
PART I

**FRAUD AND FORENSIC
ACCOUNTING OVERVIEW**

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FRAUD IN SOCIETY

“Yes! Finally captured Martha Stewart. You know, with all the massive and almost completely unpunished fraud perpetrated on the American public by such companies as Enron, Global Crossing, Tyco and Adelphia, we finally got the ringleader. Maybe now we can lower the nation’s terror alert to periwinkle.”¹

WHAT IS FRAUD?

Fraud is an activity that takes place in a social setting and has severe consequences for the economy, corporations, and individuals. It is an opportunistic infection that bursts forth when greed meets the possibility of deception. The fraud investigator is like the attending physician looking and listening for the signs and symptoms that reveal an outbreak.

The Association of Certified Fraud Examiners defines occupational fraud as: “The use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.”²

Before dealing with the accounting details and the investigation itself, we introduce some attempts by the courts, law enforcement, and regulatory authorities to define fraud. Since the subject of this book is workplace fraud, we then outline the nature of workplace fraud through a look at the accounting cycle. We complete the tour with a look at the motives of fraudsters and the consequences of their acts.

The modern definition of fraud is derived primarily from case and statute law, but many of the ancient elements remain. Those roots can be traced to *fraus*, a Latin noun carrying a wide range of meanings clustered around the

notions of harm, wrongdoing, and deceit. The modern definition derived from case law focuses on the intent of the fraudster(s) to separate the trusting victim from property or a legal right through deception for his or her own benefit. This deception involves any false or misleading words or actions or omissions or concealment of facts that will cause legal injury. Criminal prosecution of fraud must prove beyond a reasonable doubt that an act meeting the relevant legal definition of fraud has been committed by the accused. In civil cases, liability must be demonstrated on a balance of probabilities.

White-collar crime should be viewed as a subclass of fraud. Fraud includes confidence schemes, art forgery, falsified scientific research data, lying on a resume, and so on. White-collar crime, however, is committed by individuals embezzling, manipulating accounts, taking bribes, and so on at their place of business. What they all have in common, however, is the intent to deceive. This book limits its discussion to the field of white-collar crimes committed against businesses and their accounting systems and will not discuss consumer and other types of fraud. The forensic accounting techniques discussed below are central to the discovery of fraud in the business environment.

U.S. Supreme Court Definition of Civil Fraud

Fraud takes many forms, and the courts and other institutions have had a hard time finding a definition broad, yet specific, enough to give anything beyond a working definition. While there may not be one definitive all-encompassing definition, it is clear that the public and those not involved every day in its detection have a better understanding than perhaps even five years ago.

The U.S. Supreme Court in 1888 provided a definition of civil fraud as:

First: That the defendant has made a representation in regard to a material fact;

Second: That such a representation is false;

Third: That such representation was not actually believed by the defendant, on reasonable grounds, to be true;

Fourth: That it was made with intent that it should be acted on;

Fifth: That it was acted on by complainant to his damage; and

Sixth: That in so acting on it the complainant was ignorant of its falsity, and reasonably believed it to be true. The first of the foregoing requisites excludes such statements as consist merely in an expression of opinion or judgment, honestly

entertained; and again excepting in peculiar cases, it excludes statements by the owner and vendor of property in respect of its value.³

FBI Definition of Fraud

The Federal Bureau of Investigation (FBI) offers a broad but useful definition of fraud that incorporates the elements recognized over the centuries:

White-collar crimes are characterized by deceit, concealment, or violation of trust and are not dependent upon the application or threat of physical force or violence. Such acts are committed by individuals and organizations to obtain money, property, or services; to avoid the payment or loss of money or services; or to secure a personal or business advantage.⁴

Financial fraud, the subject of this book, is criminal fraud of the white-collar type. It is committed against businesses by both employees and outsiders such as vendors and contractors. Sadly, this type of crime has also gone beyond the typical “business” or commercial organization. Case in point is highlighted in a recent article entitled “Stealing from the Collection Plate,” where it was noted, “Churches and religious groups are at greater risk for financial misconduct because of the nature of their missions and management structures.”⁵

SEC Definition of Fraud

The U.S. Securities and Exchange Commission (SEC) has its own definition of fraud as it applies to transactions involving securities. Although the law governs securities, the principles invoked reiterate the constellation of ideas central to definitions of fraud with broader application. The Securities Exchange Act of 1934, Section 10b-5, states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or the mails, or of any facility of any national securities exchange,

- a) to employ any device, scheme, or artifice to defraud,
- b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

- c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

TYPES OF FRAUD

White-collar fraud involves an intentional deception by employees, management, vendors, and customers to obtain money or other assets or services from a business. Some frauds are perpetrated by individuals and some in collusion across the management–employee social boundaries or between insiders and outsiders. The most useful way to classify the activity of the fraudster is to discuss briefly the five typical accounting cycles of any business where it will likely leave some kind of audit trail. The five cycles follow:

1. Sales and Collections
2. Purchases and Payments
3. Payroll and Personnel
4. Inventory and Warehousing
5. Capital Acquisition and Repayment

Sales and Collections Cycle

The sales and collections cycle bills clients for sales of goods and services and collects the money. This is the most cash-intensive of the five cycles. The most common frauds in this cycle are:

- Outright cash thefts
- Theft of other assets
- Kickbacks to customers
- Front-end frauds

Outright Cash Thefts Cash thefts are the easiest and most common type of fraud to perpetrate in this cycle and are usually carried out through unrecorded sales, underringing of sales, lapping schemes, and overbilling, among others.

Theft of Other Assets Assets can be stolen by ordering and shipping goods to an address other than that of the business.

Kickbacks to Customers In customer kickback schemes, the fraudster underbills the customer for merchandise and they split the difference or receivables are written off as uncollectible for a fee.

Front-End Frauds Front-end frauds are committed by the fraudster directing customers to take their business elsewhere or misappropriating a rebate.

Purchases and Payments Cycle

This cycle includes non-capital procurements and payments for goods, equipment, and services used in company operations. The buyer may act alone by setting up shell companies to receive goods misdirected from his company by false invoices. These schemes are often extremely complex and involve bank accounts, mail drops, and even corporate filings for the dummy entities. Procurement fraud is frequently a collusive employee–vendor fraud. The vendor will typically provide a bribe or kickback in return for business or, in the case of tendered contracts, for the employee to rig the bidding in favor of the fraudulent vendor. In another scheme, which may or may not be related to the original procurement scheme, once the vendor has been awarded the contract, the cost of the bribe may be recovered and profits increased by substituting products inferior to contract specifications, billing for work not done, shipping less than ordered, padding overhead expenses, and so on. Collusive fraud is the most common form of acquisition-and-payment fraud.

Payroll and Personnel Cycle

This cycle deals with hiring and termination, salaries, timekeeping, expense account reimbursements, and health and other types of employee insurance coverage. Common forms of fraud in this cycle are paying ghost employees, overstating hours worked, overstating expenses, and filing false medical claims. Employee and management fraud can overlap in this cycle, especially in the area of false expense account reports. An important but often overlooked area of personnel fraud is the improper vetting of job applicants. Collusion between a personnel department employee and a fraudster applicant could install a fraudster within the company with untold consequences.

Inventory and Warehousing Cycle

This cycle controls the purchase and storage of goods for later processing and sale or just for sale. The most common frauds in this cycle are ordering unneeded inventory and then stealing it for personal use; committing outright theft; and charging embezzlements occurring elsewhere in the company to inventory losses. These schemes can often become extremely complex and involve loading-dock workers, inventory accounting personnel, truck drivers, and receivers of stolen goods in other parts of the state or country.

Capital Acquisition and Repayment Cycle

This cycle accounts for debt and equity financing, interest, and dividend payments. The results of these transactions are reflected on the financial statements of the company. Because these accounts are developed at the executive level, this type of fraud is committed almost exclusively by management. The usual frauds are borrowing company money for personal use, misuse of interest income, and misuse of proceeds from financings.

Other Types of Financial Fraud

Some frauds that affect business often occur outside the typical accounting cycle. Customer fraud, for example, can severely affect insurance companies through filing of false applications and fraudulent claims, especially those for personal injury. Banks and other financial institutions suffer customer fraud through submission of false financial information on loan applications.

Management fraud deserves special mention in these days of corporate scandals. In addition to theft through the capital acquisition and repayment cycle, management can commit fraud through the manipulation of earnings reported on the financial statements prepared for shareholders and creditors. This type of fraud can affect the stock price, management bonuses, and the availability and terms of debt financing. Enron, WorldCom, Global Crossing, and many others are particularly egregious examples of management manipulation of the financial statements that enriched a few but caused the collapse of company pension plans, enormous losses to innocent shareholders, and unemployment for thousands of staff. These frauds have also contributed to the downfall of a major accounting firm (Arthur Andersen), a spate of suits

against others, and the decline in the public's confidence in the accounting profession.

As we discuss later in this book, fraudsters often rationalize their deeds by claiming "I wasn't hurting anyone"—clearly, this is far from reality.

Recent Corporate Fraud in Perspective It is sometimes suggested that the size and complexity of the Enron, WorldCom, Global Crossing, and other cases mean we are living in a new era of fraud. What should we make of this suggestion? Is this a new phenomenon, or is it because we are in the age of "real-time" reporting (news hits us instantly, rather than when it isn't "new" anymore)? Instant news means instant reaction—the media searches for instant answers, perhaps before even those of us considered experts have had a chance to digest, reflect, and then comment.

Perhaps, rather than being trend-setting events, these scandals are merely the latest in a history of revelations that have always followed market excesses since the Dutch Tulip Mania of the 1630s.⁶ The dot-com bubble of the late 1990s was no exception. The English polymath Walter Bagehot captured all the elements of excess in the following passage from *Lombard Street*, his 1873 critique of the English banking system:

The mercantile community will have been unusually fortunate if during the period of rising prices it has not made great mistakes. Such a period naturally excites the sanguine and the ardent; they fancy that the prosperity they see will last always, that it is only the beginning of a greater prosperity. They altogether overestimate the demand for the article they deal in, or the work they do. They all in their degree—and the ablest and the cleverest the most—work much more than they should and trade far above their means. Every great crisis reveals the excessive speculations of many houses which no one before suspected, and which commonly indeed had not begun or had not carried very far those speculations, till they were tempted by the daily rising price and the surrounding fever.⁷

A Bit of Background The great bull markets of the twentieth century were all followed by revelations of malfeasance that only came to light after equity values had declined from heights unjustified by earnings growth rates and historical price-earnings multiples. When the Jazz Age ended in October 1929, the reputation of business executives was in just as much trouble as it is today. The shenanigans of the bigger players were ultimately exposed when the investigations of the Senate Committee on Banking and Currency in 1933–

1934 revealed the true behavior and ethics of the bankers and brokers in the previous decade. The practices of the great financiers of the day as presented in 12,000 pages of testimony were so shocking that the government felt it necessary to establish the Securities and Exchange Commission in 1934 to regulate the financial industry.

Richard Whitney, head of his own investment firm and five times president of the New York Stock Exchange, proved to be an exceptionally poor businessman. He borrowed \$30 million from his friends, relatives, and accounts in his trust and owed \$6.5 million at the time he declared bankruptcy. He served three years and four months of a five- to ten-year sentence for misusing funds from his father-in-law's estate.

The More Things Change . . . We may have short memories, but let's just go back to the bull market of the mid-1980s, which was a time of merger mania and the heyday of the junk bond market. The *crime du jour* was insider trading. The investment banker Drexel Burnham Lambert collapsed, and Denis Levine, Ivan Boesky, Michael Milken, and others went to jail.

Perhaps we can learn from previous experience to avoid overlooking possibilities of fraud into the future. Look no further than www.theprosandthecons.com, a speakers' bureau that employs experts and ex-cons to help companies avoid and detect fraud. Fraudster-turned-consultant Frank Abagnale has spent the past 30 years working with the FBI and lecturing on fraud-techniques. Abagnale was the subject of the 2002 movie *Catch Me If You Can*. Comments director Steven Spielberg, "I did not make this film about Frank Abagnale because of what he did . . . but because of what he has done with his life the past 30 years."⁸

Sarbanes-Oxley The purpose of the Sarbanes-Oxley Act of 2002 was to provide investors with greater confidence in American corporations and allow them to rely on financial statements as an accurate representation of the financial condition of the companies in which they are stakeholders. The Act was a response to the revelations of lax auditing practices and conflicts of interest between auditors and their clients.

This book will not discuss Sarbanes-Oxley in great detail, as much has been written about it elsewhere. However, what is key is to look at the Act's effect and how its effectiveness is perceived.

In its "2005 Oversight Systems Report on Corporate Fraud," Oversight Systems⁹ surveyed certified fraud examiners "to report the trends, risks and

major concerns that businesses face today.” Oversight noted that while most examiners saw Sarbanes-Oxley as an effective tool, “few think it will change the culture of business leaders.” That is a very telling comment. Whether we discuss the Dutch Tulip Mania, the heady days of insider trading, or recent corporate scandals, what we need to realize is that perhaps we cannot stop fraud from happening, but we can limit the vehicles that allow it. We discuss later in this book *Business as a Vehicle*; most worrying is that similar to automobiles, when one model becomes obsolete, another is sure to follow. Just because certain types of business scandals are behind us, this does not mean new methods will not ensue.

WHAT THE NUMBERS TELL US ABOUT FRAUD

Comprehensive concrete and official fraud statistics are hard to come by because government agencies and industry groups tend to keep records only of those frauds that affect their area(s) of interest.

We must also remember that all fraud statistics are based on known frauds. What is most unnerving is the fact that the numbers quoted are considered to be only the tip of the iceberg. Aside from the many undetected frauds are those frauds not reported by the harmed organization for fear of embarrassment. Many organizations would rather complete an investigation and move on, than bring to public light the full extent of a fraud perpetrated against them.

Notwithstanding the uncertainty of the true extent of financial fraud, there are studies that shed light on the enormous impact.

Study: Association of Certified Fraud Examiners

For purposes of this book, the best overview of financial fraud comes from studies done by the Association of Certified Fraud Examiners (ACFE). In 1996, the ACFE published *Report to the Nation on Occupational Fraud and Abuse* based on occupational fraud cases reported by its members. In its 2004 *Report to the Nation on Occupational Fraud and Abuse*, the results were based on a study of 508 cases reported by the Certified Fraud Examiners (CFE) who investigated them.¹⁰ These reported cases resulted in over \$761 million of losses. The ACFE estimates that applied to the Gross Domestic Product, this translates to approximately \$660 billion in total losses. This is a

significant increase over the \$400 million estimated to have been lost in 1996 when the first report was written.

Small-Business Fraud

According to the ACFE study, “small businesses suffer disproportionately large losses due to occupational fraud and abuse.” The median loss for these businesses was \$98,000, which was higher than for all but the very largest companies.

Frauds committed by owners and executives caused a median loss of \$900,000, six times higher than losses caused by managers and 14 times higher than losses caused by employees. However, the study added that companies are less likely to take legal action against owners than against employees.

Additionally, only 12 percent of fraudsters in the study had previous convictions for a fraud-related offense. To reiterate what we said earlier, one should keep in mind that, although the billion-dollar scandals at Enron, WorldCom, and other corporations have splashed onto the front pages in recent times, it is the slow, steady drip, drip, drip of fraudulent activity at small businesses that is larger in aggregate and potentially does the greater damage to the economy over the long run. Also, while you may make one vehicle obsolete, newer generations of fraudsters will create new models to perpetrate their crimes.

Categories of Occupational Fraud

The ACFE divides occupational fraud into three broad categories:¹¹

1. Asset misappropriation
2. Corruption
3. Fraudulent statements

Asset Misappropriation Asset misappropriations are the theft or misuse of assets and account for 90 percent of all occupational fraud in the study. It is pointed out in the study that these schemes have the lowest median loss (\$93,000), while fraudulent statements, the subject of much news surrounding WorldCom et al., only occurred in 7.9 percent of the reported frauds, but had the highest median loss at \$1 million.

Cash thefts usually occur in three different ways:

1. Fraudulent disbursements
2. Skimming
3. Cash larceny

FRAUDULENT DISBURSEMENTS Fraudulent disbursements use some device such as false invoices or timecards to create a false payment obligation for a company. It is the most common type of cash fraud, accounting for 74.1 percent of the studied cases and creating a mean loss of \$125,000.

Fraudulent disbursements break down into five principal types:

1. *Billing*: Fraudulent billing schemes accounted for 52.1 percent of fraudulent disbursements and created a median loss of \$140,000.
2. *Check tampering*: Check tampering made up 31.3 percent, with a median loss of \$155,000.
3. *Expense reimbursement*: Expense reimbursements comprised 22.1 percent of schemes and caused a median loss of \$92,000.
4. *Payroll*: Payroll schemes represented 19.6 percent of cases studied, and the median loss was \$90,000.
5. *Register disbursement*: Register disbursements made up only 4.3 percent, with the smallest median loss of the group at \$18,000.

SKIMMING Skimming is the theft of cash during its collection but *before* it is recorded on the company books. Skimming occurred in 28.2 percent of the cash frauds and showed an \$85,000 mean loss.

CASH LARCENY Cash larceny is the theft of cash *after* it has been recorded. This form of fraud accounted for 23.9 percent of the cases, with a mean loss of \$80,000.

Drawing Conclusions

Returning to the Oversight Systems survey, 52 percent of those surveyed believed Sarbanes-Oxley has been effective in helping identify instances of financial statement fraud. Remember, Sarbanes-Oxley relates solely to public companies. However, the survey also revealed that 67 percent of those surveyed believed institutional fraud is more prevalent today than five years

ago. Put this fact together with our previously noted fact from the ACFE study that frauds committed by owners and executives are six times higher than losses caused by managers and 14 times higher than losses caused by employees, and the conclusion is still worrying.

As noted in the Oversight Systems study, by Dana Hermanson of Kennesaw State University, “the risk of financial statement fraud is real and not going away.” Sadly, the risk of financial fraud by any method is real and not going away.

Society’s Perception of Fraud

Until recent years, and the full realizable impact of WorldCom, et al., through the loss of jobs and life savings, and the impact on at least one major accounting firm and countless others, fraud was often perceived as a victimless crime. Governments and businesses were seen as so wealthy that the money taken by fraud wouldn’t be missed. “They can afford it,” is the classic rationalization heard in confessions. Fraud is also viewed as an easy way to get money without running the risk of severe punishment. Dismissal is certainly a possibility, but many employers will, in fact, try to hush up news that they have been defrauded for fear of adverse publicity with their customers, vendors, bankers, and insurers.

In a recent PricewaterhouseCoopers (PwC) survey, the number of companies reporting fraud globally has increased from 37 percent to 45 percent in the past two years.¹² Said one PwC representative, “Deterrents aren’t sufficiently strong because too many white collar crimes seldom result in conviction.” Despite the public outrage caused by Enron and others, it would seem many of these crimes are still under the radar and escaping the light of day.

If, as noted earlier, \$660 billion in revenues is diverted annually by fraudsters, then \$660 billion will never work its way through to shareholders’ equity and increase the wealth of the national industrial base. Since most fraud occurs at small, and thus more vulnerable, businesses, the risk is greater that it can cause bankruptcy with its consequent costs to vendors and lenders and unemployment for company staff. A lifetime of building respect in business, in the community, and with the family can be destroyed when a trusted employee who felt protected by a reputation for honesty is exposed as a fraudster.

Fraud is far from benign. As fraudsters take advantage of technology, fraud becomes more sophisticated. It can no longer be characterized solely as employee theft for personal benefit. It is international. An American businessman

who was the victim of a Nigerian letter scam went to Lagos to check on his “investment” and was murdered for his troubles.¹³ The line between individuals stealing for themselves and fraud as part of organized crime is getting harder and harder to draw. Ruthless Russian gangs have been discovered behind corporations boasting respectable boards of directors that are actually set up to launder money and create stock frauds. As regulators close the traditional charities and other fronts used to raise money, terrorists are turning to identity, mortgage, and other types of fraud to raise the money needed to attack U.S. interests. Today the occupational fraud uncovered at a small company could be part of something much larger.

Who Commits Fraud?—Profile of the Typical Fraudster

Despite enormous scandals such as Watergate, the Iran-Contra Affair, the Savings and Loan debacle, the Wall Street insider trading exposé, the collapse of the Bank of Credit and Commerce International (BCCI), and Barings Bank, white-collar crime has not been subjected to as much research as other types of crime.¹⁴ The lack of research on crimes of this type has resulted in a paucity of research on the criminals. The small number of prosecutions and subsequent convictions further hampers such research. In this respect, corporations work against their own best interests when they refuse to prosecute employees because of a fear of adverse publicity. The result is a lack of the raw material for academic study that could lead to a better understanding of the white-collar criminal and development of better hiring and prevention policies.

Despite the deficiencies in gathering evidence and developing theory, several studies have been done that show some consistency. For those of us who write and speak regularly on the subject of financial fraud, in general terms we typically describe the perpetrator as someone who has experience, is placed in a position of trust, and who will have to be in a position of having the opportunity to commit the crime.

The 2004 ACFE study shows that 67.8 percent of the perpetrators were employees, 34 percent were managers, and 12.4 owner/executives. The findings of Weisburd et al. showed that men in the 40–50 age group with high school or less education and working alone committed most frauds. The largest amounts, however, were stolen by university-educated older men with no criminal records who were in positions of financial responsibility and perpetrating the frauds in collusion. Dishonest managers and executives working alone caused median losses of \$250,000, or about 4.2 times the \$60,000 stolen

by lower-level employees operating by themselves. When executives and managers colluded with employees, however, the median loss jumped to \$500,000, or double what executives and managers stole on their own and 8.3 times what employees stole on *their* own. Since management is responsible for the application of controls to detect fraud, the involvement of management makes detection more difficult and the fraud potentially more devastating for the company.

Women commit just about as many frauds as men, but the median amount is smaller. Fraud, too, has its “glass ceiling”! Most executive and managerial positions are still held by men, and their opportunities to steal large sums are greater. Fraudulent acts by women seem to increase as one descends the occupational hierarchy. The activity of women is especially marked at the clerical levels of the financial industry.¹⁵ One can reasonably expect that the admission of greater numbers of women to positions of power will result in a more equitable balance in the gender statistics.¹⁶

Men over 60 also stole more than 27 times the median \$18,000 taken by persons under 26 years of age, despite the fact that the older group accounted for only 2.5 percent of the cases studied, while the younger group accounted for 6.0 percent. In fact, one can conclude from this study that the median amounts taken vary directly with age.

Frauds by persons with university education are less frequent but involve larger median amounts than those committed by persons with only high school or below. Once again, this reflects the fact that educated people tend to rise to higher levels of responsibility and thus control larger amounts of money.

Perhaps the most disturbing statistic in the ACFE study is the one showing that only 12 percent of fraudsters had previous convictions for a fraud-related offense, which means 88 percent of the frauds were committed by persons who had never been charged with or convicted of any previous crime. This is consistent with Romney et al. and Weisburd et al., who discovered no sociopathic behavior patterns in the fraudsters studied in their research.

Crisis Responders and Opportunity Takers

What, then, makes a person commit that one act that turns a respectable citizen into a criminal? How does a person who does not have the statistical profile of the common criminal form the intent to break the law? Weisburd and Waring identify two broad classes of offender: crisis responders and opportunity takers. The crimes of the crisis responders “seem to be situational re-

sponses to real stress or crisis in their professional or personal lives.” The crimes of the opportunity takers seem to be “linked strongly to some unusual or special set of opportunities that suddenly materialize for the offender.”¹⁷

The crisis responders were people in positions of trust who saw a criminal act as the way out of a perceived financial crisis. These events were anomalies in their social histories. The women acted to pay family bills, and the men stepped over the line for a variety of reasons, such as financial troubles at the company they owned or to reduce their income taxes payable.

The opportunity takers were not driven to commit a crime by financial pressures; they were drawn in by the temptation created by an unusual opportunity. Many of these events were isolated wrong choices. This group, however, also includes those recruited into conspiracies operating in permissive environments. Once involved, these offenders become socialized into criminal activity that can last for years or even decades. The offense for which they suffered their one arrest was, in fact, often one long, systematic criminal activity.

The commission of a crime requires a place that connects opportunity and victim. The most harm is done by officers and managers colluding with others in ways that exploit an organization for which they work. This is the quintessential middle-class crime. Owners and sole proprietors may be from a higher social class, but the businesses they control are usually too small to permit the magnitude of the thefts possible from large corporations. Others of high social status, such as doctors and lawyers, rarely commit large complex crimes. Exceptions are those doctors who open clinics to exploit Medicaid.

It is the officers and managers who hold their positions in large companies through education and hard work rather than birth who have the opportunities to commit the big frauds. This is because they command the accounting systems as well as the controls that should safeguard those same systems. These crimes are most frequently collusive because their commission requires an assembly of skills capable of exploiting the complexity of the corporate structure.

Detection

In the ACFE’s 2004 survey, approximately 40 percent of cases are initially detected by tip, approximately 24 percent by internal audit, 21 percent by accident, 18 percent by internal controls, 11 percent by external audit, and 1 percent notified by police.

Since the victims of white-collar crime rarely know anything has happened at the time the action occurred, often a long lag develops between the

commission of a crime and its discovery and report. The ACFE notes that the majority of tips came from employees (almost 60 percent), along with tips from customers (20 percent), vendors (16 percent), and anonymous tips (13 percent).

In the recent PwC study noted earlier, internal audit was disclosed as the most successful of all processes in the management of fraud. Matching this study with the ACFE, which showed internal audit accounting for 24 percent of initial detection, should give us a pretty good clue as to where resources should perhaps be spent in organizations. However, for every point in the world of fraud detection, there is a counterpoint, and many smaller business owners will tell you their organization is too small for an internal audit department and they cannot afford such a luxury. Perhaps this then ties in with the fact that companies with fewer than 100 employees accounted for almost 46 percent of cases in the ACFE study, the largest group in the study. Companies with over 10,000 employees accounted for just over 13 percent, the smallest group in the survey.

Motivations for Fraud

In a 2001 article, “The Psychology of Fraud,”¹⁸ the authors noted that fraud, “like other crime, can best be explained by three factors: a supply of motivated offenders, the availability of suitable targets and the absence of capable guardians—control systems or someone to mind the store.”

Financial motivators obviously have a big impact on the cause of financial crime. These can range from an employee with an inability to pay her domestic bills to a senior executive under financial strain because he knows that market factors have adversely affected the business and analysts will be watching the latest results with eagerness. In this case, the strain may go beyond pure financial impact, but also to stature and reputation. Take the recent case of Computer Associates and its former CEO, Sanjay Kumar, and two other company executives. The government’s indictment noted, “Computer Associates prematurely recognized \$2.2 billion in revenue in FY 2000 and FY 2001 and more than \$1.1 billion in premature revenue in prior quarters.” The government also noted that “the SEC alleges that from 1998 to 2000, Computer Associates routinely kept its books open to record revenue from contracts executed after the quarter ended in order to meet Wall Street quarterly earnings estimates.”¹⁹ Computer Associates agreed to settlements with the SEC and the Justice Department to the tune of \$225 million and agreed to reform its financial accounting controls.

Some theorists have taken a big-picture approach and argued that white-collar crime is the inevitable outcome of the competitive ethic of capitalism. According to this theory, competition is the field on which egotism and recklessness can have full play.²⁰ We are constantly bombarded by images of the wealth and success that can be achieved through winning in the great experiment in social Darwinism in which we live. The inevitable result of such competition is the recognition of the economic inequality of winners and losers, which can be internalized as the constant fear of failing. This discontent may be sufficient to make a person see white-collar crime as the great equalizing act. The drive for money and the trappings of success are, therefore, the motivators of the act.²¹

Recent theorizing has shifted the focus to the situation in which the crime is committed. This newer thinking does not dismiss the role of personal history, which is so important in the creation of the street criminal, but questions its explanatory power. It raises the question of why certain people commit certain crimes in certain situations. This is a useful line of theorizing since it allows the criminal act to be conceptually distinguished from the criminal's life story and explained as the pursuit of short-term gratification and not the culmination of a long history of personal disadvantage.

The situation in which the potential white-collar offender finds him- or herself plays a most significant role in determining whether a crime will be committed. The corporate culture lived daily at the workplace can often create enormous pressures to commit criminal acts. Examples are common in the famous cases of price-fixing, bribery, and manufacture of dangerous products that occurred throughout the last century.²² A corrupt corporate culture can lead to the inversion of all values. The comfort of conformity then becomes the Achilles' heel of the middle-class person under pressure to "go along to get along." Loyalty can easily slip into complicity. Criminal behavior becomes normal. Team-playing becomes conspiracy. Fear of dismissal, ostracism, or losing the favor of superiors can be compelling forces in the world of a department or small company. In such an atmosphere, one learns criminal behavior "in association with those who define such behavior favorably," as Sutherland contended.²³

These acts cannot be explained by a personal history of instability and deviance since stability and conformity are the principal characteristics of these criminals' lives. Even while committing the crimes, white-collar offenders are able to lead their conventional lives, which are, indeed, their camouflage. Their conventionality and stability are the foundation of the trustworthiness that

gives them the opportunity to commit the crime in the first place. It is this life of conventionality that gives the criminal act the character of an aberration.

It is, however, the white-collar criminals' power of rationalization that is one of the most amazing aspects of their behavior. They are able to behave normally and aberrantly at the same time without feeling conflict. This behavior is possible through the use of techniques of "neutralization."²⁴ These are acts of mental deftness that allow persons to violate behavioral norms without simultaneously seeing themselves as deviant or criminal. Such self-exculpating explanations can occur both before and after the commission of a criminal act.

The most common rationalization noted several times already in this chapter is that financial crimes do not hurt other people. Embezzlers commonly tell themselves they are merely "borrowing" the money and intend to return it later without anyone else being affected. Many embezzlers justify it because they had to do it to pay mounting family bills. "Everybody's doing it" is frequently heard as an argument for systematic wrongful company behavior. Corporate offenders often consider laws as an unjust or unnecessary form of government interference disrupting free market forces. They may even argue that breaking the law was necessary for the survival of the company.

Employees frequently offer a moral justification for their thefts with the argument that their employer "owed" them the money. Fraud simply expressed their grievance. For example, they feel exploited and underpaid or hurt after receiving a smaller-than-expected bonus. Many feel justified after being passed over for promotion; others feel they can do the job just as well as, if not better than, the person with the higher education. Personal antipathies, anger after a reprimand from the boss, and the like can all be self-serving explanations for fraud. Such a sense of being wronged, whether justified or not, can fester for years before developing into a plan to defraud.

In rare cases, mental illness can drive a person to commit fraud through a wish to damage the company. Others can be motivated by pure egotism; they commit fraud just to show how smart they are. Yet others are driven by anti-capitalist ideologies and think they are destroying the system from within.

Summary

It would appear from everything said thus far that the white-collar criminal is more like Mr. and Ms. Average than like the common street criminal. It remains a mystery why these outwardly normal and respectable people com-

mit white-collar crimes. We still cannot answer the question why the bank clerk with too much personal debt decides to embezzle instead of seeking credit counseling. No one can say why the opportunity takers decide to commit and rationalize a crime when they have never before sought out criminal opportunities to better themselves. What tips these people in the one direction rather than the other? No one knows.

THE SOCIAL CONSEQUENCES OF ECONOMIC CRIME

Economic crime is an enormous social problem whose consequences are often not fully realized by the public at large. The *2004 Report to the Nation on Occupational Fraud and Abuse* of the Association of Certified Fraud Examiners estimated that fraud would cost the American economy \$660 billion, or 6 percent of gross domestic production (GDP). These amounts represent only the known amounts stolen directly by the fraudsters and do not measure the ripple effect that can engulf whole companies, employees, vendors, suppliers, and banks. The trickle-down effect of Enron, WorldCom, and others has become familiar to us all.

At the ACFE's 15th Annual Conference in Las Vegas, NV, July 2004, Bernard Katz, CFE, CPA, noted that "the WorldCom scandal has taught the world many things. It's also a classic study of what not to do in the corporate world when it comes to financial records and how to avoid disaster."²⁵

In a recent *Washington Post* survey, a variety of experts (accountants, chief executives, and others) completed a corporate governance report card. Their conclusion was that "the ingredients for a similar financial disaster remain."²⁶ According to former SEC Chairman, Harvey Pitt, "many shareholders may have been led to believe that [reforms] have cured all the problems and we're home free. Unfortunately, that's a prescription for disaster." The article also noted the U.S. Chamber of Commerce and others complaining that boards and accountants spend too much time meeting meaningless criteria rather than getting to the root of the more insidious problems."

The previously noted Oversight Systems survey seems to echo this sentiment. "The findings of this survey foreshadow a real need for continued vigilance among executives toward institutional fraud" according to Patrick Taylor, CEO of Oversight Systems. As we said earlier in this chapter, the more things change . . .

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NOTES

1. Jon Stewart, comedian and actor, <http://en.thinkexist.com/quotations/fraud/>.
2. *2004 Report to the Nation on Occupational Fraud and Abuse*. www.cfenet.com.
3. *Southern Development Co. v. Silva*, 125 U.S. 247, 8 S. C. Rep. 881, 31 L. Ed. (1888).
4. Federal Bureau of Investigation: *Facts and Figures 2003*, <http://www.fbi.gov/libref/factsfigure/wcc.htm>.
5. Herbert Snyder, Ph.D, CFE; and James Clifton, MA, CPA, CFE, *Fraud* magazine, December 2005, published by the Association of Certified Fraud Examiners.
6. The prices of tulips and the practice of tulip speculation became so extreme that the States of Holland passed a statute in 1637 curbing this activity!
7. Walter Bagehot, *Lombard Street* (New York: Scribner, Armstrong & Co., 1873; new ed., London: Smith Elder & Co., 1915; rpt., New York: Arno Press, 1978).
8. www.abagnale.com/index2.asp.
9. www.oversightsystems.com.
10. www.cfenet.com/.
11. www.cfenet.com/.
12. www.eaststandard.net/print/news.php?articleid=35927.
13. The intended victim of this scam typically receives a letter purporting to be from a Nigerian official who needs to use the victim's bank account to move millions of dollars out of Nigeria. The letter requests the victim's address and bank account numbers on the promise of a share usually between 15 and 30 percent of the amount.
14. Hazel Croall, *Understanding White Collar Crime* (Philadelphia: Open University Press, 2001), p. 5.
15. *Ibid.*, p. 55.
16. *Ibid.*, p. 56.
17. Weisburd and Waring, *White-Collar Crime and Criminal Careers*, p. 58.
18. Grace Duffield and Peter Grabosky, *Psychology of Fraud*, Australian Institute of Criminology, www.aic.gov.au/publications/tandi/ti199.pdf.
19. www.sec.gov/news/press/2004-134.htm.
20. James William Coleman, *The Criminal Elite* (New York: St. Martin's Press, 1989), p 211 ff.

21. For an interesting attempt to combine microeconomics, psychology, and risk analysis into a motivational theory, see: Stanton Wheeler, "The Problem of White-Collar Crime Motivation," in Kip Shlegel and David Weisburd, *White-Collar Crime Reconsidered* (Boston: Northeastern University Press, 1992), pp. 108–123.
22. Coleman, *The Criminal Elite*, passim.
23. Sutherland, *White Collar Crime*, p. 234.
24. Gresham M. Sykes and David Matza, "Techniques of Neutralization: A Theory of Delinquency," *American Sociological Review*, 22 (December 1957): 667–670, cited in Coleman, *The Criminal Elite*, p. 211.
25. Bernard Katz, CFE, CPA, "Preventing and Detecting Financial Statement Fraud."
26. http://seattletimes.nwsourc.com/html/business/technology/2002800032_corpfraud12.html.

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