

CORPORATE FRAUD HANDBOOK

**Prevention
and Detection**

THIRD EDITION

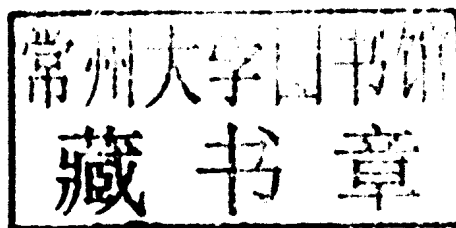
JOSEPH T. WELLS

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Prevention and Detection

Third Edition

Joseph T. Wells



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*To my loving wife,
Judy Gregor Wells*

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Preface

As I wrote in my fifth book, *Occupational Fraud and Abuse*, few people begin their careers with the goal of becoming liars, cheats, and thieves. Yet that turns out to be the destiny of all too many. Corporate fraud and abuse—as we have seen in such headline-grabbing cases as Enron, WorldCom, Parmalat, and Tyco—costs organizations billions and billions annually. The losses in human terms are incalculable.

The Corporate Fraud Handbook: Prevention and Detection is for those whose job it is to reduce these losses: fraud examiners, auditors, investigators, loss prevention specialists, managers and business owners, criminologists, human resources personnel, academicians, and law enforcement professionals, among others.

There are four broad objectives of this work:

1. To detail a classification system to explain the various schemes used by executives, owners, managers, and employees to commit these offenses
2. To quantify the losses from these schemes
3. To illustrate the human factors in fraud
4. To provide guidance in preventing and detecting occupational fraud and abuse

How this book came about is a story in itself. As improbable as it seems looking back, I am well into my fourth decade in the field of fraud detection and deterrence. Like many of you, my career path did not start where it ended up. In the third grade, I distinctly remember pledging to be an astronomer. But by college, quantum physics had proved my undoing. Just a few credits shy of a math/physics degree, I switched to business school and majored in accounting.

After two years toiling in the ledgers of one of the large international auditing firms, I decided I could not stand it anymore; my life had to have more excitement. So I became a real-life, gun-toting FBI agent. Thankfully, I did not have to use my pistol too many times to track down heinous robbers. And I learned in a hurry that the expensive crimes were not the bank robberies, anyhow—they were the bank embezzlements. For the next nine years, I specialized exclusively in investigating a wide range of white-collar crimes in which the federal government was a party at interest. The cases ran the gamut, from nickel-and-dime con artists to Watergate.

My second decade was with Wells & Associates, a group of consulting criminologists concentrating on white-collar crime prevention, detection, and education. That eventually led to the formation of a professional organization, the Association of Certified Fraud Examiners. For 23 years, I have been chairman of the Board of Directors. I hope to spend the remainder of my professional career with what I have discovered to be my secret love: writing.

The Corporate Fraud Handbook: Prevention and Detection has its genesis in *Occupational Fraud and Abuse*. At the time, I was intrigued by the definition of “fraud” as classically set forth in *Black’s Law Dictionary*:

All multifarious means which human ingenuity can devise, and which are resorted to by one individual to get an advantage over another by false suggestions or suppression of the truth. It includes all surprise, trick, cunning or dissembling, and any unfair way by which another is cheated.

This definition implied to me that there was an almost unlimited number of ways people could think up to cheat one another. But my experience told me something else: After investigating and researching literally thousands of frauds, they seemed to fall into definite patterns. If we could somehow determine what those patterns were and in what frequency they occurred, it would aid greatly in understanding and ultimately preventing fraud. And since so much fraud occurs in the workplace, this particular area would be the starting point.

So I began a research project with the aid of over 2,000 certified fraud examiners (CFEs). They typically work for organizations in which they are responsible for aspects of fraud detection and deterrence. Each CFE provided details on exactly how their organizations were being victimized from within. That information subsequently was summarized in a document for public consumption, the *1996 Report to the Nation on Occupational Fraud and Abuse*. Since that time, the report has been published on five occasions, the latest being in 2010.

Although the reports provide a basic framework, this book is intended for a different audience—those of you who need to know all the details. You will discover that while fraud may outwardly seem complex, it rarely is. You do not need an accounting degree—just an understanding of fundamental business procedures and terminology. As the saying could go, fraud ain’t rocket science.

Rather than an unlimited number of schemes, this book suggests that occupational fraud and abuse can be divided into three main categories: asset misappropriation, corruption, and fraudulent statements. From the three main categories, there are several distinct schemes identified and classified, and they are covered in detail herein.

The book begins with an overview of the complex social factors that go into creating an occupational offender. People do things for a reason, and understanding why employees engage in this behavior is the key to creating ways to prevent it. You will therefore find these pages rich in personal detail.

Following the introduction, the book is divided into chapters devoted to the specific occupational fraud and abuse schemes. Each of the chapters is organized similarly. First, a case study provides insights. Next, the scheme itself is flowcharted

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and the scheme variations are scheduled, along with statistics for each method. Finally, observations and conclusions on each chapter will help in devising prevention and detection strategies.

A project such as this is not a solo venture, even though I accept final responsibility for every word, right or wrong. I must first gratefully acknowledge the thousands of CFEs who provided the case examples. I am especially appreciative of the efforts of John Warren and Dawn Taylor, who did much of the detailed research. Jim Ratley, Jeanette LeVie, John Gill, Andi McNeal, and Nancy Bradford merit special recognition. Mary-Jo Kranacher provided invaluable guidance in Chapters 12 and 13. Several writers assisted in preparing case studies: Michael C. Burton, Sean Guerrero, Brett Holloway-Reeves, Katherine McLane, Suzy Spencer, and Denise Worhach.

Special thanks go to the CFEs and other professionals who furnished details of their cases: Bradley Brekke, CFE; Anthony J. Carriuolo, Esq.; H. Craig Christiansen, CFE, CPA; Harvey Creem, CFE, CPA; Jim Crowe, CFE; Harry D'Arcy, CFE; Marvin Doyal, CFE, CPA; Tonya L. DiGiuseppe, CFE, CPA; Harold Dore, CFE, CIA; Stephen Gaskell, CFE; Gerald L. Giles, Jr., CFE, CPA; Paul Granetto; James Hansen, CFE; Paul Hayes, CFE; Charles Intriago, Esq.; Terry Isbell, CFE, CIA; Douglas LeClaire, CFE; Barry Masuda, CFE; Terrence McGrane, CFE, CIA; David McGuckin, CFE; David Mensel, CFE, CPA; Dick Polhemus, CFE; Trudy Riester, CFE; Lee Roberts, CFE; Peter Roman, CFE; James Sell, CFE, CPA; Harry J. Smith III, CFE, CPA; and Donald Stine, CFE, CPA.

Finally, I must thank the one person without whom these pages would not have been written. My wife, Judy, has endured countless weekends and early mornings alone while I sat at this keyboard. She has become accustomed to me jumping up in the middle of dinner to write down a new thought on a scrap of paper. And she has done every bit of it by cheering me on, never complaining. First to Judy Gregor Wells—then to those of you trying to make a better world by reducing fraud—this book is dedicated.

Joseph T. Wells
Austin, Texas
April 2011

About the ACFE

The Association of Certified Fraud Examiners (ACFE) is the world's largest antifraud organization and premier provider of anti-fraud training and education. Together with nearly 55,000 members, the ACFE is reducing business fraud worldwide and inspiring public confidence in the integrity and objectivity within the profession.

Established in 1988, with headquarters in Austin, Texas, the ACFE supports the profession by providing expert instruction, practical tools, and innovative resources in the fight against fraud. The ACFE hosts conferences and seminars year-round while offering informative books and self-study courses written by leading practitioners to help members learn how and why fraud occurs and to build the skills needed to fight it effectively. Members of the ACFE also have the ability to expand their antifraud knowledge and assert themselves in the antifraud community by obtaining the certified fraud examiner (CFE) credential. This globally preferred certification indicates expertise in fraud prevention, deterrence, detection, and investigation.

The ACFE oversees the CFE credential by setting standards for admission, administering the Uniform CFE Examination, and maintaining and enforcing the ACFE Code of Professional Ethics. CFEs on six continents have collectively investigated more than one million suspected cases of civil and criminal fraud.

The ACFE is also committed to providing educational resources to the academic community and has established the Anti-Fraud Education Partnership to address the unprecedented need for fraud examination education at the university level. In pursuit of this objective, the ACFE has provided free training and educational materials to institutions of higher learning throughout the world.

Criminologist and former FBI agent Dr. Joseph T. Wells, CFE, CPA, is chairman and founder of the ACFE as well as an advisory member of the Board of Regents. Dr. Wells writes, researches, and lectures to business and professional groups on fraud-related issues. He has won top writing awards from both the *Internal Auditor* and the *Journal of Accounting* magazines, and he is a winner of the Innovation in Accounting Education Award presented by the American Accounting Association. He was named to *Accounting Today* magazine's annual list of the "Top 100 Most Influential People" in accounting nine times. In 2010, for his contributions to the antifraud field, he was honored as a Doctor of Commercial Science by York College of the City University of New York.

ABOUT THE ACFE

Labeled “the premier financial sleuthing organization” by the *Wall Street Journal*, the ACFE has also been cited for its efforts against fraud by media outlets such as *U.S. News & World Report*, the *New York Times*, CNN, CNBC, *Fortune*, ABC-TV’s *Nightline* and *20/20*, and CBS News’ *60 Minutes*.

Further information about the ACFE is available at www.acfe.com, or (800) 245-3321.

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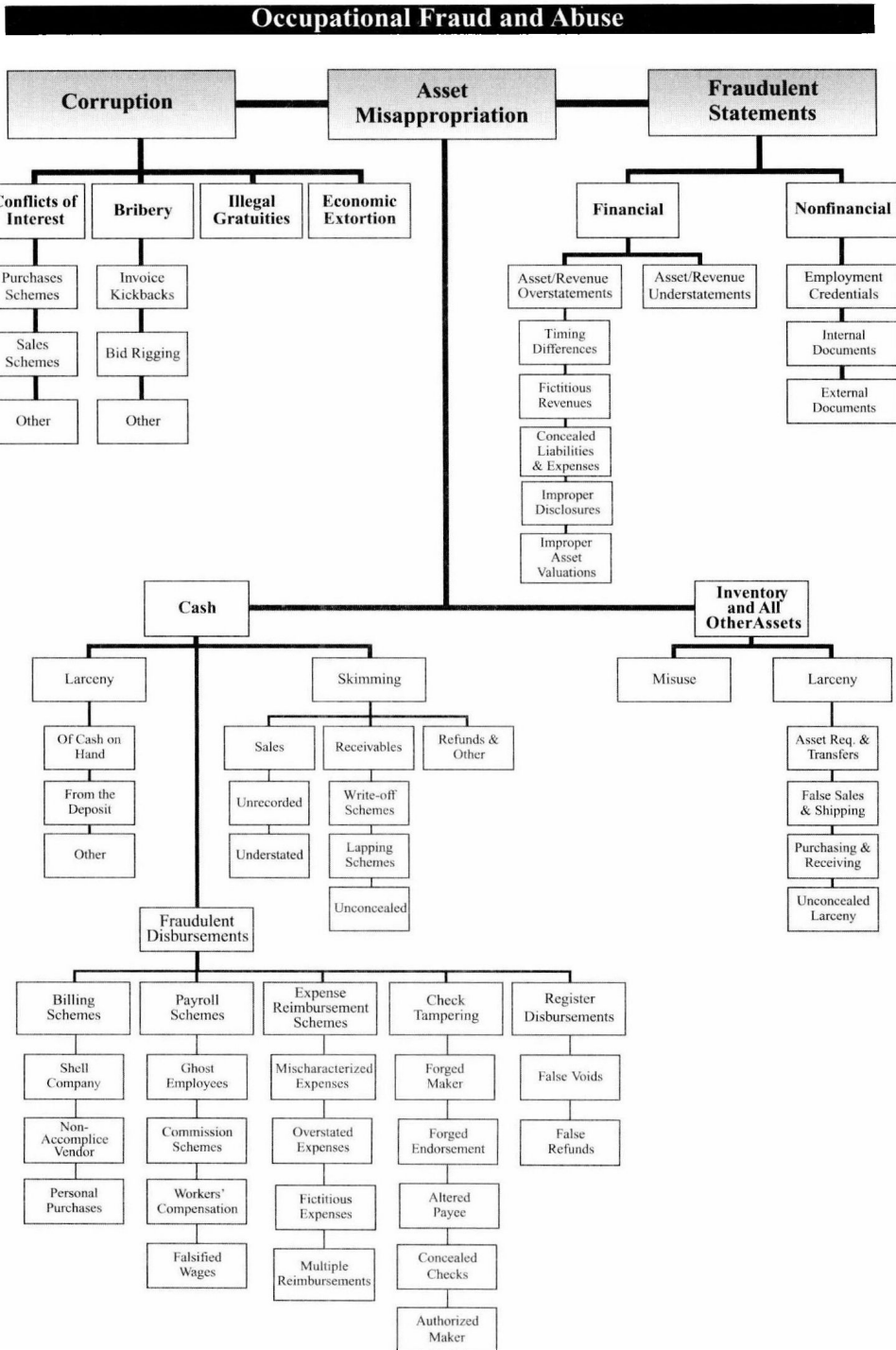
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Introduction



In the world of commerce, organizations incur costs to produce and sell their products or services. These costs run the gamut: labor, taxes, advertising, occupancy, raw materials, research and development—and, yes, fraud and abuse. The latter cost, however, is fundamentally different from the former: The true expense of fraud and abuse is hidden, even if it is reflected in the profit and loss figures.

For example, suppose the advertising expense of a company is \$1.2 million. But unknown to the company, its marketing manager is in collusion with an outside ad agency and has accepted \$300,000 in kickbacks to steer business to that firm. That means the true advertising expense is overstated by at least the amount of the kickback—if not more. The result, of course, is that \$300,000 comes directly off the bottom line, out of the pockets of the investors and the workforce.

DEFINING “OCCUPATIONAL FRAUD AND ABUSE”

The example just given is clear-cut, but much about occupational fraud and abuse is not so well defined, as we will see. Indeed, there is widespread disagreement on what exactly constitutes these offenses.

For purposes of this book, “occupational fraud and abuse” is defined as “the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.”¹

This definition’s breadth means that it involves a wide variety of conduct by executives, employees, managers, and principals of organizations, ranging from sophisticated investment swindles to petty theft. Common violations include asset misappropriation, fraudulent statements, corruption, pilferage and petty theft, false overtime, use of company property for personal benefit, and payroll and sick time abuses. As the first *Report to the Nation on Occupational Fraud and Abuse*, from 1996, states: “The key is that the activity (1) is clandestine, (2) violates the employee’s fiduciary duties to the organization, (3) is committed for the purpose of direct or indirect financial benefit to the employee, and (4) costs the employing organization assets, revenues, or reserves.”²

An “employee,” in the context of this definition, is any person who receives regular and periodic compensation from an organization for his or her labor. The term is not restricted to the rank and file but specifically includes corporate executives, company presidents, top and middle managers, and other workers.

Defining “Fraud”

In the broadest sense, fraud can encompass any crime for gain that uses deception as its principal modus operandi. Of the three ways to illegally relieve a victim of money—force, trickery, or larceny—all offenses that employ trickery are frauds. Since deception is the linchpin of fraud, we will include *Merriam-Webster’s* synonyms: “‘Deceive’ implies imposing a false idea or belief that causes ignorance, bewilderment, or helplessness; ‘mislead’ implies a leading astray that may or may not be intentional; ‘delude’ implies deceiving so thoroughly as to obscure the truth; ‘beguile’ stresses the use of charm and persuasion in deceiving.”

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Although all frauds involve some form of deception, not all deceptions are necessarily frauds. Under common law, four general elements must be present for a fraud to exist:

1. A material false statement
2. Knowledge that the statement was false when it was uttered
3. Reliance on the false statement by the victim
4. Damages as a result

The legal definition is the same whether the offense is criminal or civil; the difference is that criminal cases must meet a higher burden of proof.

Let us assume an employee did not deceive anyone but stole valuable computer chips while no one was looking and resold them to a competitor. Has he committed fraud? Has he committed theft? The answer, of course, is that it depends. Employees have a recognized fiduciary relationship with their employers under the law.

The term “fiduciary,” according to *Black’s Law Dictionary*, is of Roman origin and means

*a person holding a character analogous to a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires. A person is said to act in a “fiduciary capacity” when the business which he transacts, or the money or property which he handles, is not for his own benefit, but for another person, as to whom he stands in a relation implying and necessitating great confidence and trust on the one part and a high degree of good faith on the other part.*³

So, in our example, the employee has not only stolen the chips—in so doing, he has violated his fiduciary capacity. That makes him an embezzler.

*To “embezzle” means willfully to take, or convert to one’s own use, another’s money or property of which the wrongdoer acquired possession lawfully, by reason of some office or employment or position of trust. The elements of “embezzlement” are that there must be a relationship such as that of employment or agency between the owner of the money and the defendant, the money alluded to have been embezzled must have come into the possession of defendant by virtue of that relationship and there must be an intentional and fraudulent appropriation or conversion of the money.*⁴

In other words, embezzlement is a special type of fraud.
“Conversion,” in the legal sense, is

*an unauthorized assumption and exercise of the right of ownership over goods or personal chattels belonging to another, to the alteration of their condition or the exclusion of the owner’s rights. An unauthorized act which deprives an owner of his property permanently or for an indefinite time. Unauthorized and wrongful exercise of dominion and control over another’s personal property, to the exclusion of or inconsistent with the rights of owner.*⁵

So by stealing the chips, the employee also engages in conversion of the company's property.

The legal term for stealing is "larceny," which is

*felonious stealing, taking and carrying, leading, riding, or driving away with another's personal property, with the intent to convert it or to deprive the owner thereof. The unlawful taking and carrying away of property of another with the intent to appropriate it to a use inconsistent with the latter's rights. The essential elements of a "larceny" are an actual or constructive taking away of the goods or property of another without the consent and against the will of the owner and with a felonious intent. Obtaining possession of property by fraud, trick or device with preconceived design or intent to appropriate, convert, or steal is "larceny."*⁶

As a matter of law, the employee in question could be charged with a wide range of criminal and civil conduct: fraud, embezzlement, obtaining money under false pretenses, or larceny. As a practical matter, he probably will be charged with only one offense, commonly larceny.

"Larceny by fraud or deception" means that

*a person has purposely obtained the property of another by deception. A person deceives if he purposely: (1) creates or reinforces a false impression, including false impressions as to law, value, intention or other state of mind; but deception as to a person's intention from the act alone that he did not subsequently perform the promise; or (2) prevents another from acquiring information which would affect his judgment of a transaction; or (3) fails to correct a false impression which the deceiver previously created or reinforced, or which the deceiver knows to be influencing another to whom he stands in a fiduciary or confidential relationship; or (4) fails to disclose a known lien, adverse claim, or other legal impediment to the enjoyment of property which he transfers or encumbers in consideration for the property obtained, whether such impediment is or is not valid, or is or is not a matter of official record.*⁷

The fraudulent aspect of occupational frauds, then, deals with the employee's fiduciary duties to the organization. If those duties are violated, that action may be considered fraud in one of its many forms. Under the definition of occupational fraud and abuse in this book, the activity must be clandestine. *Black's* defines "clandestine" as "secret, hidden, concealed; usually for some illegal or illicit purpose."⁸

Defining "Abuse"

A litany of abusive practices plagues organizations. Here are a few of the more common examples of how employees "cost" their employers. As any employer knows, it is hardly out of the ordinary for employees to:

- Use employee discounts to purchase goods for friends and relatives.
- Take products belonging to the organization.
- Get paid for more hours than worked.

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- Collect more money than due on expense reimbursements.
- Take a long lunch or break without approval.
- Come to work late or leave early.
- Use sick leave when not sick.
- Do slow or sloppy work.
- Work under the influence of alcohol or drugs.

The term “abuse” has taken on a largely amorphous meaning over the years, frequently being used to describe any misconduct that does not fall into a clearly defined category of wrongdoing. *Merriam-Webster’s* states that the word “abuse” comes from the Latin word *abusus*—to consume—and that it means “1. A corrupt practice or custom; 2. Improper or excessive use or treatment: misuse; 3. A deceitful act: deception.”⁹

Given the commonality of the language describing both fraud and abuse, what are the key differences? An example illustrates: Suppose a teller was employed by a bank and stole \$100 from her cash drawer. We would define that broadly as fraud. But if the teller earns \$500 a week and falsely calls in sick one day, we might call that abuse—even though each has the exact same economic impact to the company—in this case, \$100.

And, of course, each offense requires a dishonest intent on the part of the employee to victimize the company. Look at the way each typically is handled within an organization, though: In the case of the embezzlement, the employee gets fired; there is also the remotest of probabilities that he will be prosecuted. In the case in which the employee misuses sick time, she *perhaps* gets reprimanded, or her pay is docked for the day.

But we also can change the “abuse” example slightly. Let us say the employee works for a governmental agency instead of in the private sector. Sick leave abuse—in its strictest interpretation—could be a fraud against the government. After all, the employee has made a false statement for financial gain (to keep from getting docked). Government agencies can and have prosecuted flagrant instances. Misuse of public money—in any form—can end up being a serious matter, and the prosecutive thresholds can be surprisingly low.

Here is one real example. In 1972, I was a rookie FBI agent assigned to El Paso, Texas. That division covered the Fort Bliss military reservation, a sprawling desert complex. There were rumors that civilian employees of the military commissary were stealing inventory and selling it out the back door. The rumors turned out to be true, albeit slightly overstated. But we did not know that at the time.

So around Thanksgiving, the FBI spent a day surveying the commissary’s back entrance. We had made provisions for all contingencies—lots of personnel, secret vans, long-range cameras—the works. But the day produced only one measly illegal sale out the back door: several frozen turkeys and a large bag of yams. The purchaser of the stolen goods tipped his buddy \$10 for merchandise valued at about \$60. The offense occurred late in the day. We were bored and irritated, and we pounced on the purchaser as he exited the base, following him out the gate in a caravan of unmarked cars with red lights. The poor guy was shaking so badly that he wet his pants. I guess he knew better than we did what was at stake.

Because he was in the wrong place at the wrong time and did the wrong thing, our criminal paid dearly: He pled guilty to a charge of petty theft. So did his buddy at the