

Are You Sitting Next to a Fraudster?

Fraud is a universal and expensive problem. An average organization's fraud losses amount to five percent of annual revenue, according to the [Association of Certified Fraud Examiner's](#) (ACFE) most recent report. Globally, the cost of fraud may total more than \$2.9 trillion and actual losses may be significantly higher. The ACFE study states "... many cases will never be revealed, and, of those that are, the full amount of the losses might not be uncovered, quantified or reported."

The association's [2010 Report to the Nations](#), which examined 1,843 occupational fraud cases that occurred in 106 countries found that:

- More than 80 percent of frauds were committed by employees who worked in accounting, operations, sales, executive/upper management, customer service or purchasing.
- Industries most subject to fraud included banking/financial services, manufacturing, and government/public administration.
- Small businesses with less than 100 employees experienced the highest incidents of fraud.

The report's findings demonstrate the need for AR professionals to learn fraud's warning signs and how to stop it from happening. Best practices to prevent fraud include establishing internal controls that segregate responsibilities, employee education programs, and hotlines. (For more information read [Fraud's Impact on Accounts Receivable and Preventing and Recognizing Fraud in Your Accounting Operation](#) on [The Accounts Receivable Network](#).)

Who Commits Fraud?

The roster of fraudsters includes senior managers, bookkeepers, bank tellers, customer service representatives, contractors and warehouse employees. Consider the following:

- The bookkeeper enjoyed a lavish lifestyle until an owner's wife became suspicious of the employee's jewels, furs, and travel. The wife hired a private investigator whose detective work lead to the discovery of a multi-million dollar fraud in the small company.
- The trusted, high level bank executive's judgment was never questioned. During loan committee meetings he simply described real estate projects that members quickly rubber stamped. No one knew he took kickbacks until the real estate market collapsed.
- The law firm's receptionist became so well known at the financial institution she could sign her name to checks. But, she was not a signatory on the multi-million dollar trust accounts that she depleted with her boyfriend's, the bookkeeper, assistance.



Joseph P.
Dooley

There is no such thing as a stereotypical fraudster, says retired FBI agent, Joseph P. Dooley. “I’ve seen people from all different walks of life commit fraud schemes. I’ve seen Girl Scout leaders. I’ve seen religious leaders, I’ve seen senior executives, I’ve seen homemakers,” says Dooley, a managing director in global risk management and investigations firm Stroz Friedberg’s business intelligence and investigations division.

Other law enforcement agents, certified fraud examiners (CFEs), and forensic accountants concur. Statistics from the ACFE’s biennial report also bear out his assessment. Among the findings:

- Fraudsters were almost evenly divided between employees, 42.1 percent, and managers, 41 percent.
- Owners and executives committed a smaller percentage of the frauds, only 16.9 percent, but accounted for a much higher median loss of \$723,000.
- In all regions, males committed more than half, 66.7 percent, of the documented frauds.
- Fraudsters are becoming slightly younger; more than half of the cases in the 2010 study were committed by individuals 31 to 45 years old versus those in the 36 to 50 age range described in the 2008 report.
- More than 85 percent of the fraudsters had never been previously convicted or charged with a fraud-related offense.

The Fraudster Next Door

The report’s findings illustrate why fraudsters are often difficult to identify, says CFE James D. Ratley, the ACFE’s president and chief executive officer. “We are trained by television. Bad people are supposed to look and act a certain way. Well, fraud perpetrators are not like that.”

“Most of them have never been arrested for anything before. Most of them are married, own their own home, have children, have a college education. They fit the same social circle we fit,” Ratley says. “They usually have an award winning personality. They are trusted.”

Ratley, who began his career with the Dallas police department, thinks the reason more men than women commit fraud is the “glass ceiling” syndrome. “Look at Enron. WorldCom and you think ‘Where are all the women?’ How many women executives did they have? Very few,” he says.



James D.
Ratley

Why Fraud is Committed



Scott P.
Hilsen

Atlanta attorney Scott P. Hilsen is a CFE and president of the ACFE's Georgia chapter. He joins other CFEs, forensic accountants and law professionals, in dividing fraudsters into two camps. "One category is where the person is a psychopathic. Or someone who gets a thrill from committing a fraud instead of putting all the time and effort into something legitimate. It's not a one-time event. People who do Ponzi schemes are people who start out creating something to defraud."

Fraudsters in the second category do not set out to commit fraud, but succumb to temptation and opportunity, says Hilsen, Director in Investigations at KPMG Forensic. "In my opinion, far more people fall into this category. Whatever moral lapse they have, whatever combination of events at that time in their life, they commit a fraud."

Experts frequently refer to the "fraud triangle" or the three reasons that contribute to fraud: motive, opportunity, and rationalization. The following examples demonstrate their point:

- **Motive:** Until she took a vacation, the beloved, long-time customer service representative successfully and quietly moved - over a three year period - hundreds of thousands of dollars between her client's bank accounts and her pocket. It later came to light she was experiencing financial difficulties at home.
- **Opportunity:** The beer distributor's warehouse manager collected payments from drivers when they returned from their routes. The manager was also authorized to make journal entries, and he kept some of the money instead of depositing it. A senior manager discovered the skimming when he questioned why cash flow was declining, but sales were steady.
- **Rationalization:** "In health care, revenue recognition is a very tricky thing ...In my mind it wasn't fraud, it was accounting estimates..." - Aaron Beam, HealthSouth's first chief financial officer and co-founder discussing his involvement in the company's accounting scandals during an ACFE interview.

Inside the Mind of a Fraudster

When the ACFE asked Amy Adler to develop a course entitled Inside the Mind of a Fraudster, she spent six months researching the psychology of fraud and reasons why fraudsters commit their crimes. She reviewed footage from interviews that ACFE members had conducted with fraudsters and studied books written by industry experts.

Adler's reading list included *Snakes in Suits: When Psychopaths Go To Work*, a work co-authored by Dr. Robert D. Hare and Dr. Paul Babiak. According to Dr. Hare's research, approximately one percent of the population is psychopathic. "There are people who are emotionally unhealthy and have some psychological disorders. People who are psychopathic don't have remorse for any wrong-doing," Adler says. "Those folks are the scariest fraudsters because once caught they don't necessarily reform."



Amy
Adler

Like Hilsen, the Atlanta attorney, Adler divides fraudsters into two categories: those with psychological disorders and those who meet the fraud triangle's criteria. "The younger generations are starting to grow up with a larger sense of entitlement. They have this expectation that things are going to be handed to them. When that doesn't happen they get disgruntled and find other ways to get what they want or what they feel they deserve. There's motivation and rationalization right there for fraud."

Adler, Hilsen, Ratley, Dooley and other professionals knowledgeable about why people commit fraud, cite numerous reasons, including individuals who are:

- Disgruntled employees who believe they were not fairly rewarded for their hard work, were bypassed for a promotion or may lose their jobs;
- Experiencing financial difficulties, such as astronomical medical bills;
- Pressured to meet personal and professional goals;
- Addicted to drugs or gambling; and
- Living beyond their means.

Living Large and Other Clues

One of fraud's biggest warning signs: individuals living beyond their means. In the 2010 report, it was cited as a red flag in 43 percent of the documented cases. Ratley, the ACFE executive, recalls a fraudster who stole \$6 million in six months. The man insisted his lifestyle did not change except for a "few things" like purchasing custom made suits, BMWs for the family, and monthly trips to the Cayman Islands.

Financial difficulties and control issues in the workplace are other key indicators, according to the study. Prime example: Richard Scrusby, HealthSouth's embattled former CEO. In an ACFE interview, Beam, HealthSouth's first CFO, says Scrusby became "obsessed with buying airplanes," including a \$25 million Gulf Stream. When the pressure to report inflated earnings escalated, Scrusby began packing a gun and hired bodyguards. "Richard had the ability to sell you into believing what he wanted to do."



David
Wood

In the corporate world, a warning sign might be a company's unexpected results, says CPA David Wood, partner in charge of Porter Keadle Moore, LLP's banking task force. "If everybody seems to be struggling, but somehow a company is inexplicably doing just fine or the results are not like their competitors, it might be a tip something is happening," he explains. "It doesn't always mean that something bad is going on, but it could trigger a forensic investigation."

We Don't Have Enough Runs This Quarter – We Need More Hits

When fraud is suspected or reported by a tip (the most common way frauds are discovered), companies often hire outside auditors, CFEs, or forensic accountants to investigate. Wood explains that traditional auditing is a process of verifying a company's books and records. "In a forensic accounting atmosphere or engagement, our radar is up. We look to find evidence."

Many of Hilsen's cases begin with an anonymous letter, email or voice on a hot line. "There has to be some amount of specificity in the allegation. Most of the time we have enough specificity to get into the documents and books."

Hilsen may run statistical tests on the books, review reserve accounts, and interview internal auditors, as well as other employees. He also reads emails. "Emails tend to be treasure trove," he says. "It's amazing what people talk about and say in emails."

Key word searches run the gamut. Hilsen says you learn what business metrics are important in the company under investigation. He cites examples such as "understate," "overstate," and "reserve."

"Sometimes people talk in code. I had a case where they used baseball terms to talk about fraud," Hilsen recalls. "We need more hits was a code for we need more revenue. We don't have enough runs this quarter. Runs were reserves."

Look in and for Cookie Jars

Companies frequently have reserve accounts that need to stay on the books for certain reasons Hilsen explains. Fraudsters take money from reserve accounts and use the funds to increase income. "That's a big form of accounting fraud," he says. "Reserve accounts are cookie jars. That's a term people use."

In Denial

Auditors are frequently criticized for not discovering more fraud, Ratley says. "The primary purpose of an audit is not to detect fraud. Fraud is hidden. Anyone who is going to perpetrate a fraud from the CEO of the organization all the way down to the cleaning crew knows you have to make the books balance."

The former policeman cites a case where a large organization's vehicle maintenance department's books balanced, but fraud was suspected. When Ratley discovered a vehicle that had more than 234 carburetors installed in less than a year and van with more than 100 sets of new tires in six months he approached the department's vice president. Confronted with the findings, the vice president who was not involved in the fraud, said: "Well, you know these roadways out here are hell on a set of tires."

Thankless Job

Ratley says this is a familiar scenario to fraud investigators. "You can talk to auditor after auditor and practically every one of them will tell you when they discover an anomaly, they have to go up against everybody because that's bad news and people don't like bad news. They have an uphill battle."

After a fraud is discovered, many companies are reluctant to prosecute. "In a lot of cases, it is bad publicity," says Donald Berez, director of Georgia Southern University's Center for Forensic Studies in Accounting and a business instructor. "They don't want it to come out that they were subject to fraud. "They just want to get rid of the employee and sweep it under the rug."



Donald
Berez

"It can be quite expensive to prosecute or bring it to court," Berez says. "In a lot of cases the schemes are so complex it would cost a fortune to investigate it fully and get a jury to understand it."

Bad Press

Some organizations have no choice about prosecuting a fraudster, Hilsen says. "In publically-traded and other large companies if fraud is discovered by a manager, an executive or someone higher up, they can't just quietly terminate the person. They have to report it," he says. "Particularly if it is someone in the accounting function that the external auditors rely on."

Dooley adds, "Some companies want to prosecute to the fullest extent of the law. Others don't want the publicity. We encourage organizations to prosecute because that sends a message to the community and it sends a message to other employees."

Dooley, who investigates fraud for Stroz Friedberg, says although there are still numerous paper documents, today most evidence resides on computers. When he started his career, computers weren't prevalent in the business world. "The fraud schemes don't change. It's a different format," he says. "Old wine in a new bottle."