



Overview

VARIETIES OF FRAUD/PERSPECTIVE

The contention of this book is that major management fraud is primarily a zero-sum game: fraud against the organization, for the benefit of the individual (“I win, you lose”), with the largest single area of loss resulting from conflict-of-interest corruption. To start, we will examine the landscape and define the terminology.

Fraud encompasses an array of irregularities and illegal acts characterized by intentional deception. It can be perpetrated for the benefit of or to the detriment of the organization and by persons outside as well as inside the organization.¹

The primary emphasis in this book is on major fraud perpetrated to the detriment of (*against*) the organization for personal gain by individuals occupying positions of trust and influence in management positions (inside). The secondary emphasis is on management fraud for the benefit of (*for*) the organization, with a focus on the interrelationship between fraud *for* and *against* the organization. It goes without saying that fraud for the organization invariably involves some personal benefit for the perpetrator.

In discussing fraud, I am reminded of the tale of the six blind men describing an elephant, in which the first blind man describes it in terms of its trunk, the second in terms of its ears, and so on. The point is that fraud assumes various guises, and your perspective will shape your perception of what typically constitutes fraud.

2 OVERVIEW

Actually, the fraud elephant has at least two dimensions. The first dimension is the *type of fraud*:

- Internal misappropriation or corruption (fraud *against* the organization)
- Fraudulent financial reporting (fraud *for* the organization)
- Other fraud for the organization (various forms of bribery and corruption, money laundering, etc.)
- External fraud against the organization (e.g., credit card fraud)

This book examines the first three types of fraud, with the primary emphasis on the first one.

The second dimension is the *class of perpetrator*:

- Management
- Employee
- Nonemployee

Again, this book emphasizes the first class. Since an essential ingredient in fraud is the ability of the perpetrator to exercise significant control, these types of fraud could also potentially involve nonmanagement individuals who could exert such influence over extended periods of time.

The organizational business environment and context could be considered a third dimension of fraud. Fraud is shaped by the organization in which it occurs. The form that the fraud takes depends on whether the organization is governmental, not-for-profit, manufacturing, financial service, retail, or of some other nature.

In 2002, the Association of Certified Fraud Examiners (ACFE) issued an update to its landmark 1996 “Report to the Nation on Occupational Fraud and Abuse.” The 2002 report asserted that 16 percent of all frauds involved losses of \$1 million or more. Since the ACFE data indicate that 5 percent of all fraud is financial-reporting fraud, which typically exceeds \$1 million, at least 11 percent of all fraud would be million-dollar fraud that *does not* involve financial reporting.² This 11 percent constitutes the primary focus in this book: major management fraud *against* the organization.

Here are some additional factors derived from the ACFE “Reports to the Nation”³:

- Excluding financial reporting, the median loss in each management-committed fraud is five times higher than that in each employee-committed fraud (see Appendix C).
- The median loss from each instance of corruption (\$530,000) is 6.6 times that from asset misappropriation (\$80,000).

Given these statistics, the logical conclusion is that a considerable majority of serious fraud against organizations involves management and entails corruption rather than misappropriation.

In the interest of verbal shorthand, this book frequently refers to fraud against the organization as *management fraud* (or, in the case of bribery and corruption against the organization, *operating-management fraud*) rather than “management non-financial-statement fraud against the organization,” which would be technically more correct. Please see Chapter 2 for further development of the perspective based on the ACFE data.

Considerably oversimplified, major instances of fraud tend to follow a pattern that corresponds to the positional authority of the particular management group: Fraudulent financial reporting typically is at the direction of senior management, major instances of fraud involving corruption and conflict of interest are at the direction of operating management, and major asset-misappropriation schemes are typically orchestrated by administrative management.

By the way, the particular perspective presented in this book derives from the author’s experience in managing internal audit functions for 31 years for Fortune 250 industrial companies. The case studies that illustrate principles of management fraud against the organization throughout this book are drawn from that point of view. My elephant will probably be somewhat different from yours on the surface; however, the underlying principles and dynamics should be the same.

This book takes the following points of view:

- The dynamics of management fraud are different from those of employee accounting-cycle fraud—for example, management fraud against the organization is frequently relational; employee accounting-cycle fraud is transactional (see “Characteristics” in Chapter 3).
- As noted earlier, management fraud involves using positional power rather than taking advantage of internal control weaknesses.

4 OVERVIEW

- Financial-reporting fraud occurs at the top of the organization and is committed by senior management; management non-financial-statement fraud against the organization is usually committed by nonexecutive management.
- Operating management will typically commit bribery and corruption types of fraud, whereas administrative managers are more apt to commit asset-misappropriation types of fraud (see “Classifications” in Chapter 2, and “Financial Reporting” in Chapter 7).
- Typically, operating-management bribery and corruption fraud, the greatest single area of loss from occupational fraud, is “off the books”; administrative-management asset-misappropriation fraud is “on the books.”
- Financial-reporting and operating-management frauds are interrelated—fraud *for* the organization usually leads to fraud *against* the organization (see “Bullet-Proof and Invisible Leads to Flaunting” in Chapter 4).
- While not estimable with precision, data from the ACFE indicate that management corruption (i.e., non-financial-statement fraud) represents the largest single area of loss from occupational fraud (see “1996 and 2002 Association of Certified Fraud Examiners Reports to the Nation” in Chapter 2 and Appendix D).
- Management non-financial-statement fraud has not received proportionate recognition in the professional literature, particularly given that it represents the largest single category of loss from occupational fraud (see “More Than Fraudulent Financial Statements” later in this chapter).
- Effective prevention depends on the probability of detection and prosecution more than on any other single factor, because management fraud typically involves override rather than taking advantage of control weaknesses (see Chapter 10 in particular, but this is a recurring theme throughout this book).
- Management non-financial-statement fraud has a pronounced risk/reward dynamic: the ability to keep the effect off the income statement, thereby avoiding detection, coupled with a belief that the fraud will not be prosecuted if detected, leads to this type of major fraud (see “Major

Management Fraud Is Different” later in this chapter, “Opportunities Afforded by the System for Performance Accountability” in Chapter 3, and “Bullet-Proof and Invisible Leads to Flaunting” in Chapter 4).

- Recognition and detection of management non-financial-statement fraud require a broad business perspective that extends well beyond traditional accounting (this is a pervasive concept in this book—see “Managerial as Well as Accounting Perspective” in Chapter 10).
- For the preceding and other reasons, management fraud is significantly underdetected. Moreover, when it is recognized, it is all too frequently not prosecuted. The risk/reward implications of underdetection and underprosecution are obvious (see “The Risk/Reward Dynamic” in Chapter 10).
- Due to the greater complexity of management corruption and the broader skill set required to investigate such fraud, the primary responsibility of internal audit personnel is recognition (see “Emphasis: Recognition and Detection—Case Studies” later in this chapter).
- From the standpoint of major loss and the total effect on the organization, management non-financial-statement fraud is the greatest fraud challenge for internal auditors (see “Major Management Fraud Is Different” later in this chapter and the concluding statement in Chapter 10).

The recognition signals—symptoms and red flags—for management fraud in your organization will be different from the red flags for employee fraud. This book provides examples of red flags derived from multiple organizations, but the specific flags for your organization are dependent on your particular culture and business context. Typically, these are organization-specific, and I would encourage you to develop your own.

MORE THAN FRAUDULENT FINANCIAL STATEMENTS

On hearing the phrase “major management fraud,” an internal auditor’s first thought is usually about fraudulent financial reporting. However, the primary emphasis in this book is on other kinds of management fraud, in part because fraudulent financial reporting is the one area of management fraud that the professional literature has dealt with extensively. More important

6 OVERVIEW

(and the real reason for this book's focus) is that management non-financial-statement fraud entails significantly more loss than does fraudulent financial reporting.

Total losses from management fraud against organizations are larger than losses due to all other variations of internal fraud. Using admittedly soft numbers—estimates based on estimates—the projected annual loss from management misappropriation and corruption was arguably at least three times that of the annual loss to investors from financial-statement fraud during the six years through 2001.

This book estimates (please see Appendix D) that, normally, slightly more than *60 percent of all loss from occupational fraud is due to management non-financial-statement fraud*—that is, fraud against the organization. Although Enron, WorldCom, and their confreres would impact that ratio, it is safe to say that management non-financial-statement fraud against organizations accounts for a majority of all loss from occupational fraud, at least during more normal times. Consequently, this book deals with fraudulent financials primarily as manifestations of the underlying dynamics of management fraud, particularly the interrelationship between fraud for and fraud against the organization. We approach fraudulent financial reporting from an organizational and managerial perspective—that of corporate governance or the tone at the top—rather than employing a debit-and-credit or internal accounting control focus.

While presenting a much broader emphasis than just that of fraudulent financial reporting, this book limits the attention paid to fraud prevention and deterrence from an internal control perspective, and to specific controls to prevent accounting and basic employee fraud. This is not because these areas are unimportant; obviously, they are. However, these topics are already adequately addressed in the existing professional literature; furthermore, they are less important for the prevention of operating and senior management fraud, which involves the positional override of established controls.

EMPHASIS: RECOGNITION AND DETECTION—CASE STUDIES

The emphasis of this book is on fraud recognition and detection. To that end, it employs a case-study approach that illustrates symptoms of fraud. The primary focus is on the concept underlying the particular type of fraud,

MAJOR MANAGEMENT FRAUD IS DIFFERENT 7

and only brief discussion is provided. The intent is not to provide a textbook but rather to illustrate different types of fraud through case studies meant to engage and entertain readers.

Much of the material is addressed to readers on the level of relatively experienced internal auditors or investigators. However, the emphasis on principles and case studies will benefit anyone in an organizational environment who has an interest in recognizing and detecting management fraud—public accountants, chief financial officers (CFOs), audit committees, operating managers, and so on. In addition, the conceptual, principle-based approach should be useful for students just embarking on their professional careers.

All competent professional internal auditors should have the ability to recognize the red flags and symptoms that indicate the possible existence of management fraud, and they should also be able to perform diagnostic procedures to assess the probability of occurrence. Investigation of cases of more complex management fraud beyond determining whether fraud probably occurred normally requires specialized experience and skills. Nevertheless, we cannot overemphasize the importance of recognition. Simply put, recognition must occur before investigation can start.

According to the Institute of Internal Auditors (IIA), “The internal auditor should have sufficient knowledge to identify the indicators of fraud but is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.”⁴ Furthermore, the IIA maintains that “[d]etection of fraud consists of identifying indicators of fraud sufficient to warrant recommending an investigation.”⁵

This book covers the relevant principles such that an experienced internal auditor would be equipped to carry the recognition process through to detection as well as assess the probability of occurrence. Thereafter, certain specialized aspects of forensic investigation are essentially paralegal and technical, and thus are beyond the scope of this text. However, the book offers sufficient guidance for experienced internal auditors to hold up their end while working as part of an investigative team with representatives from the security and law functions.

MAJOR MANAGEMENT FRAUD IS DIFFERENT

Major management fraud differs from the typical employee fraud in its characteristics as well as its frequency. The red flags and symptoms are

8 OVERVIEW

different, and it is recognized, detected, and investigated in a different manner. Although most fraud is committed by employees (58 percent), management fraud occurs significantly more frequently on a per capita basis, because of the greater opportunity.

There are two important factors that recur in the various case studies presented in this book:

1. Major management fraud against the organization is mostly off the books or, more accurately, off the P&L (profit-and-loss statement). This is a matter of avoidance of detection. For this reason, an understanding of the anticipated operating results from a market-based business rather than an accounting perspective is imperative for recognition and detection.
2. An important dynamic in fraud against the organization is the belief that the fraud would not be prosecuted even if it were detected—as, for example, when the perpetrator “has something” (equally incriminating) on the company or superior.

An example of the first factor is unexpected windfall profits that can be diverted in off-the-books fraud or used to absorb excessive charges related to fraud on the books. This practice permits undetected fraud for extended periods. Chapter 3 expands on the practice of obscuring the P&L in the section entitled “Opportunities Afforded by the System for Performance Accountability.”

The second factor—a belief by the perpetrator of the fraud that even if the fraud were detected it would not be prosecuted—is related to the idea that fraud *for* the organization leads to fraud *against* the organization, and vice versa. This conviction on the part of the perpetrator can derive from having some incriminating information on the company or superior or it might simply be the result of an apparent track record of non prosecution of management fraud that exists at many organizations. Chapter 4 discusses this further in the section entitled “Bullet-Proof and Invisible Leads to Flaunting.”

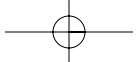
The ACFE estimates that the average company loses as much as 6 percent of its gross revenue to all forms of occupational fraud and abuse.⁶ Although the true total is most likely considerably lower—say, 1.5 to 2 percent—even

MAJOR MANAGEMENT FRAUD IS DIFFERENT 9

that economic cost is staggering. A more subtle cost is the organizational emotional trauma related to betrayal by trusted employees.

Major management fraud against organizations is particularly difficult for most internal audit departments to detect because effective recognition requires a broader perspective than just that of traditional accounting. This major management fraud is the greatest fraud challenge for internal auditors because the total losses are more significant than with other types of fraud, and the organizational trauma and loss of business are more severe. Moreover, because the fraud is frequently off the books and usually more complex, it is the most difficult to detect and investigate successfully.

<http://www.pbookshop.com>



<http://www.pbookshop.com>

