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PREFACE

The catastrophic business failures of this decade have been revealing on many levels. From my professional perspective as a forensic accounting investigator, I couldn’t help but notice the need across much of the business community for a better grasp of the scope and skills of the forensic accounting investigator. Most people seemed to be struggling. How could these massive frauds have occurred? How can such events be deterred—if not wholly prevented—in the future? Who is responsible for deterrence, detection, and investigation? Is it a matter of systems, of attitudes, of aggressive internal policing, of more stringent regulatory oversight, of “all of the above” and more still? What methods are effective? What should an auditor, a corporate director, an executive look for? There were far more questions than answers, and all the questions were difficult. Forensic accounting investigation had become important to the larger business community and the public. They were relying on it to solve problems, deter new problems, and contribute to new, tougher standards of corporate behavior and reported information. But all concerned, from CEOs to financial statement auditors, still have much to learn about the relatively new discipline of forensic accounting investigation.

We live in the post-Enron era. The keynotes of the era are tough new legislation and regulation to strengthen corporate governance and new oversight of the auditors. Additionally, the Public Company Accounting Oversight Board (PCAOB) continues to review the need for a new fraud standard. All of these initiatives are intended to increase investor confidence in corporate information.

Pushing these trends relentlessly forward is the conviction of the concerned public that corporate fraud is unacceptable. It may well occur—this is an imperfect world—but everything must be done to deter, detect, investigate, and penalize it. Investors look to corporate directors and executives, internal and external auditors, and regulators to keep companies honest. They want to be able to trust securities analysts to report and recommend without concealed self-interest. And they expect lenders, business partners, and others who deal with a corporation to exercise and require sound business ethics.

Where fraud is concerned, there is no silver bullet. Clearly, a book would help to address the needs of three broad constituencies: management, corporate directors, and auditors (internal and external). Just as clearly, it shouldn’t be a book that focused only on concepts and facts. It would need to look at practice. It would have to convey effective working attitudes and realistic perspectives on many issues, from the varied skills required of forensic accounting investigators to working with attorneys and reporting findings. It would have to offer case studies that reveal the thinking both of experienced investigators and of the
fraudsters they pursue. In short, it would have to bring its readers into the complex and evolving culture of forensic accounting investigation while serving as a comprehensive, reliable, easily used reference source.

This was a tall order. Two close PricewaterhouseCoopers colleagues in our firm’s forensic accounting investigation practice, Steven Skalak and Mona Clayton, accepted the challenge with me. We quickly realized that the topics worthy of inclusion needed a still larger team with diverse experience. With this in mind, we invited forensic accounting investigators within our global organization, as well as admired attorneys with whom we had worked in other organizations, to join us as chapter authors. We three necessarily remained at the center, questioning, revising, and applauding. We were also responsible for chapters of our own. The process took two years.

This is a book that some readers will explore page by page; others will use it as a reference. However it is approached, it will reveal the surprising complexity of fraud deterrence, detection, and investigation and offer a step-by-step method to understanding that complexity. The range of concerns is vast—from the tightly constructed guidelines of SAS 99 (the most recent Statement on Auditing Standards concerned with fraud detection) to the tough-minded skills required to conduct an admission-seeking interview with an alleged perpetrator of fraud. Some readers will seek in this book a broad appreciation for investigative techniques so that they can more effectively manage the process when and if needed. Others will want to commit the details to memory. For both types of reader, it is all here: common fraudulent schemes, the psychology of the fraudster, the need for professional skepticism, responding to whistle-blowers, working with lawyers and prosecutors, new technologies that facilitate detection, and much more.

A common theme running through all of the chapters is the need for change. External and internal auditors must train thoroughly in fraud-detection procedures and attitudes. The university education of the next generation of auditors should reflect the new emphasis on fraud deterrence, detection, and investigation. And executives and directors must be fully aware of the threat of fraud and do all they can to institute measures to deter it, ranging from robustly enforced codes of ethics to internal controls that make fraud less likely and easier to detect.

In practical reality, no one can guarantee that all frauds will be either prevented or detected in a timely manner. Yet the toolbox of those who safeguard the integrity of corporate information and investigate possible wrongdoing is well filled. This book will make that clear. It puts before the reader what is, to my mind, an extraordinary array of best practices, tools, and techniques for the deterrence, detection, and investigation of corporate fraud. The skills and knowledge of the forensic accounting investigator are evident in every page.

This is by no means a casual book, tossed off to meet an ephemeral need. We hope that the effort that has gone into it will make it substantively useful over the long term. With proper knowledge and diligence among all those who are responsible for providing financial information for the capital markets, financial fraud can be significantly deterred. As the suspicion and reality of fraud dimin-
ish across the corporate world, investors will regain confidence in the integrity of corporate information. The ultimate purpose of this book reaches past the audit profession—and the directors and managers who hire and work with auditors—to address the needs of the capital markets worldwide.

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A book of this scope is a collective endeavor. We want to take this opportunity to thank Dennis Nally, Juan Pujadas, Greg Bardnell, and Greg Garrison. We want also to identify those individuals who have contributed to a sustained effort of thinking, writing, fact-checking, editing, and project management.

There was a team around us from the beginning. We owe a particular debt of gratitude to Robbie Pound. This is a better book for his review and editorial suggestions. Mark Friedlich was indispensable as project manager, editor, and counselor. Hillary Ruben, serving as coproject manager, kept us focused on the next mountain to climb and ensured, thorough communication, as we progressed. If we remained of good cheer, it was largely her doing. Roger Lipsey’s editorial skill is evident throughout the book. That we have achieved a consistent and clear voice has much to do with his efforts. We also benefited from the editorial contributions of Gene Zasadinski, David Evanson, Paula Plantier, and Michael Juhre. Wendy Amstutz kept us thinking about the audiences for this book and dazzled us with the possibility that we might someday actually complete and publish it. And Mark Starcher created and administered the enormously helpful Web site where we all could share in developments.

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Our greatest thanks go to our fellow authors—practitioners in the United States and around the globe, and a number of attorneys with other firms or government, who drew on their time, experience, and wisdom to write many of the chapters. At the head of each chapter, readers will find these individuals clearly and gratefully identified. This is their book as much as it is ours.

The following roster names, with gratitude, the authors who created the original drafts of all chapters and approved their final form. All are partners or employees of PricewaterhouseCoopers apart from clearly identified exceptions.

1. Fraud: An Introduction
   Steven L. Skalak
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 2. The Roles of the Auditor and the Forensic Accounting Investigator
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11. Financial Statement Fraud: Other Schemes and Misappropriations
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The authors offer this book with the hope that it answers a very real need and
will provide its readers with a new and compelling vision of the role of forensic
accountants in the deterrence, detection, and investigation of corporate fraud.
The views expressed in this book are those of the individual authors and are not
necessarily the views of PricewaterhouseCoopers or any other Pricewaterhouse-
Coopers partner or employee. Unless otherwise indicated, the authors are not
attorneys and their comments are based on their personal experiences and do not
represent legal advice.

Thomas W. Golden
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CHAPTER 1

FRAUD: AN INTRODUCTION

Steven L. Skalak
Manny A. Alas
Gus Sellitto

Fraud evokes a visceral reaction in us. It is an abuse of our expectation of fair treatment by fellow human beings. Beyond that, it is a blow to our self-image as savvy managers capable of deterring or detecting a fraudulent scheme. Whether we react because of values or because of vanity, nobody likes to be duped. Many elements of modern society are focused on maintaining an environment of fair dealing. Laws are passed; agencies are established to enforce them; police are hired; ethics and morals are taught in schools and learned in businesses; and criminals are punished by the forfeiture of their ill-gotten gains and personal liberty—all with a view to deterring, detecting, and punishing fraud. The profession of auditing grew out of society’s need to ensure fair and correct dealings in commerce and government.

One of the central outcomes of fraud is financial loss. Therefore, in the minds of the investing public, the accounting and auditing profession is inextricably linked with fraud deterrence, fraud detection, and fraud investigation. This is true to such an extent that there are those whose perception of what can be realistically accomplished in an audit frequently exceeds the services that any accountant or auditor can deliver and, in terms of cost, exceeds what any business might be willing to pay (see Chapter 2). In the past few years, public anger over occurrences of massive fraud in public corporations has spawned new legislation, new auditing standards, new oversight of the accounting profession, and greater penalties for those who conspire to commit or conceal financial fraud.

This book addresses the distinct roles of corporate directors, management, external auditors, internal auditors, and forensic accounting investigators with
respect to fraud deterrence, fraud detection, and fraud investigation. As will quickly become apparent later in this introductory chapter, these professionals are by no means the only ones concerned with combating fraud. However, each has a significant role in the larger effort to minimize fraud.

**FRAUD: WHAT IS IT?**

Generally, all acts of fraud can be distilled into four basic elements:

1. A false representation of a material nature
2. Scienter—knowledge that the representation is false, or reckless disregard for the truth
3. Reliance—the person receiving the representation reasonably and justifiably relied on it
4. Damages—financial damages resulting from all of the above

By way of illustration, consider the classic example of the purchase of a used car. The salesperson is likely to make representations about the quality of the car, its past history, and the quality of parts subject to wear and tear, ranging from the transmission to the paint job. The elements of fraud may or may not arise out of such statements. First, there is a distinction between hype and falsehood. The salesperson hypes when he claims that the 1977 Chevy Vega “runs like new.” However, were he to turn back the odometer, he would be making a false representation. Second, the false statement must be material. If the odometer reading is accurate, the salesperson’s representation that the car runs like new or was only driven infrequently, is, strictly speaking, mere hype: the purchaser need only look at the odometer to form a prudent view of the extent of use and the car’s likely roadworthiness. Third, the fraudster must make the material false misrepresentation with scienter, that is, with actual knowledge that the statement is false or with a reckless disregard for the truth. For example, the car may or may not have new tires. But if the salesperson, after making reasonable inquiries, truly believes that the Vega has new tires, there is no knowing misrepresentation. There may be negligence, but there is no fraud. Fourth, the potential victim must justifiably rely on the false repre-

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1. “Forensic accountants” are members of a broad group of professionals that includes those who perform financial investigations, but it is actually wider. The public often uses the term “forensic accountants” to refer to financial investigators, although many forensic accountants do not perform financial investigations. In Chapter 27 we discuss the many other services encompassed under the broader term “forensic accounting.” A forensic accounting investigator is trained and experienced in investigating and resolving suspicions or allegations of fraud through document analysis to include both financial and nonfinancial information, interviewing, and third-party inquiries, including commercial databases. See Auditing and Investigation at end of this chapter.

“Auditors” is used throughout this text to represent both internal and external auditors unless otherwise specified as pertaining to one group or the other.

2. The term “material” as used in this context is a legal standard whose definition varies from jurisdiction to jurisdiction; it should not be confused with the concept of materiality as used in auditing, in which one considers the effect of fraud and errors related to financial statement reporting.
sentation. A buyer who wants a blue car may actually believe the salesperson’s representation that “it’s really blue but looks red in this light.” Reliance in that case is, at best, naïve and certainly not justified. Finally, there must be some form of damage. The car must in fact prove to be a lemon when the purchaser drives off in it and realizes that he has been misled. Regardless of context, from Enron to WorldCom to Honest Abe’s Used Car Lot, fraud is fraud, and it displays the four simple elements noted above.

♦ FRAUD: PREVALENCE, IMPACT, AND FORM

Fraud is a feature of every organized culture in the world. It affects many organizations, regardless of size, location, or industry. According to the ACFE survey, approximately $660 billion was lost by U.S. companies in 2004 due to occupational fraud and abuse, and nearly one in six cases cost the organization in excess of $1 million.\(^3\) Thirty-two percent of all fraud is committed by males aged 41 to 50, while the greatest loss per fraudulent act is caused by males aged 60 and over.\(^4\) In the area of material financial reporting fraud, in two studies conducted on the issue, both using information obtained from the SEC, it was determined that over 70 percent of all financial statement frauds are committed by the top executives of the organization.\(^5\)

However, if one were to look at the FBI’s statistics for white-collar crime, one would not reach this conclusion because those statistics are based upon prosecutions and, as discussed in Chapter 22, “Supporting a Criminal Prosecution,” the overwhelming majority of frauds are not prosecuted. Based upon our own experience as well as on surveys conducted by PwC (PwC Economic Crime Survey) and the Association of Certified Fraud Examiners (ACFE), we believe that fraud is pervasive. In Europe, according to the PwC Global Economic Crime Survey statistics for prior years, 42.5 percent of larger European companies fell victim to fraud in 2000 and 2001. Across all of the companies surveyed, the average cost of fraud was €6.7 million. Overall, approximately 40 percent of large European organizations believe that the risk of fraud in the future will be at least as high as it is now, while about one-third of them believe that it will be even higher.\(^6\) While these statistics were gathered in 2001, if anything, the current climate in Europe suggests that higher percentages would prevail today in a resurvey of the same population.


4. Id.


FRAUD IN HISTORICAL PERSPECTIVE

Fraud in one form or another has been a fact of business life for thousands of years. In Hammurabi’s Babylonian Code of Laws, dating to approximately 1800 B.C.E., the problem of fraud is squarely faced: “If a herdsman, to whose care cattle or sheep have been entrusted, be guilty of fraud and make false returns of the natural increase, or sell them for money, then shall he be convicted and pay the owner ten times the loss.” The earliest lawmakers were also the earliest to recognize and combat fraud.

In the United States, frauds have been committed since the colonies were settled. A particularly well-known fraud of that era was perpetrated in 1616 in Jamestown, Virginia, by Captain Samuel Argall, the deputy governor. Captain Argall allegedly “fleeced investors in the Virginia Co. of every chicken and dry good that wasn’t nailed down.” According to the book *Stealing from America*, within two years of Argall’s assumption of leadership in Jamestown, the “whole estate of the public was gone and consumed. . . .” When he returned to England with a boat stuffed with looted goods, residents and investors were left with only six goats.

Later, during the American Civil War, certain frauds became so common that legislatures recognized the need for new laws. One of the most egregious frauds was to bill the United States government for defective or nonexistent supplies sold to the Union Army. The federal government’s response was the False Claims Act, passed in March 1863, which assessed corrupt war profiteers double damages and a $2,000 civil fine for each false claim submitted. Remarkably enough, this law is still in force, though much amended.

Soon after the Civil War, another major fraud gained notoriety: the Crédit Mobilier scheme of 1872. Considered the most serious political scandal of its time, this fraud was perpetrated by executives of the Union Pacific Railroad Company, operating in conjunction with corrupt politicians. Crédit Mobilier of America was set up by railroad management and by Representative Oakes Ames of Massachusetts, ostensibly to oversee construction of the Union Pacific Railroad. Crédit Mobilier charged Union Pacific (which was heavily subsidized by the government) nearly twice the actual cost of completed work and distributed the extra $50 million to company shareholders. Shares in Crédit Mobilier were sold at half price, and at times offered gratis, to congressmen and prominent politicians in order to buy their support. Among the company’s famous sharehold-
ers were Vice President Schuyler Colfax, Speaker of the House James Gillespie Blaine, future Vice Presidents Henry Wilson and Levi Parsons Morton, and future President James Garfield.\textsuperscript{13}

\section*{TYPES OF FRAUD}

There are many different types of fraud, and many ways to characterize and catalog fraud; however, those of the greatest relevance to accountants and auditors are the following broad categories:

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\item \textit{Employee Fraud}/\textit{Misappropriation of Assets}. This type of fraud involves the theft of cash or inventory, skimming revenues, payroll fraud, and embezzlement. Asset misappropriation is the most common type of fraud.\textsuperscript{15} Primary examples of asset misappropriation are fraudulent disbursements such as billing schemes, payroll schemes, expense reimbursement schemes, check tampering, and cash register disbursement schemes. Sometimes employees collude with others to perpetrate frauds, such as aiding vendors intent on overbilling the company. An interesting distinction: Some employee misdeeds do not meet the definition of fraud because they are not schemes based on communicating a deceit to the employer. For example, theft of inventory is not necessarily a fraud—it may simply be a theft. False expense reporting, on the other hand, is a fraud because it involves a false representation of the expenses incurred. This fraud category also includes employees’ aiding and abetting others outside the company to defraud third parties.

\item \textit{Financial Statement Fraud}. This type of fraud is characterized by intentional misstatements or omissions of amounts or disclosures in financial reporting to deceive financial statement users. More specifically, financial statement fraud involves manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared. It also refers to the intentional misapplication of accounting principles to manipulate results. According to a study conducted by the Association of Certified Fraud Examiners, fraudulent financial statements, as compared with the other forms of fraud perpetrated by corporate employees, usually have a higher dollar impact on the victimized entity as well as a more negative impact on shareholders and the investing public.\textsuperscript{16}
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\item \textsuperscript{14} “Employee” here refers to all officers and employees who work for the organization.

\item \textsuperscript{15} Association of Certified Fraud Examiners, \textit{2002 Report to the Nation on Occupational Fraud and Abuse} (Austin, Tex.: Association of Certified Fraud Examiners, 2002), 6.

\item \textsuperscript{16} Id.
\end{itemize}
As a broad classification, corruption straddles both misappropriation of assets and financial statement fraud. Transparency International, a widely respected not-for-profit think tank, defines corruption as “the abuse of entrusted power for private gain.” \(^1\) We would expand that definition to include corporate gain as well as private gain. Corruption takes many forms and ranges from executive compensation issues to payments made to domestic or foreign government officials and their family members. Corrupt activities are prohibited in the United States by federal and state laws. Beyond U.S. borders, contributions to foreign officials are prohibited by the Foreign Corrupt Practices Act.

This book is primarily concerned with fraud committed by employees and officers, some of which may lead to the material distortion of financial statement information, and the nature of activities designed to deter and investigate such frauds. Circumstances in which financial information is exchanged (generally in the form of financial statements) as the primary representation of a business transaction are fairly widespread. They include, for example, regular commercial relationships between a business and its customers or vendors, borrowing money from banks or other financial institutions, buying or selling companies or businesses, raising money in the public or private capital markets, and supporting the secondary market for trading in public company debt or equity securities. This book focuses primarily on two types of fraud: (1) frauds perpetrated by people within the organization that result in harm to the organization itself and (2) frauds committed by those responsible for financial reporting, who use financial information they know to be false in order to perpetrate a fraud on investors or other third parties, whereby the organization benefits.

**ROOT CAUSES OF FRAUD**

As society has evolved from barter-based economies to e-commerce, so has fraud evolved into complex forms—Hammurabi’s concern about trustworthy shepherds was just the beginning. Until just a few years ago, companies headquartered in the developed world took the view that their business risk was highest in emerging or Third World regions, where foreign business cultures and less-developed regulatory environments were believed to generate greater risk.\(^2\) Gaining market access and operating in emerging or less-developed markets seemed often enough to invite business practices that were wholly unacceptable at home. Sharing this view, the governments of major industrial countries enacted legislation to combat the potential for corruption. The United States enacted the Foreign Corrupt Practices Act (FCPA); countries working together in the Organization for Economic Cooperation and Development (OECD) enacted the Convention on Combating Bribery of Foreign Public Officials in

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