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DETECTING FRAUD **IN** ORGANIZATIONS

Techniques, Tools, and Resources



JOSEPH R. PETRUCELLI

Detecting Fraud in Organizations

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data:

Petrucelli, Joseph R., 1960—

Detecting fraud in organizations : techniques, tools, and resources / Joseph R. Petrucelli.

p. cm. — (Wiley corporate F&A series)

Includes bibliographical references and index.

ISBN 978-1-118-10314-2 (cloth) — ISBN 978-1-118-22392-5 (ePDF)

ISBN 978-1-118-26218-4 (Mobi) — ISBN 978-1-118-23735-9 (ePub)

ISBN 978-1-118-55597-2 (O-BK)

1. Commercial crimes—United States. 2. Corporations—

Corrupt practices—United States. 3. Fraud investigation. I. Title.

HV6769.P48 2013

658.4'73—dc23

2012034377

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

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Preface

IN WRITING THIS BOOK, MY goal was to keep the subject matter as simple and straightforward as possible. This book is designed to get you thinking about fraud from a new perspective, with a focus on people and proactive thinking.

When people in organizations put their own self-interest (greed) above the interests of others, it creates an atmosphere conducive to fraud. The FBI's fiscal year 2010–2011 *Financial Crimes Report to the Public* states that “corporate fraud matters involving self-dealing by corporate executives, particularly utilizing companies to perpetrate large-scale, high-yield fraud schemes, continue to be an issue of concern.”* The focus of this book is the people in today's organizations and identifying how and where the value in those organizations is exposed to fraud.

I have spent more than 30 years in the accounting field in various positions. From my experiences and observations, I have learned that fraudsters ultimately give themselves away, through guilt, stupidity, or the obvious dissipation of assets. I have seen fraud perpetrated by the most unlikely person as well as by the most likely person in an organization. I have seen fraud in government, in private and public organizations, and domestically and internationally. One common theme has permeated my experiences of dealing with fraud: *people* are involved. As long as there are *people* with an *access* to something of *value*, the need to combat fraud will exist.

My mission in writing this book was to make learning about fraud both fun and easy. I express my concerns through cartoons, pictures, and humor. I reinforce the importance of developing the proper ethical tone with the people in your organization, from top to bottom. I hope the book will challenge you by continually posing questions and offering you brainstorming opportunities

* Federal Bureau of Investigation, “Financial Crimes Report to the Public: Fiscal Years 2010–2011 (October 1, 2009–September 30, 2011),” <http://www.fbi.gov/stats-services/publications/financial-crimes-report-2010-2011>.

to solve multiple one-minute mysteries. I have included motivational quotes to help you maintain a positive attitude while getting through the sometimes grueling efforts and endless documents required to establish intent.

Remember that numbers don't lie, people do. My hope is that after reading this book, you will see beyond the numbers and learn the importance of transparent and open communication with the people involved in various organizational processes. It is important to maintain independent and ethical judgments when you are called on to deal with the often gray areas that can arise in an organizational process. I believe that an 800-pound friendly gorilla awareness of fraud can aid in detecting, deterring, and preventing it. The only way to accomplish this is through the development of ethical people in organizations in order to maintain proactive rather than reactive thinking.

Acknowledgments

WHenever you accomplish a dream, it is possible only with a supporting cast. I would like to thank Mike Breon. I'm glad we had that first Jack and Diet Coke, and I appreciate all your initial input on the ideas for what would become this book.

I also want to thank Cheryl Hyder. What can I say, aside from the fact that having the same birthday makes us complement each other in all aspects of our professions. Thanks for your support and your contributions to this book.

I also want to thank James Lee for your incredible artistic contribution. Your artwork helped to shape my vision and give the book its perspective and personality.

Thank you to Brien Jones from the National Association of Certified Valuation Analysts for your continual support for this book.

Thanks to Jennifer MacDonald, Kimberly Monroe-Hill, Judith Antonelli, Judith Howarth, Brandon Dust, and John DeRemigis at John Wiley & Sons for believing in this project and for dealing with the twists and turns we encountered. Jen, I promise to “mind dump” less next time! John, I told you “I think I can” and managed to get the book done! Thanks for sticking with me and believing in me.

Thank you to my partners, Tim Piotrowski and Kevin Duffy, for your continual support and friendship and for being a big part of this book. I greatly appreciate all of your insight and input. We truly are the Three Musketeers! I want to thank our staff at PP&D Accounting: Lynn, Ian, Joey, Nicole, Matt, and Lauren. Your loyalty, integrity, and commitment to our firm have brought insight and energy into our business. I thank you for being a big part of getting this book done, too.

Thanks to all of my students at the College of Staten Island for challenging me every day and giving me the opportunity to make a difference in your lives and help you develop into professional accountants. To the Business

Department at the College of Staten Island, thank you for your support and for allowing me to help create our Forensic Accounting Introduction course. Special thanks to Loretta, for believing in me, and to Professor Thomas Tellefsen.

To Professor Patricia Galletta, I thank you for taking the time to review the copyedited manuscript and your input. I appreciate your support and perspective not only in helping with this book but also as a colleague and friend at the College of Staten Island.

To Timothy G. Little, Esq., partner at Katten Muchin Rosenman, LLP. Tim, next to my family, you are one of my oldest relationships. It has spanned from being soccer teammates in grammar school to our current adult life. You are one of the smartest individuals I know, and I appreciate your taking the time to review the copyedited manuscript and provide feedback. But what I appreciate most is our lifelong friendship and the common values we share, specifically that we both live for our families.

To Sergeant Howard “Howie” Askelson, who gives me the opportunity to relive those moments when we first started our families. The expressions of love you show your children and wife make me feel as if I am looking back in time. Your ability to be an 800-pound friendly gorilla in as calming a manner as I have ever seen is a model for my 800-pound friendly gorilla spirit. Your ability to immediately take the copyedited material and make it your own amazes me. My purpose in writing the book was to capture that exact spirit. Thanks for your insight and input, but more important, the friendship we have developed.

To Robert Morrison, CPA, Hodulik & Morrison PA, thank you for taking the time to review the copyedited manuscript and provide me valuable feedback. It is not often that professionals support each other. Thank you for the wisdom you continually share and for the friendship we enjoy. You truly are an 800-pound friendly gorilla.

Thank you to my parents who taught me that I can be whatever I want to be. Mom, I think of all those times you made me read *The Little Engine That Could* and do my homework till I got it right. You taught me that practice and persistence lead to success. Dad, thanks for always encouraging me to make the most out of my life.

To my dog, Buddy, my miracle with paws: You are greatly missed.

To my brother, this is a professional book, so I cannot call you the names I would really like to. As your older brother, I learned to protect, help, and love. Everyone needs a little brother to act as the caboose and tag along. Thanks for always looking up to me and making me *feel* like a big brother.

Thanks to Spencer Rockman, my mentor, who proved to me that everything a person does is a life lesson and that life skills can be learned through soccer. Your advice over the years has been priceless. You truly are the older brother I never had.

To Rob Karabinchak, who always seems to bring me back down to earth: Thanks for the friendship and support and making me continually believe in my abilities. Rob, the numbers don't lie with integrity like yours.

To my adopted accounting daughters, Nicole DiGeso and Lauren Komar, and my adopted son, Ian Aizenberg, thanks for the continual rereading and corrections and your youthful input to this book.

Thank you to my two sons. First, to Matt, for teaching me that it's important to follow *your* dreams and not someone else's. Thanks for all of the copying and organizational help. Second, to Joey, for being himself all the time—your genuineness is amazing. You help me to look at things from a different perspective. I could never have written this book without your help. What a great gift it is to be able to fulfill a dream with my child! I can't wait to read your first book!

Thank you to my mother-in-law and father-in-law, who not only gave me the best soul mate and partner one could ask for but who have also provided continual support and love.

And finally, thank you to my wife, Angela, for your love, affection, amazing dedication to our family and continued support. Without you, this book could never have been written. I love you!

Introduction

I HAVE DRAWN INSPIRATION from the many people and experiences that have shaped my career and my life, and especially from the classic children's novel *The Little Engine That Could*. The recurrent themes in that book are persistence, determination, and positive mental attitude. I truly believe that anybody can be what he or she wants to be by following the little train's creed of "I think I can!"

I challenge you to become sufficiently self-aware by reflecting on the key events and influences that define *you* as both a professional and a person. This quest should lead to a greater insight into yourself, your ethics, and the many people who have influenced your character and who you are. Knowing yourself well and believing in yourself will inevitably assist you in learning to detect, deter, and prevent fraud.

THE 800-POUND FRIENDLY GORILLA

The "800-pound gorilla" is a concept often used to describe a person or an organization so powerful that it can act without regard for the rights of others or established principles and rules.¹ In this book, we are going to adapt this

metaphor for a more positive concept. The 800-pound gorilla in this book is friendly and promotes the interests of the organization in a positive manner. He or she generates effective communication with all of the people in an organization in a friendly, proactive way.

The 800-pound friendly gorilla has power, but his or her job is to ensure that people in the organization follow the rules. Our gorilla uses his or her power to ensure not only that people obey the organization's principles and rules but also that the organization does not infringe on the rights of others and that it maintains open channels of communication. If someone commits fraud, for instance, the gorilla will not be happy, but he or she will try to understand why it took place and learn from it.

Throughout the book you will see that organizations need more than one 800-pound friendly gorilla to combat fraud. Organizations need to create a spirit that helps to develop a workforce full of 800-pound friendly gorillas. Whether investigating a potential fraud, or detecting, deterring, or preventing fraud, the 800-pound friendly gorilla seeks to understand the people in the organization in a calm, rational, and friendly manner. Start to think of who the potential 800-pound friendly gorillas are in your organization.

Organizations worldwide lose an estimated 5 percent of revenue to occupational fraud each year, according to the reports of the Association of Certified Fraud Examiners (ACFE). As a result of my professional experience, I believe the number is much higher because many frauds are not included in the ACFE estimate because of bankruptcy, failure to prosecute, insurance payments, and restitutions.

Clearly, we need to detect fraud in organizations by looking beyond the numbers and developing proactive thinking about the people in organizations. Starting with the device of our 800-pound friendly gorilla, we can communicate an organization's principles, ensure that an organization tells the true story about its numbers, and discover any falsification or deception. To find where in an organization the business risk of fraud exists today and in the future, we will consider the following:

- What role should current or future technology play?
- Is using futuristic technology to identify fraud the answer?
- What role should third-party risk management consultants who develop ethics and compliance policies play?

This book suggests that fraud detection is a matter of identifying the people involved in the organizational process who can commit fraud and learning from people who have committed various types of fraud in the past. We will discuss

how to think like a fraudster in the organizational process. The 800-pound friendly gorilla maintains professional skepticism (a questioning of people) and understands the importance of interviewing, performing proper background checks, and getting to know the people in an organization's processes. Our gorilla also understands where the potential fraud forces (value) exist. The key to detecting fraud in today's organizations is simply to understand where people and organizational value meet, paving the way for fraud.



NUMBERS DON'T LIE, PEOPLE DO

It is true that numbers don't lie. But what most people fail to realize is that even though numbers don't lie, the people reporting them often do. Numbers can be manipulated by people who want to advance their self-interest (i.e., greed). In fact, numbers can often be manipulated so well that the average person is unable to detect the misrepresentation. A statement may be considered true when enough people believe it is true and is considered false when enough people believe it is false. Statements are perceived as true or false because of judgments *made by people*. The concepts of truth and falsehood depend on there being minds to judge a situation, and we need those minds to belong to people we can trust. Still, people will think some things are demonstrably true or false no matter what. For example, people once believed the earth was flat even though this is not true and there was evidence to prove that it is round. It is accepting "truths" at a perceived acceptable level of thinking that enables fraud to exist. Organizations should develop 800-pound friendly gorillas who think beyond accepted levels and formulate questions that challenge statements and actions involving the organization to ensure that those statements and actions are not later found to be false.

What do Enron (energy), WorldCom (telecommunications), Adelphia (cable television), Tyco (manufacturing), and Bernie Madoff (financial services) all have in common? They fell victim to greed and false numbers and were eventually destroyed by frauds conceived and committed in the C-suite (i.e., by the corporation's "chiefs," or most important senior executives: chief executive officer, chief operating officer, chief information officer, and so on). These frauds brought out the familiar refrain, "Where were the auditors?"

Each gouged its own gaping wound in the soul of the global economy, further contributing to a larger economic collapse. Revisiting any of these frauds will not solve the glaring and ongoing problem of fraud overall. But at their most basic level, fraud and other financial irregularities need people to

perpetrate them, or they do not happen. Therefore, without people, there is no risk of, vulnerability to, or susceptibility to fraud.



AN OVERVIEW OF FRAUD

Fraud is an incredibly dynamic phenomenon stemming from greed and self-interest. While fraud has been around as long as people, modern fraud is exacerbated by the complexities of today's business environment. You can hardly pick up a newspaper or turn on the news without hearing about fraud. This book explores fraud from the unique perspective: the people perspective.

When you employ people, they are immersed in an environment full of fraud enablers and detractors. This book will help you to understand your employees and the fraud enablers and detractors in your organization. It is easy to become distracted by the schemes themselves or the drama associated with a potential fraud. However, it is essential to recognize that *people* are the root cause of fraud, not the enablers or the schemes themselves. Most organizations focus on the *apples* on the tree rather than the tree's *roots*. Are you looking at the roots or just the apples? Remember, an organization is a group of people who come together with a common goal. Unless all the people in the organization are rowing the boat in the same direction, fraud will be a greater threat.

Understanding the concepts in this book will help you to assess where the risk of fraud is rooted in your organization and to implement strategies to prevent some of it. The book examines business processes (e.g., the collection of cash) that will help you apply the ideas to your workplace or the specific business processes within it. I believe that this book is an essential read for everyone from the business school student to the board member, since fraud puts everyone's financial well-being in jeopardy.

The only way to minimize fraud and its impact is for everyone to understand fraud and how fraud can manifest itself in what he or she does day in and day out. It is important to create the 800-pound friendly gorilla (see Exhibit I.1) in the room to establish the sense that someone is watching but in a professional, skeptical, and friendly manner.

Detecting fraud in organizations requires an Albert Einstein level of thinking. Einstein once said, "Problems cannot be solved at the same level of thinking that created them." I believe that if you want to detect fraud, you need to replicate the thinking of the fraudsters, but you also need to break away from the traditional control- and rules-oriented thinking and start approaching fraud in a more creative manner. By using your imagination and creative thinking,

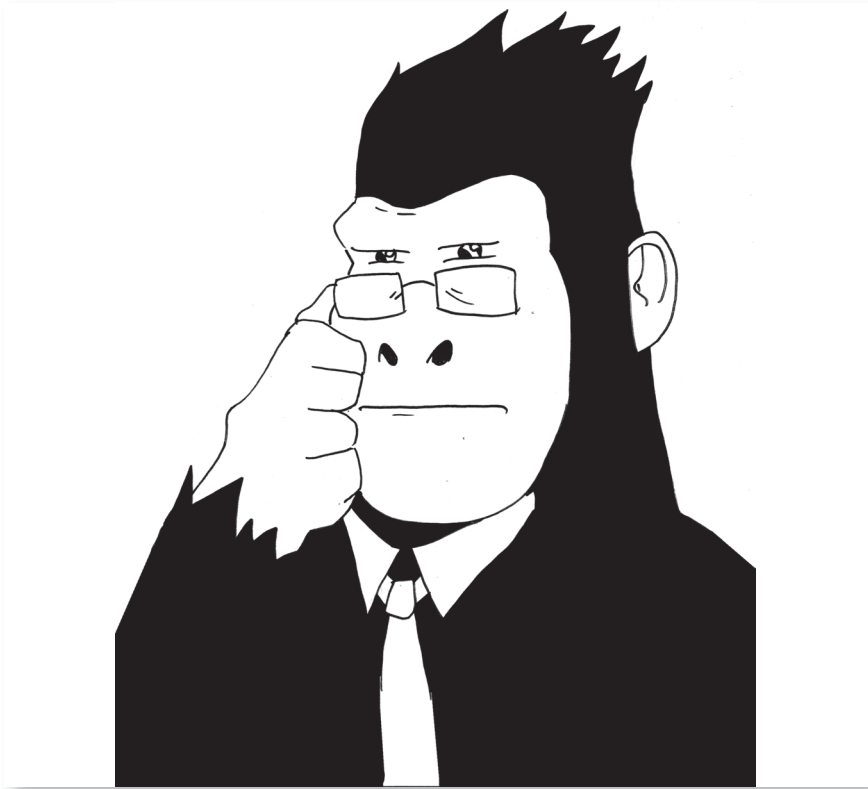


EXHIBIT I.1 The 800-Pound Friendly Gorilla

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you can make sense of the often bizarre world of fraud. Fraud detection does not depend on highly complex formulas or theories. Deterring and detecting fraud requires people who can look at things from different perspectives, moving away from the traditional paradigms.

Widespread fraud will continue to occur until there is sufficient outrage expressed by all stakeholders in the business world that will result in a restructuring of some of the fundamental institutions and processes of business, such as how an audit is conducted. This book explains how the business community, legislators, and others have actually made perpetrating fraud easier over the years while spending a tremendous amount of time and money supposedly fixing the problem. All the fraud checklists, formulas, triangles, diamonds, and pentagons in the world will not detect or deter fraud, because people commit

fraud. Most fraud is discovered through tips or whistleblowers, so you need to start from a new level of thinking that is centered around people:

- Where and when did the fraudster become predisposed to commit fraud?
- Was it before becoming part of the organization or after?
- Was his or her behavior influenced by the organization's environment?

Fraud occurs where people meet value. Value takes many forms, such as cash, inventory, copyrights, patents, and customer lists. It is essential to understand how the concept of value has changed over the years. In the past it was clear: Value resided in cash, buildings, and equipment. Now the value in many organizations resides in information. This is not a traditional value. Where does the value reside in your organization? We will explore this very important concept throughout the book.

Understanding that fraud occurs where people and value come together is the crux of many strategies to stop fraud. However, many of these strategies have simply become too focused on the actual processes of implementing the strategies. High-priced consultants are often leading the charge. But fraud is not a hard thing to find if you know what to look for—and if you are in a business of any kind, you owe it to yourself and your employer to know what fraud looks like.

Fraud is everywhere, and it is a relatively easy thing to detect if you understand where the value lies in your organization and its processes. Fraudsters will always find a way to take advantage of a given situation to perpetrate fraud. Fortunately for us, even the smartest people outsmart themselves while perpetrating fraud, which usually results in their discovery. It is not practical to think that you can ever prevent all fraud from happening. However, you can do some quite simple things to deter fraud or to identify it once it happens.

Notice that I say it is relatively easy to *detect* fraud, not *prevent* it. The most important point is that no matter how good you think your people, internal controls, and auditors are, fraud is happening in your organization, so unless you take a proactive approach, fraud will continue to exist. To conduct business, you need employees, and you must be able to trust them with things of value in order to get anything done; otherwise you would be out of business very quickly. The decision of whom you trust to conduct business on your behalf is probably one of the most important decisions you will make in business.

At this point, you may be thinking:

- “My organization does not have to worry about fraud. This is something that happens to others. We only hire honest people.”

- “I know nothing about our books because I am not a numbers person, but my bookkeeper has been here for years, and I trust him or her completely.”

In my years of experience in detecting fraud, I have heard all of the excuses, and it is this type of thinking that allow fraud to exist. Unfortunately, so many of the people who once thought it could not happen to them are now out of business or have suffered extreme financial loss. Had they taken a critical look at where the people they employed came into contact with value, they might have predicted to a certain extent where fraud would be likely to occur. If you are thinking that it could not happen to you, you really need to keep reading this book, because it will probably save you a lot of money and frustration.

Enablers of Fraud

Everything in your organization, beyond the understanding that fraud actually exists, is essentially an enabler of fraud. Organizations that do not think fraud can exist do not have 800-pound friendly gorillas watching and are therefore susceptible to fraud. In this book, I discuss these enablers in great detail and show how they are embedded in various layers of an organization.

Enablers help fraudsters perpetrate and conceal fraud. An enabler can be as simple as a lax supervisor who fails to understand the importance of reviewing his or her employee's time sheet or expense reports, or it can be the use of the complexities of accounting principles to mask the true results of an organization's performance. A fraudster who creates complexity has created the necessary diversion or distraction to be able to perpetrate the simplest frauds.

An enabler can also be a false sense of safety and security established through a false pretense or a misunderstanding. For instance, people often think that a financial statement audit will detect fraud. They are mistaken. In fact, auditors go out of their way to communicate the fact that they are not responsible for the detection of fraud. The auditor or accountant statement in the body of the report purports to provide reasonable assurance, which in itself means that the financial statements are not 100 percent guaranteed to be correct. Auditors are not engaged to detect fraud, and an audit conducted in accordance with all applicable professional standards could easily miss a multimillion dollar fraud in an audit of a Fortune 500 company.

The problem is that many of these communications are addressed to the organization and its management and not to the investing public. Just because an organization has an auditor or accountant does not mean it does not have fraud. Remember, fraud is happening in every organization, large and small,

even those that have been audited. The only unknown variable is *how much* fraud is actually occurring. The actual value lost to fraud is something we will never know because most fraud is never reported.

But some enablers of fraud are much simpler than accounting and auditing complexities and/or shortfalls. Probably the biggest enabler is the fact that businesspeople simply do not know what fraud looks like, because they are too busy or it does not affect them—compounded by the fact that as humans we want to trust the people around us, even when we know we shouldn't. Knowing the common enablers of fraud and how to overcome them is essential for the success of your company and your future. This book explores the potential enablers in detail and how to overcome them.

Detractors of Fraud

There are ways to reduce the likelihood and impact of fraud through detractors. The 800-pound friendly gorilla, for instance, is a detractor and can help to watch what is going on in the company.

Detractors are intended to lessen the likelihood or impact of fraud. When people think about fraud prevention, they usually think about internal controls, which are indeed essential for preventing fraud. Many times, however, small-business owners will say that internal controls are expensive and that they do not have the personnel to implement them. This concern about implementing fraud prevention is referred to as the “dreaded cost-benefit analysis.” It is far from the reality. Internal controls can easily be tailored to meet the size of your organization and do not have to cost anything. The challenge is to maximize the resources you already have to limit the risk of fraud.

One of the most powerful controls is simply for owners and managers to pay attention to detail and spend time with the employees, making them think that you (the 800-pound friendly gorilla) are watching them. Don't overlook the fact that this simple control has a significant influence on people. Knowing your people and what they are doing goes a long way in deterring fraud. This book covers detractors in detail and offers practical ways to implement them.



THE ONE-MINUTE FRAUD MYSTERIES

When evaluating a person's role in fraud, we look at things like character and how it is developed. Perhaps a person's character was formed on the nights that Mom read him or her a bedtime story, or maybe it was formed by family

dinners, friends, school experiences, religious services, television, or even a tragic event. All of these things and more can shape a person's character. What were your defining moments? What are your ethical and moral boundaries?

You may be asking, "What does this have to do with fraud?" People are shaped by their experiences and environments, and you should take this into consideration as you read this book and learn how to assess the people in your organization to work toward the detection and prevention of fraud.

There is nothing we do can do to stop fraud altogether, but creating a sense of outrage that normally emerges after the fact in the news media and transforming it into a preventative measure can create sustainable action in which businesspeople can understand the dynamics of fraud before it happens and can try to control it.

At the beginning of each chapter in this book, there is a "one-minute fraud mystery." Each mystery outlines a hypothetical situation. Using the objectives and ideas presented in that chapter, you should analyze the situation and try to determine where fraud may be present in the organization in the example. Specifically, focus on where the people meet the value. At the end of the chapter, I reveal my thoughts as a guide from my years of experience.

Approach the one-minute fraud mystery in each chapter with skepticism, almost like playing the game 20 questions. Develop questions for the individuals of interest or create a road map for understanding the organizational process that is taking place in as simple a perspective as you can. Be sure to ask questions of the individuals you believe to be the most ethical and the most likely to tell the truth, but be cautious; remember that as humans we like to trust.

As you work through the various one-minute fraud mysteries, develop questions beyond the examples given in the chapters. Use your imagination by first thinking divergently ("outside the box") and then thinking in a more convergent (critical) fashion. But, most important, always try to maintain independence, objectivity, and integrity.

Suggested Thought Processes and Questions

Here is a list of sample thought processes and questions you can use as you review the one-minute fraud mysteries:

- Develop an understanding of the organizational and individual ethical tones of the people involved.
- Identify the organizational business process being examined and the value (cash or cash-convertible) involved.

- Map out the organization, its people, and those who have access to its value.
- What are the people's jobs?
- How do the departments operate?
- What do you think about the problem the mystery is trying to exemplify?
- What is the process in the mystery?
- What accounts have the potential to be circumvented?
- What are the policies of the organization? Where are the distractions in the process?
- Where are the diversions in the process?
- Where is the division in the process?
- Who are the people of interest? The enablers? The detractors?
- Who are the responsible parties overseeing the business process controls?
- What are the potential overlapping responsibilities that require a segregation of duties with access to organizational value?
- When was the last time any person of interest took a vacation?
- What potential conflicts exist?
- What are the underlying assumptions?
- What skills are needed to employ or develop the fact-finding aspects of the case?
- What accounting principles and standards may have been violated?
- Have any laws been broken?
- What documentation is available to prove the case?
- What are the potential deceptions between the people and the organization?
- Where is there a clear division between the people and the organization?

These are just some of the questions you can keep in mind when reviewing the mystery in each chapter. Remember, whenever applying any level of thinking, you must also adhere to the American Institute of Certified Public Accountants (AICPA) General Standards rule 101 (independence) and rule 201 (professional competence, due professional care, adequate planning and supervision, and sufficient relevant data). Also make sure that when you are reviewing a possible fraud incident, your people can adequately answer the classic questions of who, what, where, when, why, and how.

This book encourages you to develop your own outline and decide what works best for you. There is no one way that fraud is committed, and as a result, there are multiple ways to detect, deter, and prevent it. Make sure that whatever approach you use is simple and to the point; the last thing you want is to be led on a wild-goose chase.

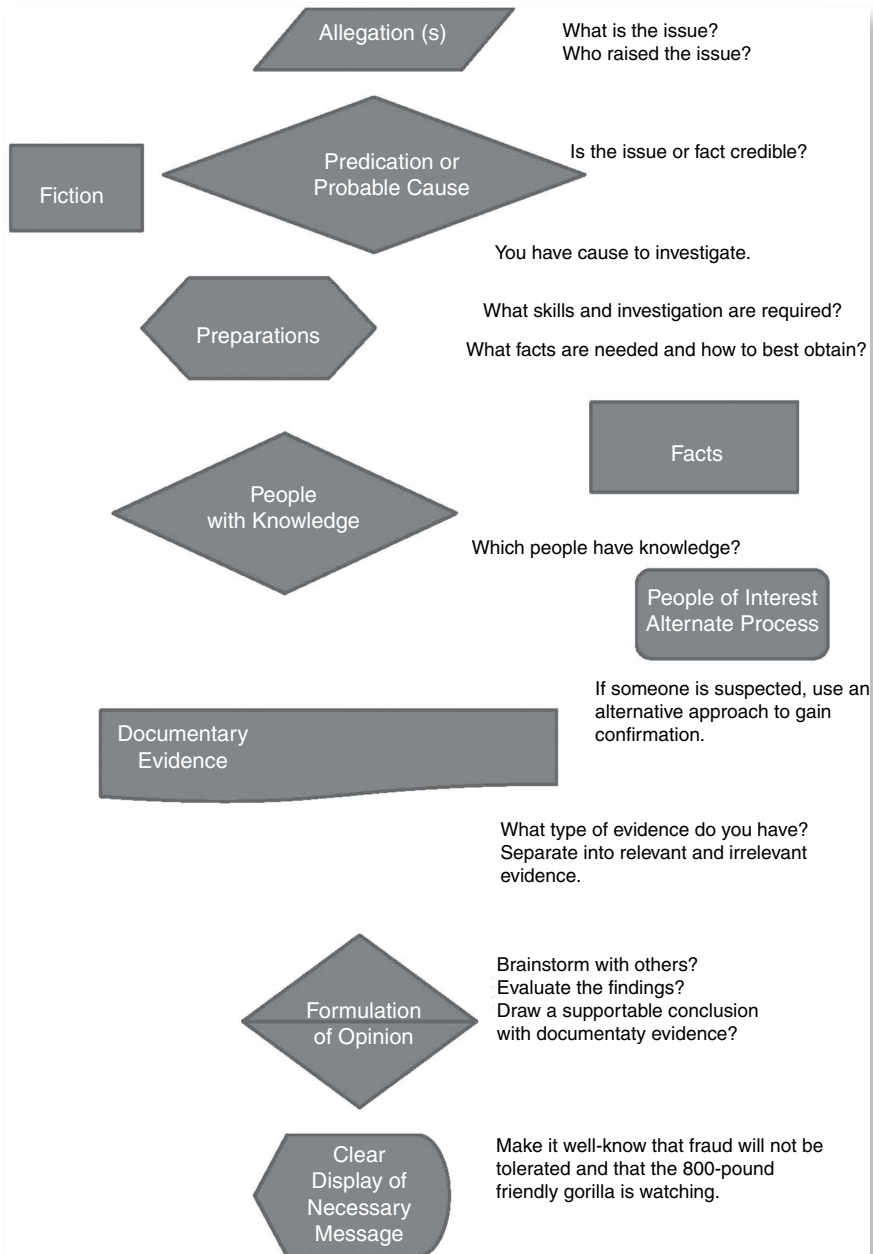
**EXHIBIT I.2** Flowchart to Use to Help Solve Fraud Mysteries

Exhibit I.2 shows a flowchart you can use when formulating your findings for the mystery in each chapter.

Think of the organizational processes in the same context that the organization did when formulating its overall business plan, including the following:

- Who are the people of interest?
- What activities are being performed?
- What resources are needed?
- What are the cost centers?
- Where is the value found?
- Who are the customers? Distributors? Vendors?
- What are the potential conflicts of interest?
- What are the market segments for the business?
- What are the business's revenue streams?
- What generates the organizational goodwill (i.e., an intangible value such as the organization's good name)?

Then look at the trends and the market, industry, and macroeconomic forces in play to develop the various scenarios in the mystery. Describe the scenarios and then brainstorm them to formulate a well-documented opinion.

Basically, do not just accuse someone of fraud. Only a judge and jury can do that. As a fraud detector, you are more of a fact finder. Exhibit I.2 offers a great method for collecting the necessary ideas to solve most fraud mysteries as well as to understand where the people and the value in an organizational process meet. You need to focus on that dynamic to detect, deter, and prevent fraud.

Solving fraud can be broken down into the following simple checklist by subject:

- **Allegation.** What is the issue? Who raised it?
- **Predication.** If there is probable cause to investigate, then continue. If the allegation is only fiction, then stop.
- **Preparation.** What skills and investigation are required?
- **Facts.** What facts are needed and what is the best way to obtain them?
- **People with knowledge.** Which people have knowledge?
- **People of interest.** If someone is suspected, use an alternative approach to gain confirmation (i.e., a third-party approach so the person of interest is not clued in to the investigation).
- **Documentary evidence.** What type of evidence proves the alleged facts: documents, testimony, electronic data? Separate your evidence into two

piles: relevant and irrelevant evidence. Also maintain a chain of custody: the chronological documentation or paper trail showing the seizure, custody, control, transfer, analysis, and disposition of evidence (physical or electronic) to support your opinion and findings.

- **Formulation of an opinion.** Brainstorm with others to sort out the evidence, draw supportable conclusions, and confirm all documentary evidence.
- **Clearly display the necessary message.** Send the message that fraud will not be tolerated and that the 800-pound friendly gorilla is watching.



A FEW TIPS FOR DETECTING FRAUD AS YOU BEGIN

There are a few things you should note up front to get you started in reviewing situations and events for possible fraud and in thinking differently about the who, what, when, why, and how of your business. As you delve into each chapter, you'll gain a greater understanding, but here are a few things to keep in mind.

Keep a Chain of Custody and Organized Records

A chain of custody keeps a paper trail of the documents that support a case in chronological order (i.e., as received). Maintaining a chain of custody is one of the most critical components of a fraud investigation. After the documents are put in chronological order, they should be organized by the parties they are received from (i.e., witnesses, professionals, or others).

A chain of custody helps to establish a “smoking-gun file” for easy access to the most relevant documents that support your fraud investigation findings. When you expect a large amount of documentary evidence to surface, it helps to establish an organized database early in a case. Microsoft Excel is a good program for organizing a chain of custody because it has an easy Find feature (Ctrl + F). A well-organized chain of custody allows you to provide a list of what documents you reviewed when formulating your opinion on a case.

Understand Data Analysis Queries

The steps in the following accounts payable example show the data you would analyze to detect fraud in this area of a business:

- Examine paid invoices to manually compare them with actual invoices.
- Summarize large invoices by amount, vendor, and so on.

- Identify debits to expense accounts outside the normal default accounts.
- Look for journal or correcting entries in the subsidiary or general ledgers.
- Reconcile check registers to disbursements by vendor invoice.
- Verify vendor 1099 requirements.
- Create vendor detail and summary analysis reports, which include an aging analysis to look for past-due vendor accounts, duplicate payments, and unusual or unexplained variations.
- Review recurring monthly expenses and compare to actual posted and paid invoices.
- Randomly and vendor-specifically generate reports on particular vouchers for manual audits or investigations.
- Look for conflicts of interest.
- Make sure you set up data analysis to be used in analyzing any organizational processes.

Know Whom You're Dealing With: Background Checks and Confirmations

Where permitted by law, the following checks and confirmations are useful to note when reviewing cases of fraud:

- Check the status of licensed individuals (such as certified public accountants and doctors) and entities with the appropriate boards or overseeing bodies. Remember, licenses exist to ensure that basic job requirements are met.
- Confirm addresses and Social Security numbers by using credit header searches.
- Research state and federal criminal court records and statewide criminal convictions to uncover past criminal histories.
- Obtain consumer credit reports for employee selection, retention, and promotion (making sure you get the proper authorization to pull these credit reports, of course).
- Obtain public filings such as bankruptcy filings, tax liens, and judgments to identify adverse financial matters that can serve as potential motivators for fraud.
- Check Department of Motor Vehicle driving records when a prospective or current employee drives a personally owned vehicle or an employer-owned vehicle to perform responsibilities for the employer. These types