

CHAPTER 1

The World of Fraud

I am often asked for my thoughts on fraud. A common question posed is whether I believe fraud is on the rise. My response usually goes like this: “When you say fraud, what do you mean by fraud, and what kind of fraud are you talking about? If you are asking me about fraud in general, my answer is yes, I believe fraud in general has significantly increased during my professional lifetime. If you are asking me if society has become less honest and more accepting of individuals who are trying to beat the system, my answer again would be yes. However, are you referring to a particular area of fraud?”

Definition of Fraud

What is fraud? Although there are common definitions of fraud, no two definitions are the same. If an employee brings home some office supplies for their kids to use with their school projects, is that fraud? Or is it simply an employee stealing office supplies? Or is it just an accepted practice in business that some office supplies may end up being used for personal purposes—a cost of doing business, if you will? Or are we saying the same thing, but three different ways? How about a business that overstates reserve balances on their financial statements, only to use those overstated balances in future periods to “smooth” earnings trends? Is that considered fraud, or is it simply a widely accepted business practice—technically incorrect, but otherwise allowed

and accepted? Lastly, how about a family who wants to have their children attend a particular college that they can't afford? In preparing the financial aid forms, they don't report certain bank and investment accounts, and underreport their true earnings so that their child will be eligible for financial aid. Are they committing fraud, or are they simply working the system to gain access to funds available for that specific reason—to assist families with high tuition costs?

Depending on who is asked each of these questions, we may get consistent answers or (more likely) we will get disparity based on each individual's background, values, and beliefs.

Therefore, before we can get into discussions and cases relating to fraud, it would be a good idea to make sure we are all talking about the same thing—fraud. One of the best resources for an objective, defensible definition of fraud is *Black's Law Dictionary*. According to *Black's Law Dictionary*, fraud is defined as “a knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment.”¹

As mentioned earlier, to further define and understand fraud, it has to be discussed within a specific context. Fraud can be further broken down into subcategories of fraud, along with various methods used to commit each type of fraud. Unfortunately, fraud has become prevalent within virtually every aspect of our lives, is accepted by many as the status quo, and acts as a constant reminder of the sad state of society in which we live. Personal characteristics that were likely found within individuals living a socially responsible life, things like ethics, morals, and pride, have been replaced by greed, self-promotion, and the “what's in it for me” mentality.

The Many Types of Fraud

Names like WorldCom, Enron, and Arthur Andersen have become more than commonplace in discussions regarding fraud.

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Their names and others—such as Martha Stewart, who was found guilty of lying to authorities about possible insider trading, and Richard Hatch, a *Survivor* winner who failed to pay the taxes due on his winnings, can and often are used in analogies of what can go wrong. Instances of fraud occur every day and either go undetected or are deemed not worthy of attention. Only cases involving overwhelming amounts of money or some other news-grabbing aspect make the headlines. Traditionally, only one in nine fraud cases ever appears in the media, which means that for every fraud you read or hear about, eight more will never appear in the public eye.

Two main areas of fraud exist in the world of accounting: *management fraud*, commonly known as financial statement fraud, and *employee fraud*, or embezzlement. Many of the notorious frauds of this and past decades fall into one of these two categories. However, many other categories of fraud or fraudulent activity exist. If you watch the news, read the newspaper, or scan news posts on the Internet, you should be able to name a few more categories. How about political malfeasance? These frauds are committed by elected officials who abuse their office or position, usually for some form of personal enrichment. Bribes, gifts, preferential treatment, bid rigging, and kickbacks involving politicians and elected officials have been the target of many investigations and convictions as seen in so many news stories.

Then, of course, there is tax fraud. Tax fraud can be carried out by any business, organization, or individual, at the federal or state level. And for all the types of taxes that are imposed at the local, city, county, state, and federal level, there exists an equal number of tax fraud schemes committed to minimize each type of tax. Based on personal experience, the rate of occurrence of some form of tax fraud, whether a large scheme or simply minor cheating, is present on virtually every tax return filed.

Rounding out the top most widely known fraud categories are crimes committed at the federal level: wire fraud, mail fraud, and bank fraud, to name a few of the most common. Convictions on these types of fraud are generally easy to obtain. A scheme to defraud involving an electronic banking transaction or simply mailing a check or payment is all it would take for a violation. The use of either means, common in so many schemes, can lead to a conviction of a federal law. The only conviction easier to obtain is obstruction of justice. Simply provide any false statement or fact to a federal investigator and you have committed obstruction of justice.

There is a risk for fraud in every type of social program that exists. Unfortunately, the reality of the situation is that every program in existence has a certain level of fraud; due to limited resources available to combat the issue, many individuals successfully defraud the programs. At the local level, for example, many towns offer residents below a set income level assistance with their town tax bills. Typically, a form needs to be completed by each applicant, along with a copy of the most recent tax return. Change the amounts to lower figures, copy the return, and submit it with the form and you will receive assistance. At the state level, complete the forms required for state aid, remain silent about the children's father working, earning a decent amount, and living in the same home, and the household income then falls below the set levels so that rent assistance will be provided by the state.

Case Study 1.1 – Public Aid Goes “Fraud Proof”

In my state, we have a publicly funded social program available to low-income individuals whereby qualifying

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recipients receive state aid to purchase food and other qualifying provisions. Our food stamp program used to require individuals to apply for assistance, and once qualified, the individuals received food stamps in the mail each month to be used similar to cash for purchasing food.

There were many fraud schemes perpetrated involving the food stamp program. Food stamps were often mailed to recipients on the same day each month, and the theft of recipients' mail became commonplace, as did simply robbing the recipient of his or her food stamps as they redeemed them. Food stamps became a form of currency on the black market, used in exchange for virtually any item and service. Recipients would pay for things never intended to be covered by food stamps, and in turn the individuals who were redeeming food stamps for food purchases were often living well beyond the intended income levels of the program.

There were also individuals who received multiple food stamp allocations each month by applying and qualifying using different names and multiple addresses. Children of qualified individuals were often claimed by several different individuals in their own qualification process, enabling each applicant to receive more food stamps per month than they were entitled to by listing children who were actually someone else's children who were already receiving food stamp benefits.

I remember waiting in the supermarket checkout lines behind individuals purchasing groceries with food stamps. Although the program required recipients to purchase generic labeled items, they were purchasing brand-name labels intermixed with generic items. I also saw alcohol, cigarettes, magazines and many other non-covered items

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being purchased. In the stores with more sophisticated registers, the non-covered items would be segregated and could not be paid for using food stamps. The clerk would collect food stamps for the covered items and then I would watch as the customer pulled out a large roll of cash to pay for the remaining items. I often wondered how the person could have qualified for food stamps with such a large amount of cash. In less sophisticated stores, though, all the items (even those specifically deemed as non-qualifying items) went through and were purchased with food stamps.

Once I asked a cashier after the customer had left why the non-covered items were allowed to be paid for by food stamps. The clerk told me that the store is reimbursed by the state for the same amount either way, so why should they tell customers what they can and can't buy with the food stamps? That mentality made the store an accessory to defrauding the food stamp program.

A few years ago, the state recognized the extent of the fraud issues, or more likely decided to finally address the issue and developed a new system. I attended a session sponsored by the food stamp program in which the two individuals who designed the new automated system presented the way the new food stamp system would work. The individuals explained that they had developed a debit card system to eliminate fraud within the program.

Each recipient would be issued a card similar to an ATM card that could be used to purchase qualifying food items. Each card would have an account associated with it, and each month the card would be replenished with the individual's qualifying amount. There would be no mailing of coupons, theft of mail, or robbing recipients. One card

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would be issued to each recipient, eliminating the risk that recipients would trade cards or use the monthly proceeds as trade in other transactions.

The presentation ended with the individuals feeling confident that their new system would eliminate the prior fraud and abuse, allowing the program to become a better steward over the public's funds.

The program wasn't even a month old when I found myself behind a customer using one of the new cards. I remembered the session, and my interest was piqued to see how this new system would work. I watched as the groceries were rung, and items not covered were segregated for the customary separate cash payment. The individual opened her wallet and removed her state card, then swiped it on the credit card terminal used for debit and credit card purchases. Three swipes later the clerk told the customer the balance on the card was insufficient to cover the cost of the groceries. Without blinking an eye, the customer opened her wallet again and removed three similar cards. By the third card swipe, there were sufficient funds to complete her purchase.

So much for the state's new program! And how much did they invest in this new system?

Financial aid programs are generally available at every private school, from pre-school through college, to assist families who qualify based on income limits and other requirements. Once again, the families often complete the forms and provide a "version" of the latest tax return showing lower than actual income. These fraud schemes are perpetrated against every program in existence.

Case Study 1.2 – Creative Approaches to Funding Higher Education

Many programs have an application process that requires supporting information to be provided to corroborate the information provided. Unfortunately, the programs' screening processes are often inadequate or outdated. Home computers and inexpensive software packages have made it relatively easy to create supporting documentation that, unless scrutinized and challenged, can easily meet the requirements for eligibility for the program. Bank statements can be easily scanned and then altered to reflect any desired balances. Tax returns can be run over and over again using packages like TurboTax to produce different results.

One great example of this type of fraud is the application process for college financial aid. In addition to completing the required forms, the applicant must also provide copies of tax returns and bank statements.

In one of my recent cases involving a business owner, I obtained copies of his personal income tax returns for the past three years. I identified that he was married with two children, and he owned a home estimated at a value of \$500,000, located in one of the best sections of our state. The taxes on his home alone were in excess of \$10,000, and the total of his itemized deductions in the latest year was nearly \$20,000.

The total income he reported on their jointly filed tax return was \$3,500. I was beyond words. A family of four, living in a \$500,000 house in the most expensive section of our state was living on \$3,500 per year? Sure!

On the bottom of each page of their tax returns, there was a reference to the daughter's name and Social Security number. I found a similar reference on each page of the

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returns for all three years. That was when I realized that the copies of the returns he had given me were the copies he had used to obtain financial aid for his daughter, the one whose name was written on each page of her parent's return—a requirement of the financial aid system.

With a little research, I learned that the daughter was attending the most expensive college in our state. By giving her school versions of their tax returns reflecting little to no income, I surmised the daughter was likely attending based on funds received through financial aid.

It turned out the tax returns were prepared by her father on his home computer using TurboTax and this was simply the "version" he generated to support his application for financial aid for his daughter's college education.

Here's my question: How could this very sophisticated school's financial aid process not be able to identify that the returns provided were obviously false and that the reported income was unreasonably low based on the other information in plain view on the same returns?

Let's look at the world of insurance. How many types of insurance fraud can you name? First, there is the fraud committed in the application process to obtain coverage, regardless of the type of coverage. Fraud can be committed in virtually every type of insurance known to exist. Leave the past health issues off the health insurance application, fail to mention that the vehicle will be used primarily for business on the automobile application, or indicate that you will be living in the property when a tenant has already been lined up. Then there are the insurance claim fraud schemes. Staged accidents, torched cars (especially when the amount owed on the vehicle exceeds the car's value), faked injuries, previous undisclosed health conditions,

burglaries that never occurred, fires that were set, water damage that was intentional, thefts that never occurred, and inflated inventories supporting a loss claim are just a few scheme areas. The goal is to obtain free money from the insurance company, who supposedly can afford the pay out, especially since high premiums have been paid to the insurance company on time all along—a “return on investment” rationalization.

Case Study 1.3 – How Many Did I Say It Was?

While attending college, I worked in construction, often building or renovating shopping plazas. The money was better than what I could earn anywhere else, and I was learning a trade that I still use to this day.

In my last year on the job, we were renovating a small shopping plaza that included a jewelry store. We knew all the shop owners and employees, as we interacted with them daily while rebuilding their shops. One sunny afternoon, a man ran out of the jewelry store, followed seconds later by the owner. The owner yelled to stop the guy, as he had just stolen a Rolex watch. The owner chased the thief a short distance, but he had disappeared. It happened so fast, that our crew never had time to come down from the staging to assist in the apprehension.

Within minutes, the police were at the plaza and cruising the neighborhoods looking for the thief. As the store owner spoke with police, he knew pretty quickly that the guy had successfully eluded police apprehension. We overheard the shop owner recount the individual's actions in the store.

The owner stated that the individual came into the store and asked to see different watches. Several were taken out and he tried on different ones. Then all of a sudden he grabbed three watches and ran out the store.

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Three watches? We all looked at each other. We all heard the owner, as he ran out of the store, yelling the guy had stolen a (one) Rolex watch. Somehow, once he knew the thief was gone and likely was not going to be caught, the single watch became three watches.

Why would the owner change his story for the police from one to three watches? Simple—seize the opportunity to make some money. The owner had insurance for thefts and robberies. If the owner reported to the police that a single watch was stolen, that would be the most the owner could recover. But by changing the quantity to three watches, knowing there was no one else who could support or refute the claim, the owner could be fraudulently reimbursed for the cost of three watches—a profit from the day's events!

Most of us didn't like the owner after that day and were glad we hadn't had time to get off the staging to get involved with the situation. However, one of the guys on our crew thought what the owner did was perfectly acceptable. Of course he was the same guy who was always scamming something and getting things for little to no cost.

Last year, I handled a case involving the "burglary" of a store. The claim alleged that individuals had cut the alarm wires and emptied the store on a stormy night. No inventory records were maintained, and there were no working cameras in the store.

In reviewing their claim and interviewing the owners, I found that there was actually nothing available to show that there was actually inventory in the store to steal that night. The only thing I could show was that wires were in fact cut, but there was no evidence to establish whether the wires were cut by burglars or by the owners themselves. Staged burglaries for insurance claims are all too common.

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The claim included a listing of the inventory alleged to be in the store along with the associated costs. No supporting invoices were provided showing how the items had been purchased.

Through interviews with the owners, I learned the quantities were determined based on quantities that were typically maintained of each item, not by the actual counts on hand—i.e., what should have been there versus what was actually there. Better still, the costs were not based on what the owners actually paid for each item. The costs used in their claim were based on an average cost they would pay today to replace the items. Additionally, the owners had no records to show how long their inventory had been on hand.

In the end, the claim was denied for lack of supporting information. Nothing could ever be provided to show that the inventory was actually in the store that night or that the owners hadn't simply removed the inventory from the store and claimed a burglary occurred.

Financial institutions have their share of fraud as well, committed by both banking customers and bank employees alike. Retail banking schemes could include opening new accounts under false pretenses or using fraudulent information, passing stolen or counterfeit cash or checks, and kiting (building up a fictitious balance in an account). The lending side of banking is at risk for loan application fraud, collateral fraud (the collateral is nonexistent, fictitious, or owned by someone else), and financial statement fraud. Mortgage fraud alone has developed into a multifaceted area for fraud investigations, involving attorneys, appraisers, real estate agents, mortgage brokers, loan originators, lenders, and anyone else party to a real estate closing.

Linked to financial institution fraud are investment fraud schemes. Hedge fund managers and investment advisors

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churning investments to generate commissions, outright stealing investments or proceeds from inactive investment accounts, and issuing fictitious statements to account holders to conceal the activity are all common practices. Certainly, Bernard Madoff's Ponzi scheme may be the largest in history at \$50 billion, but as more facts surface about the scheme, it may have been nothing more than an outright theft of investor funds. Two more similar schemes have recently been discovered in my state alone, each approximating \$350 million. It makes you wonder just how many of these exist, waiting to be revealed.

While the recent cases with staggering amounts involved have caught significant attention, making it appear as if these schemes are a new phenomenon, the reality is that investment schemes have been occurring ever since individuals have entrusted others with their funds. The following is a case I worked on early in my career.

Case Study 1.4 – Trust Me, We're Friends

Madelyn was in her mid-70s when a young, fresh face anxious to spend time with her befriended her. Lonely for companionship, Madelyn found herself quickly bonding with Jackie, an investment manager in her late 20s who worked for the local branch of a national investment firm. Jackie would call or meet Madelyn almost daily, and call her on the days when they didn't meet. They shared the most intimate of details about their lives; Madelyn even attended Jackie's wedding.

Over time, Madelyn developed a sense of trust in Jackie, shifting more and more of her estate over to Jackie's firm for Jackie to manage. Madelyn stayed with Jackie through two maternity leaves and treated Jackie's two children

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as if they were her own grandchildren. Madelyn's children and grandchildren were all grown and living in distant states.

Their relationship continued for more than ten years. During that period, Madelyn moved all of her investments to Jackie to manage and was quite happy with how Jackie handled her portfolio.

As Jackie reached 40, Madelyn knew all about the issues arising in Jackie's marriage; before long, Jackie was divorced. Raising two children, Jackie found it harder and harder to continue maintaining the long and demanding hours at the investment firm and was faced with a difficult decision. Jackie contacted Madelyn to discuss the option of leaving the firm to start her own practice, taking with her the accounts and assets she managed, if her clients would follow her.

Madelyn embraced the decision, and soon thereafter, Jackie established her own investment management company. The decision was easy for Madelyn. Jackie had managed her portfolio for so long, eliminating the details and demands of managing her own accounts and assets. How could she survive without her friend's help?

Month after month for the next few years, Madelyn received the regular monthly package from Jackie, just as she did when Jackie was with the investment firm. No major changes were identified each month.

Since going on her own, the time required by Jackie to manage her practice and care for her two children resulted in less contact with Madelyn. One day, Madelyn called Jackie to check on things. Much to Madelyn's surprise, the automated message indicated Jackie's number was no longer in service. Madelyn hung up and tried again, receiving the same message.

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Frantic that something happened to her good friend, frail Madelyn contacted a neighbor to help her determine what was happening with Jackie. The friend reviewed samples of Madelyn's investment reports produced by Jackie and compared them from month to month. Nothing unusual was found in the reported assets and activity.

At Madelyn's urging, the friend drove to Jackie's last known address only to find the house empty. The friend returned and advised Madelyn to contact an attorney to look into what happened to Jackie.

I received the call from the attorney, who suspected right away that Jackie had likely stolen all of Madelyn's funds and fled. The attorney had met with Madelyn and her friend and collected all of her investment reports as far back as possible. He provided me with the boxes of her records.

When Jackie worked for the firm, the monthly reports summarizing Madelyn's holdings and investment activity were generated directly from the investment firm's system, a reliable system used by this very well known and established investment firm. The statements showed shares, costs, gains and losses, and provided assurance to the account holder that the portfolio holdings were in fact being held at the brokerage in the customer's account.

However, shortly after Jackie left the firm and started her own practice, the form and format of the monthly reports changed dramatically. Summaries of the investments, along with color graphs and other illustrative depictions of the assets and activity, were included. Jackie had told Madelyn that the new format would make it easier for her to understand and follow her investment account.

However, nothing directly from the investment brokerage was ever included in the monthly package or received

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directly by Madelyn, showing that her assets were in fact still in her account.

Month after month, Madelyn continued to trust Jackie and rely on the new reports provided by Jackie until that dreaded day of the unanswered phone call.

I was able to obtain the actual investment account statements for Madelyn's account for the period from when Jackie left the firm to the most recent month. In comparing Jackie's reports to the actual investments provided by the brokerage firm, I found that the assets and activity were properly summarized and included in the new report format by Jackie for the first few months.

Then, I noticed a stock sale and cash disbursement from Madelyn's account. These two transactions never made it into Jackie's reports for the month. Instead, the activity and balances reported by Jackie were summarized as if the transactions never occurred and that the funds remained in Madelyn's account.

Month after month, I watched as Madelyn's assets were sold off, creating large cash balances that were depleted through checks written out of the account. In the months leading up to Madelyn's phone call, the account was fully liquidated and diverted by Jackie, yet the monthly reports Jackie prepared for Madelyn reported all the assets as if no sales had ever occurred and no checks were ever written.

Madelyn lost everything: the best friend she had had in years, a "daughter" and two "grandchildren" she would never see again, and all of her money—a mere \$600,000. It was all gone in a heartbeat. I still remember today how she described that feeling as total emptiness and betrayal beyond words, and although Madelyn passed away several years later, hearing the recent stories of Madoff's victims brings her back to mind.

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Jackie's whereabouts were determined when a warrant was issued for her arrest. Jackie had fled the state and was located in the South with her two children. I learned that Madelyn was not her only victim, although she was the only victim I investigated. It turned out that Jackie had made off with most of the funds her clients had "entrusted" to her, clients who had followed her when she left the firm to start her own practice. None of the funds were ever recovered.

Had any of the victims requested that monthly investment statements be mailed directly from the brokerage firm that maintained their account, they would have detected Jackie's scheme in the month of the first sale and check.

The point being made in this chapter is that there are many different types of fraud, more than can ever be covered in one book, let alone one chapter. The focus of the remaining chapters will be on financial fraud schemes perpetrated by employees and organizations. In the next chapter, we discuss why fraud is committed, as well as why the occurrences are increasing at an alarming rate.

Note

1. Garner, Bryan A. (ed.-in-chief), *Black's Law Dictionary* 8th edition (West, a Thomson Business: 2004).

