By the end of the first day, he had settled nearly 1,000 claims with the panicked crowd.

By continuing to meet all of his obligations, the angry masses began to dwindle and public support swelled. Crowds followed Ponzi's every move. He was urged by many to enter politics and was hailed as a hero. Loud cheers and applause were coupled with people eager to touch his hand and assure him of their confidence.

Because of the additional attention, Ponzi dreamed of opening more investments. For example, Ponzi began to make plans to establish a new type of bank where the profits would be split equally between shareholders and depositors. Ponzi also planned to reopen his company under a new name, the Charles Ponzi Company, whose main purpose was to invest in industries throughout the world.

The public continued to support Ponzi until August 10, 1920. On this date, the auditors, banks, and newspapers declared that Ponzi was indeed bankrupt. Two days later, Ponzi confessed to serving 20 months in a Canadian prison in 1908 on forgery charges related to a similar high-interest scheme followed by an additional two-year sentence in Atlanta, Georgia, for smuggling five Italians over the Canadian border into the United States.

On August 13, Ponzi was finally arrested by federal authorities and released on $25,000 bond. Just moments later, he was rearrested by Massachusetts authorities and re-released on an additional $25,000 bond.

Following his arrest, there were federal and state civil and criminal trials, bankruptcy hearings, suits against Ponzi, suits filed by Ponzi, and the ultimate closing of five different banks. An estimated 40,000 people had entrusted an estimated $15 million (about $140 million in U.S. funds today) in Ponzi's scheme. A final audit of his books concluded that he had taken in enough funds to buy approximately 180 million postal coupons, of which authorities could only actually confirm the purchase of two.

Ponzi's only legitimate source of income was $45 that he received as a dividend of five shares of telephone stock. His total assets came to $1,593,834.12, which didn't come close to paying off the outstanding debt. It took about eight years, but noteholders were able to receive an estimated 37 percent of their investment returned in installments.

Ultimately, Ponzi was sentenced to five years in federal prison. After three years in prison, Ponzi was sentenced to an additional seven to nine years by Massachusetts' authorities. However, Ponzi was released on $14,000 bond pending an appeal and disappeared the following month.

Ponzi turned up a short time later in Florida under the assumed name of Charles Borelli. Again, Ponzi was involved in a pyramid land scheme by purchasing land at $16 an acre, subdividing it into 23 lots, and selling each lot for $10 a piece. He promised all investors that their initial $10 investment would translate into $5.3 million in just two years. Unfortunately, much of the land was under water and worthless.

Ponzi was again indicted for fraud and sentenced to one year in a Florida prison. Once again, Ponzi jumped bail and was later found in Texas. Ponzi hopped a freighter headed for Italy but was captured on June 28 in a New Orleans port. On June 30, he sent a telegram to President Calvin Coolidge asking to be deported. Ponzi's request was denied, and he was sent back to Boston to complete his jail term. After seven years, Ponzi was released on good behavior and deported to Italy on October 7, 1934. Back in Rome, Ponzi became an English translator. Mussolini then offered Ponzi a position with Italy's new airline, and he served as the Rio de Janeiro branch manager from 1939 to 1942. Ponzi discovered that several airline officials were using the carrier to smuggle currency, and Ponzi wanted a cut. When they refused to include him, he tipped off the Brazilian government. World War II brought about the airline's failure, and Ponzi found himself unemployed.

Ponzi died in January 1949 in the charity ward of a Rio de Janeiro hospital. He left behind an unfinished manuscript appropriately titled *The Fall of Mister Ponzi*.

Fraud, Greed, Deception, and Confidence

Ponzi's scam is extremely helpful in understanding fraud. Certainly, the scheme involved deception. It also involved greed by the *perpetrator* and—this is important—greed by the *investors*, who wanted higher-than-sensible returns. Finally, Ponzi's scheme involved the element of *confidence*. If he had not paid returns to original investors, no one would have invested additional money. By paying early "returns," Ponzi gained investors' confidence and convinced them that he had a legitimate business. In fact, confidence is the single most critical element for fraud to be successful. (The word "con," which means to deceive, comes from the word "confidence.") It is difficult to con anyone out of anything unless the deceived has confidence in the deceiver. We cannot be conned unless we trust the person trying to deceive us. Similarly, employers cannot con employees if they do not have their employees' trust and confidence. And, without investor confidence, fraudulent companies cannot con unsuspecting investors.

The following scenario illustrates the role that confidence plays in committing fraud:

> *Two men enter a bank. One is dressed in a business suit and is well groomed. The second has scraggly hair, has tattoos up and down both arms, is wearing tattered jeans, and is carrying a motorcycle helmet under his arm. Based on the probably unfounded categorization of these two individuals by most people in society, which one do you think is in the best position to successfully con a teller?*

Most of us would agree that the man in the business suit is in a better position to defraud the bank. He is, simply put, much more likely to be trusted, stereotypes being what they are. Most people would argue that the scraggly fellow is unlikely to pull off a successful fraud because the bank employees would be less likely to trust him, at least initially.

One common response of fraud victims is disbelief: "I can't believe she would do this. She was my most trusted employee … Or my best customer … Or my best friend." Someone who understands fraud will sadly tell you, "What else could they be? They wouldn't have succeeded *without* your trust!" Indeed, fraud perpetrators are often the least suspected and the most trusted of all the people with whom victims associate.

One company's research revealed that its largest group of fraud perpetrators is comprised of people between the ages of 36 and 45.[14] The statistics don't tell us *why* this is the case, but we assume that this age group includes managers who have worked themselves into positions of trust. In addition, they are probably the group with the highest financial pressures. When young people graduate from college, they look ahead and think, "By the time I'm 40, I'll have my house and cars paid off and have savings to pay for my children's college." But, when many people reach 40, their houses and cars are mortgaged to the hilt and they have no savings to pay for their children's college. During this same time frame (36–45), people are also better positioned in their careers to commit fraud. As we will discuss in future chapters, any time opportunity and pressures are present, the probability of fraud increases.

> **Remember this …**
>
> *Fraud involves all deceptive ways in which one individual obtains an advantage over another by false representations. Fraud always involves confidence and trickery. Fraud is different than robbery where force is almost always used.*

STOP & THINK *Why is it more difficult to tell if someone can be trusted on the Internet than in person?*

Types of Fraud

While there are many ways to classify the various types of fraud, the most common way is to simply divide frauds into those that are committed *against* organizations and those that are committed *on behalf* of organizations.

In employee fraud, for example—fraud committed against an organization—the victim of the fraud is the employee's employer.[15] On the other hand, with financial statement fraud, for example, executives usually commit fraud "on behalf" of an organization,[16] usually to make the company's reported financial results look better than they actually are. In this case, the executives