THE *Honest Truth* ABOUT FRAUD

A Retired FBI Agent Tells All

A Practitioner's Guide to Fraud

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Edited by Dr. Sridhar Ramamoorti

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FOREWORD

"The credit belongs to the man who is actually in the arena, whose face is marred by dust and sweat and blood; who strives valiantly; who errs, who comes short again and again, because there is no effort without error and shortcoming; but who does actually strive to do the deeds; who knows great enthusiasms, the great devotions; who spends himself in a worthy cause; who at the best knows in the end the triumph of high achievement, and who at the worst, if he fails, at least fails while daring greatly, so that his place shall never be with those cold and timid souls who neither know victory nor defeat." [1]

—DESCRIPTION OF "THE MAN IN THE ARENA"
BY THEODORE ROOSEVELT ON APRIL 23, 1910

President Roosevelt describes my friend, colleague, and author of this book, Mr. Victor E. Hartman—"the man in the arena"—quite well. Vic is also both an attorney and a CPA, the almost ideal combination of professional designations for anyone working at the FBI who is investigating fraud and white-collar crime. Even Lady Fortune smiled on him, for he was stationed in Houston, Texas, when, at the dawn of the twenty-first century, Enron collapsed. He was involved in the initial fact-finding forays by the FBI teams at both Enron and WorldCom to investigate the two large accounting scandals that led to the Sarbanes-Oxley Act of 2002. The quintessential practitioner, Vic Hartman has been there, done that, and pretty much seen everything.

Vic has poured his heart and soul into this book, and he has been quite exhaustive in describing the fraud threat picture. He also coined the term "forensic posture" to describe the position professionals may find themselves in when dealing with any aspect of the fraud life cycle: prevention, detection, investigation, mitigation, and remediation. He has competently captured the highlights of different types of fraud schemes and provided his audience with a practical approach to investigations, including interviewing techniques. His personal examples are compelling. In this book, his incredible background and experience, and his perspective as an antifraud expert come alive, and his passion and enthusiasm for the subject matter are evident throughout. You cannot fail to be impressed. The writing is crisp and matter-of-fact, but also memorable, even contagious!

Over 20 years ago, I recall a senior partner of an accounting firm describing the ideal Big Four firm partner as a "SWAN = smart, workaholic, ambitious, but nice." He went on to add that such a person would look as graceful as a swan on a placid lake (who was paddling unseen like the devil underneath!) Again, the description seems to fit Vic's calm and unflappable demeanor, yet his command and knowledge of the facts and circumstances of each case are so detailed that you just know he has been burning the midnight oil. I have no doubt that if Vic had chosen to be in the private sector instead of the FBI, he would have made a terrific partner in a Big Four firm.

I believe Vic has succeeded in his goal of producing a very different kind of book—one with a broad sweep but sufficiently detailed to afford business professionals of all stripes a solid overview and analysis of fraud and white-collar crime. It is my honor and privilege to have assisted him in assembling this excellent resource for practitioners to learn about fraud and to protect themselves against it.

Dr. Sridhar Ramamoorti
Editor

PREFACE

"Because that's where the money is." [1]

—APOCRYPHAL QUOTE OF LEGENDARY BANK ROBBER WILLIE SUTTON WHEN ASKED WHY HE ROBBED BANKS

I graduated from the Federal Bureau of Investigation's Academy in Quantico, Virginia, in 1989 with a badge, a gun, and marching orders to investigate savings and loan fraud in Houston, Texas. At the time, the Savings and Loan (S&L) crisis was full-blown, with institutions falling like dominoes and the media reporting on the deluge of crooks who had stolen millions of dollars. Congress, which ironically was as much to blame for the crisis as the crooks, wanted answers. Through legislation known as the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Congress funded the FBI and the Department of Justice (DOJ) to hire FBI agents and prosecutors with law, accounting, and regulatory backgrounds to put the S&L scoundrels in jail and recoup America's money.

This is the point in the long history of financial crimes where I began my journey. The country had just gone through a series of prosecutions involving Wall Street insider traders Ivan Boesky, Michael Milken, and the like. The FBI's focus on financial crimes had now moved from securities fraud to bank fraud. Texas developers had purchased banks during a time of rising real estate values. When caught up in a deteriorating real estate environment, these same developers-turned-bank executives made reciprocal loans among themselves to refinance their failing projects in a scheme known as a "daisy chain." Under normal circumstances, a team of FBI agents would be investigating one bank failure, a many-to-one arrangement. But these were no ordinary times. During the S&L crisis in Houston, Dallas, and other cities, one agent was assigned to multiple failures, a one-to-many arrangement.

I had the honor and privilege of being an FBI agent working on behalf of the American public. I knew the job would be challenging. I believed I had the technical credentials to investigate complicated fraud. At the age of 25, I sincerely believed that what I thought I lacked in experience, I would make up for in enthusiasm. That was not exactly the case. There were some critical concepts that I found to be the linchpin for successfully working fraud cases. This was not something taught at the FBI Academy, but it was something I did learn during a career of investigating fraud.

In fact, these practical and useful concepts were the impetus for my writing this book. Let me take a step back and reframe these concepts in the form of a question. Why would an individual make a materially false representation to another individual, company, or governmental entity for the purpose of material gain? Why would the individual do this, knowing he or she could get caught, be forced to pay the money back, suffer great shame, and face the real prospect of federal prison?

Learning the answer to the "why" question would eventually make my work easier and more efficient. Answering the question is at the heart of my journey and is a core theme of this book. Consider these questions: How do I prevent fraud? How do I detect fraud? How do I investigate fraud? What is the current fraud threat picture?

The often-cited quotation of Willie Sutton referenced in the epigraph above is wrong twice over. He did not say it, and it is not true. He actually did not rob banks for the money. In his book, *Where the Money Was*, Sutton reveals his real motive:

> Why did I rob banks? Because I enjoyed it. I loved it. I was more alive when I was inside a bank, robbing it, than at any other time in my life. I enjoyed everything about it so much that one or two weeks

> later I'd be out looking for the next job. But to me the money was the chips, that's all.[2]

Although robbing a bank at gunpoint is not fraud, Sutton's motivation for that serious crime makes my point—it is not always what you think it is. His motivation was clearly not greed. The obvious reason is really not obvious at all. For Willie Sutton, it was all about the emotions that came from fun and excitement. For others, their motivations will probably be something else. Surprisingly, it may not be about greed, the so-called standard explanation.

As a young FBI agent fresh out of the FBI Academy, I was full of piss and vinegar, but I had only mastered the technical skills to fight fraud. As an attorney, I knew the legal elements of each white-collar criminal offense I investigated. I always started with the end in mind. The end is a jury trial in which the government has the burden of proving that the defendant committed each element of the offense beyond a reasonable doubt. As a CPA, I understood the language of business. I could take complex financial documents and explain them to a prosecutor, grand jury, or trial jury.

The piece of the puzzle I was missing was understanding the psychology of the fraudster. My enthusiasm did not fully compensate for this lack of understanding. At that point in my career, I simply had not debriefed enough white-collar defendants to understand them. I was simply lacking the experience of dealing with those who commit fraud—the fraudsters—and the knowledge of why they do it. That does not mean I was not successful. I had all the AICs (arrests, indictments, and convictions) to keep my supervisor happy. I just did not know as much about fraud as I thought I did. I most certainly did not know what motivated individuals to commit fraud. I thought it was all about greed, taking shortcuts, or funding a fancy lifestyle at someone else's expense. Jumping to this conclusion was often wrong. Further, my mistaken assumptions likely caused inefficiencies by my taking unnecessary investigative steps, thereby increasing the costs of my investigations. Later, after understanding the motivation of my targets and their coconspirators, my investigations became much more effective and efficient. I was better able to strategically organize my investigations. Most importantly, my interviews and interrogations were eminently more effective.

I loved every day of my 25-year career with the FBI. My work included investigations into the diverse industries of financial services, health care, and governmental organizations. I served two stints as an attorney representing the FBI. My first role as an attorney was in the Houston Division of the FBI, where I served as Associate Division Counsel, a job that included managing the division's forfeiture team. While in the Houston Division, I was asked to switch to a management role, in which I supervised a bank fraud squad, a public corruption squad, and a health care fraud squad.

The first squad I supervised was a bank fraud squad of agents and task force officers. I was constantly amazed at how many frauds are associated with banks. Although the prevalence of fraudulent mortgages and bad checks were no surprise, the occasional bribery of bank officers was disheartening.

My most challenging role was supervising a public corruption squad. Public corruption cases are often high-profile cases and have lots of oversight. I truly believe in the need for oversight, especially for corruption cases. However, oversight comes with diverging views on how to proceed with an investigation. Within the field division, there is the Special Agent in Charge and the Chief Division Counsel. Each play a significant role. Then there is the United States Attorney's Office, which prosecutes the cases. A federal prosecutor never wants to lose a case, especially one involving a high-profile elected official. Accordingly, public corruption cases are often not charged until the conduct becomes so egregious that the prosecutor is confident that a win at trial is almost a certainty. Corruption cases are never straightforward. They usually involve collusion between two parties and no paper trail. On top of that, the defendant's charisma, which probably helped the defendant get elected in the first place, can influence the jury. Then there is Washington D.C. Both FBI Headquarters and the Department of Justice will weigh in on corruption investigations. The fact that these cases ever get prosecuted is somewhat amazing. Invariably, the prosecution is the result of the dogged

FBI street agent who pushes the cases through the system by articulating the hard and undeniable facts uncovered during the investigation.

I also supervised a health care fraud squad, which included the Houston Area Health Care Fraud Task Force composed of six law enforcement agencies and in excess of 50 investigators. Health care is one of the largest sectors of our economy. In terms of the anger I felt as an FBI agent, it was at its highest when I oversaw the Houston Division's health care fraud program. I witnessed firsthand the hundreds of millions of dollars lost because of those who defraud our federal health care programs. I felt this anger because, unlike almost every other type of fraud, there were no victims to cry foul. America was, and is still, asleep at the wheel when it comes to health care fraud. Taxpayers are the victims, and yet, they have no idea of the pervasiveness of the problem or the magnitude of the dollar loss.

While I was assigned to the Houston Division, two major accounting scandals were uncovered: Enron and WorldCom. Enron, a Houston-based company, imploded, and then a year later, WorldCom, located in Jackson, Mississippi, followed with a similar fate. I played leadership roles in the early investigative phases of both of these calamities. The first prosecution related to these cases was actually Arthur Andersen, the auditor for both of these companies. Little did I know at the time that the leadership failures of Enron, WorldCom, and Arthur Andersen would result in the passage of the sweeping legislation known as SOX, the Sarbanes-Oxley Act of 2002. I think it was apropos that a lead sponsor of this legislation, the late Congressman Michael Oxley, was a former FBI agent. He used to joke that many people he met abroad thought his first name was Sarbanes! There are many insights to be gained from studying the root causes of these major frauds that led to the most significant corporate governance reform legislation since the federal securities laws of the 1930s.

My last position with the FBI was as Chief Division Counsel of the Atlanta Division. As an attorney who represented the FBI, I provided legal advice and counsel to FBI executives who were managing all of the FBI's diverse programs. While white-collar crime was always my passion, the FBI had many other priorities that required my attention as legal counsel, including counterterrorism, cybercrime, drugs, organized crime, violent crimes, and foreign counterintelligence.

Even while serving as an attorney, I still wanted to stay involved in the FBI's white-collar crime program. I was honored to be selected to serve on the FBI's elite Corporate Fraud Response Team. This team, which was necessitated by the wave of corporate failures that included Enron and WorldCom, enabled the FBI to quickly respond at any corporate headquarters with a trained cadre of motivated FBI agents and forensic accountants to execute search warrants, interview executives, and start e-mail reviews. For my tough and rugged FBI agent friends who served dutifully on dangerous SWAT (Special Weapons and Tactics) teams, I always tell them I experienced many bloody paper cuts while working on the Corporate Fraud Response Team. There are few other organizations that share the esprit de corps that develops among FBI agents. As with most Type A personalities, there is also a healthy competition among the ranks.

I retired from the FBI after a career spanning a quarter century. I now represent clients needing internal investigations, forensic accounting, fraud mitigation consulting, and assistance with whistle-blower claims. I teach a master's level forensic accounting class at two large universities and regularly speak on the topic of fraud. I believe those in academia also play a significant role in the fight against fraud. First, they are teaching students who are getting ready to enter the workforce, and second, they have produced theoretical models that are of great value. Because of all of these experiences, I am convinced that there is a need for those in charge of companies, not-for-profits, and governmental organizations to better manage the fraud risk they face.

While I truly believe the FBI has done an extraordinary job investigating fraud, it does have resource limitations and perhaps does a poor job of sharing information with the private sector. This knowledge would greatly benefit those responsible for the prevention, detection, and investigation of fraud. That is part of my motivation for writing this book.

Everyone has a role in managing fraud risk. I am confident that my insights will benefit the many professionals who are responsible for overseeing fraud-related issues, including auditors, general counsels, compliance officers, board members, human resource professionals, chief audit executives, heads of security, criminal and civil investigators, regulators, and frontline managers.

Let me end this Preface with one legally required item. Due to my prior employment with the FBI and the examples provided throughout the book, I am required to and did obtain a prepublication review of my manuscript by the FBI. I have only included material that is consistent with FBI policy, and the opinions expressed throughout this book are mine and not those of the FBI.

Vic Hartman
Atlanta, Georgia

INTRODUCTION

I have spent my entire professional life dealing with fraud, including 25 years as an FBI agent and another 5 plus years in private practice. I witnessed fraud from the inside out. I know the players. I have talked to the victims. I have interviewed the witnesses. I have put the fraudsters in prison. I am now on acquaintance terms with some of these reformed felons and make joint presentations with them to various audiences.

The sad truth is that much of the fraud I investigated could have been prevented. Obviously, the victims wanted that outcome. What may perhaps come as a surprise is that many of the fraudsters themselves wished they would have been prevented from committing their acts. The material in this book can help you understand why both fraudster and victim engaged in activities that they may have regretted later.

Fraud has a staggering impact on all of us, including commercial enterprises, not-for-profits, and governmental entities in the United States and around the world. The Association of Certified Fraud Examiners' 2018 *Report to the Nations on Occupational Fraud and Abuse* estimates that organizations, on average, lose about 5 percent of their top-line revenue to fraud from within their organizations. When this figure is multiplied by the gross world product (GWP) of $79.6 trillion, the cost of occupational fraud is nearly $4 trillion dollars.[1]

When I was conducting the research for this book, several categories of fraud caught me by surprise due to the magnitude of the losses associated with them—health care fraud, tax evasion, and theft of intellectual property. I first began calculating the magnitude of health care fraud when I was leading the Houston Area Health Care Fraud Task Force. I now estimate the health care fraud loss to be about a quarter of a trillion dollars. The federal tax gap—the difference between the true tax liability and the amount paid on time—is nearly a half trillion dollars. The theft of intellectual property—technically not fraud—may be in excess of a half trillion dollars. The problem with these numbers is the MEGO (my eyes glaze over) effect. Upon learning these numbers, you did not drop this book, call your congressman or hold a press conference; you probably just yawned and turned the page. Don't worry, you are not alone. But these numbers are alarming, and we should all be concerned about what they represent.

This is a book about fraud. I wrote this book with several audiences in mind. The book is for the casual observer who wants to understand fraud and what can be done to minimize its impact. Another audience includes the many organizations that have been impacted by fraud and whose boards of directors are mandating that something be done so that the horrific event will not happen again. The book is also for the many audiences to whom I speak and who tell me that I should write a book about my experiences. This book is also the textbook for my forensic accounting students, who are learning from a practitioner in the field. Finally, this book is for those forward-looking organizations that assign fraud risk management to a corporate official, such as the chief risk officer or the compliance officer. If you find yourself in any of these roles, this book is for you.

This book is meant to be an easy-to-read reference guide. To try to keep the topics interesting and to show you how the concepts can apply to your organization, I have provided many case examples. While I encourage you to first read Chapter 1, "Fraud Concepts," realistically, you can read any chapter in the order of your interest.

The book is organized into four parts. Part I provides fraud concepts and answers the question, "Why do people commit fraud?" It also defines fraud in the various regulatory, civil, and criminal contexts in which it occurs. Part II provides the fraud threat picture that any organization may face. I have attempted to categorize all frauds, explain the schemes, and where appropriate, discuss prevention strategies. Part III discusses the fraud life cycle from prevention through resolution. Last, Part IV addresses the various professionals who are responsible for dealing with fraud. This last part concludes with various standards and legal requirements that professionals must adhere to when investigating fraud, and it has particular relevance for forensic accountants.

PART I:
Fraud Overview

- Fraud Concepts
- Fraud Defined

CHAPTER 1
Fraud Concepts

"Trusted persons become trust violators when they conceive of themselves as having a financial problem which is non-shareable, are aware this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property."

—DR. DONALD R. CRESSEY[1]

I find the most fascinating part of investigating a fraud case is understanding the motivation of the fraudster. Why did Enron CEO (Chief Executive Officer) Ken Lay and WorldCom CEO Bernie Ebbers commit financial statement fraud? Why did congressional lobbyist Jack Abramoff engage in corruption? Why do employees routinely use their company issued P-Cards (purchasing card) or credit card to purchase personal items? These are three distinct types of fraud. As we will explore throughout this book, the motivation behind these frauds usually vary by the type of fraud being committed.

So, why do people commit fraud? Why do we care about why people commit fraud? The answers to these questions will assist us with understanding each component of the fraud life cycle: (1) prevention, (2) detection, (3)

CHAPTER 2
Fraud Defined

"The defendant was lying, cheating, and stealing!"

—A COMMONLY MADE ARGUMENT BY PROSECUTORS DURING CLOSING STATEMENTS.

What is fraud? Since this book is about fraud, I thought it would be an important question to answer. "Lying, cheating, and stealing," is a phrase I have heard echoed from the walls of state and federal courtrooms countless times during closing arguments. Even though this impactful answer gets right to the heart of the matter, this definition is not adequate for our purposes.

In Part III of this book, I will address the fraud life cycle: prevention, detection, investigation, mitigation, and remediation. As we will see, a variety of professionals deal with each of these fraud life cycle components. Depending on their purpose or goal, these professionals will approach fraud from significantly different perspectives. For example, fraud risk managers charged with deterring fraud will approach their work from a different perspective than external auditors conducting audit work to assess if the financial statements are free of material misstatements due to fraud. Internal auditors charged with assessing internal controls will approach their work from a different perspective than FBI agents investigating whether the elements of a crime are present. Likewise, the approach of prosecutors, regulators, and defense attorneys will depend on various legal definitions. Fraud examiners

PART II:

Fraud Threat Picture

- Asset Misappropriation
- Corruption and Conflicts of Interest
- Financial Statement Fraud
- Small Organizations: Small Businesses, Local Governments, and Not-for-Profits
- Nonoccupational Fraud
- Cyber Fraud
- Money Laundering and Tax Fraud

CHAPTER 3
Asset Misappropriation

"Of the three primary categories of occupational fraud, asset misappropriations are by far the most common, occurring in 89% of the cases."

—ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, 2018 *REPORT TO THE NATIONS*[1]

Asset misappropriation is by far the most common type of occupational fraud. When this occurs, an employee has either been entrusted with an asset or has the wherewithal to gain access to the asset and then convert it for a wrongful purpose. Those in fraud prevention and investigation routinely deal with these issues. A quick review of the Fraud Tree shows asset misappropriation has more subclassifications than either financial statement fraud or corruption. This is due to the multifarious ways in which this type of fraud can be committed. Asset misappropriation also differs from the other two classifications of fraud because the average dollar loss associated with it is generally lower. You will recall that the motivations for committing fraud discussed in Chapter 1 include:

- Business Need
- Ego (Pride and Shame)
- Excitement
- Parity
- Social Compact of Reciprocity

CHAPTER 4
Corruption and Conflicts of Interest

"The Rule for Reciprocation—The rule says that we should try to repay, in kind, what another person has provided us. . . . By virtue of the reciprocity rule, then, we are obligated to the future repayment of favors, gifts, invitations, and the like."

—ROBERT B. CIALDINI, *INFLUENCE: THE PSYCHOLOGY OF PERSUASION*

This chapter will delve into corruption and conflicts of interest. Conceptually, these terms can be confusing because they mean different things to different people, so I will carefully define them throughout this chapter. Corruption and conflicts of interest may be terms defined by a company policy as well as by state and federal criminal law. Determining if a policy or law relating to corruption or conflicts of interest have been violated can be challenging. As you will see, even the United States Supreme Court has wrestled with these issues over the decades.

Of the three fraud classifications—corruption, asset misappropriation, and financial statement fraud—corruption is generally the most difficult to prevent, detect, and investigate. The difficulty is due to the personal relationships among the actors. Corruption often involves collusion between an outside vendor and an inside employee. There may not be a paper trail, and

CHAPTER 5
Financial Statement Fraud

"We have to make the numbers."

—WORLDCOM CEO BERNIE EBBERS INSTRUCTING CEO SCOTT SULLIVAN TO COMMIT FINANCIAL STATEMENT FRAUD.[1]

On the early morning of July 3, 2002, my home phone rang in Houston, Texas. I was off work that day, as it preceded a holiday, and I was looking forward to a long, pleasant holiday weekend. The voice on the other end of the phone was an FBI agent assigned to the Corporate Fraud Unit at FBI Headquarters in Washington, D.C. I knew him well, as I used to be his boss when he was assigned to my public corruption squad in Houston. I knew him well enough to ask why he was calling my home phone so early on my day off. What I heard next was, "Listen up, you're heading to Jackson, Mississippi, as part of the management team leading the WorldCom investigation, and you need to get there immediately." So much for my long holiday weekend.

The phone call summoning me to the WorldCom headquarters was unusual. White-collar crimes, despite their potential egregiousness, have a five-year statute of limitations and invariably take a long time to investigate. While these investigations are very important, white-collar crimes do not ordinarily dictate a dire sense of urgency—it's not like an armed robber is holding bank employees hostage. However, these were no ordinary times. Enron was in bankruptcy and under investigation by the Enron Task Force. Enron and WorldCom's auditor, Arthur Andersen, was convicted of obstruction of justice in a Houston federal court on June 15, 2002. At the time, a

CHAPTER 6

Small Organizations: Small Businesses, Local Governments, and Not-for-Profits

"While the City was suffering, the defendant was living her dreams."

—ASSISTANT U.S. ATTORNEY JOSEPH PEDERSEN THE FEDERAL SENTENCING OF RITA CRUNDWELL FOR HER $53.7 THEFT FROM THE SMALL TOWN OF DIXON, ILLINOIS.

Small organizations can include a small business, a local government, or a not-for-profit organization. These organizations often share two common traits: (1) employees generally work in a trust-based environment, and (2) internal controls are often weak. Unfortunately, these organizations also share two other common features: (1) they are more likely to be victimized by fraud, and (2) the average dollar amount of the fraud will likely be higher. The Association of Certified Fraud Examiners' 2018 *Report to the Nations* shows that organizations with less than 100 employees are victims in 28 percent of frauds and experience an average dollar loss of $200,000. An interesting contrast is that organizations with over 10,000 employees suffer 24 percent of frauds, with an average dollar loss of $132,000. Of course, the impact of these frauds is disproportionately more devastating to the small organization and often results in severe hardship to the victims.

CHAPTER 7
Nonoccupational Fraud

"There is nothing new under the sun.
It has all been done before."

—SHERLOCK HOLMES IN
A STUDY IN SCARLET, BY SIR ARTHUR CONAN DOYLE

This chapter addresses the numerous and diverse nonoccupational frauds. These frauds are in stark contrast to the occupational frauds involving asset misappropriation, corruption, and financial statement fraud. Occupational frauds generally involve insiders who are in a trust-based relationship with their victims, which I call "privity of trust." Before these fraudsters become trust violators, the precepts of the Fraud Triangle must be present: opportunity, pressure, and rationalization. Accordingly, when privity of trust is present, those in charge of governance can develop internal controls to address each of the three vertices of the Fraud Triangle to minimize fraud in their organization.

Fraudsters committing nonoccupational fraud, however, are generally not acting in an occupational capacity. Rather, these fraudsters are mostly outsiders preying on individuals and organizations. Another significant distinction is that these fraudsters are generally not in privity of trust with their victims. Since these fraudsters are not in privity of trust, *pressure* and *rationalization* (two vertices of the Fraud Triangle) often play no role in their motivation. I

CHAPTER 8
Cyber Fraud

"A company can spend hundreds of thousands of dollars on firewalls, intrusion detection systems and encryption and other security technologies, but if an attacker can call one trusted person within the company, and that person complies, and if the attacker gets in, then all the money spent on technology is essentially wasted."

—KEVIN MITNICK
TWO-TIME FELON AND AUTHOR OF *THE ART OF DECEPTION: CONTROLLING THE HUMAN ELEMENT OF SECURITY*

In this chapter, we will cover frauds and other crimes that use or target a computer or a computer network. This conduct is known as "cybercrime," "computer crime," or "network crime." This does not include those acts in which a computer is simply used as a modality for committing a crime (e.g., a Nigerian 419 e-mail scam), since those frauds are covered in other chapters. The focus of this chapter is on computer attacks done for a variety of purposes, including fraud, theft of property, trespassing, computer damage, or a combination of any of these. Although the purpose of the attack may be something other than fraud, I will discuss a variety of these cybercrimes because the prevention, detection, and investigation of them is similar regardless of the motivation of the offender.

Of all of the criminal activities that the FBI is responsible for investigating, none have changed more than cybercrime. The technology used by

CHAPTER 9

Money Laundering and Tax Fraud

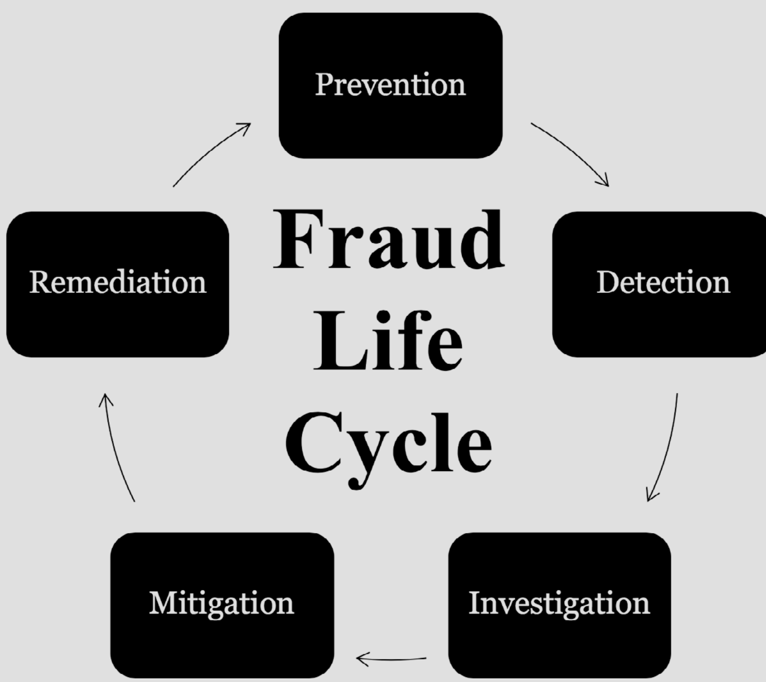
"The Panama Papers expose the internal operations of one of the world's leading firms in incorporation of offshore entities, Panama-headquartered Mossack Fonseca. The 2.6 terabyte trove of data at the core of this investigation contains nearly 40 years of records, and includes information about more than 210,000 companies in 21 offshore jurisdictions."

—INTERNATIONAL CONSORTIUM OF INVESTIGATIVE JOURNALISTS[1]

Money laundering is the process of concealing the origin of assets that one controls. By this definition, money laundering is not inherently illegal. Lawful reasons may exist for disguising the origins and extent of one's wealth. High-net-worth individuals are at risk for their personal safety, loved ones being kidnapped, and being victims of various frauds. Other individuals may want to make their wealth difficult for judgment creditors to pursue. Citizens fleeing corrupt regimes may need to launder their wealth in an attempt to prevent confiscation. Although legitimate reasons for laundering money exist—and you should be highly suspect when you hear them—that is not the subject of this chapter. This chapter is about the process of making dirty money appear clean—hence the term "money laundering." This discussion is also a logical place to address tax frauds, since many money-laundering

PART III:

The Fraud Life Cycle



CHAPTER 10
Fraud Prevention

"Respect, Integrity, Communication, Excellence—Mr. Hartman, I don't think we live up to those values"

—COMMENTS OF FORMER EXECUTIVE ASSISTANT TO ENRON CEO KEN LAY TO THE AUTHOR WHEN LEADING A SEARCH INTO LAY'S OFFICE.

The FBI has historically done well at investigating all crimes, including the gangster era's Bonnie and Clyde, foreign spies of the 1950s, civil rights, organized crime, drugs, domestic and international terrorism, and white-collar crime. I am confident that the FBI is the best investigative agency in the world. A criminal act occurs, special agents investigate, and the suspect goes to jail—at least that is how it is supposed to be.

The events of September 11, 2001 ushered in a new challenge for law enforcement. Those orchestrated terrorist attacks demonstrated a failure by the intelligence community, including the FBI. The National Commission on Terrorist Attacks Upon the United States (9/11 Commission) clearly laid out that waiting for an incident to occur, investigating it, and then putting the bad guys in jail is unacceptable when it comes to counterterrorism. Further, the 9/11 Commission noted that clues of the terrorist plots were located within various components of the intelligence community, but the intelligence community had failed to effectively comprehend the overall threat picture. The 9/11 Commission also traced the antecedents of the intelligence community's communication failures: the left hand did not seem to

CHAPTER 11
Fraud Detection

"The Whistleblowers: Persons of the Year, Cynthia Cooper of WorldCom, Coleen Rowley of the FBI, and Sherron Watkins of Enron."

—COVER OF *TIME* MAGAZINE, JANUARY 2003

In January of 2003, I was waiting in a grocery store checkout line when I noticed that *Time* magazine's "Person of the Year" edition had three women pictured on its cover. Upon closer inspection, I was shocked to realize that I had met each of those women. One woman was an FBI agent whom I had met at the FBI's annual legal conference at FBI Headquarters, and the other two women I had met at their corporate headquarters, Enron and WorldCom, respectively.

Less than two years had passed since Americans had been the victim of some of the worst calamities in modern times. We were attacked externally by foreign terrorists and internally by corporate chieftains. *Time* magazine was highlighting three women who spoke truth to power. WorldCom's internal auditor, Cynthia Cooper, reported to her board that the company's financial statements were bogus. FBI special-agent attorney for the Minneapolis Field Division, Coleen Rowley, wrote a letter to then FBI Director Robert Mueller detailing how antiterrorism agents' efforts in her field division had been stifled by FBI Headquarters' management such that it might have prevented critical information about the 9/11 attackers from being discovered before the

CHAPTER 12
Investigations

"What one man can invent another can discover."

—SHERLOCK HOLMES IN *THE ADVENTURE OF THE DANCING MEN*, BY SIR ARTHUR CONAN DOYLE

In January of 2002, I received an unusual call from my boss. She had just flown to FBI Headquarters to attend an emergency meeting about Enron. She was in a conference room full of FBI and DOJ executives when she advised me, "Vic, we may need you to lead a search of the Enron offices tomorrow." That was the first time I realized that the FBI was going to initiate an investigation into Enron. I was not totally surprised about the comment since Enron had restated its financial statements in November of 2001, had filed for bankruptcy in December of 2001, and the storied company had been making the headlines daily. What did surprise me was that I was told to ready a team to search Enron "tomorrow."

I have participated in over 50 searches, usually conducted pursuant to a search warrant. In each of those searches, we planned for days or usually weeks. The search of Enron resulted in the largest single-site search in FBI history, and I was being asked to lead the search the next day! Such an undertaking with next to no preparation would be a monumental task. As it turned out, that is exactly what I did—undertake a monumental task.

The search lasted nine days. It started under many unusual circumstances. The search was done pursuant to receiving a board-authorized consent to

CHAPTER 13
Fraud Crisis Management

"We cannot solve our problems with the same thinking we used when we created them."

—ALBERT EINSTEIN

In 2001, Enron ushered in a wave of accounting and governance malfeasance scandals. The FBI was certainly unprepared for the magnitude of the problem—it did not have a plan. From my involvement with these cases, I observed the victimized corporations did not have a plan either—they never thought fraud would ever happen to them. Once an investigation is under way and problematic facts begin mounting, an organization will have to broach the last two components of the fraud life cycle: mitigation and remediation.

Mitigation is a process of minimizing the collateral effects of fraud on the organization as well as ensuring that the particular type of fraud never occurs again. Mitigation efforts are more important if the fraud rises to the level of an organizational crisis. Remediation is the process of attempting to make the victim whole through financial recovery. Conceptually, these two processes should occur simultaneously; however, remediation usually involves legal processes that are likely to continue long after mitigation efforts are completed.

For high-impact frauds, an organization's ability to deal with these issues may depend on whether fraud was appropriately addressed in the organization's crisis management plan. A crisis management plan can be viewed as a

PART IV:
Forensic Experts

- The Professionals
- Starting with the End in Mind

CHAPTER 14
The Professionals

"None of us is as smart as all of us"

—KENNETH HARTLEY BLANCHARD

Fraud can occur in every industry, in every company, and within every division or segment of a company. Fraud investigations are challenging, especially at the start of the investigation because the investigators must learn about the industry in which a fraud is alleged to have occurred. For example, investigating a bribe of a foreign official in the pharmaceutical industry is quite different from investigating an early revenue recognition scheme in the software industry. A fraudulent invoicing scheme by a subcontractor is quite different from an elected official having an undisclosed interest in a company that is doing business with the government.

The resolution of fraud-related issues generally requires a team of professionals. The team for a typical "internal investigation" is often led by an attorney or a representative of management. While the investigative methodology remains the same, its application will vary with each engagement. The end goal is to have a final product that resolves the fraud allegation. This chapter focuses on the professionals or specialists who are needed to staff fraud engagements.

CHAPTER 15
Starting with the End in Mind

"It is not what we know, but what we can prove"

—SHERLOCK HOLMES IN *THE HOUNDS OF THE BASKERVILLES*, BY SIR ARTHUR CONAN DOYLE

"All rise. Jury foreperson—has the jury reached a verdict?" "We have, your Honor." "What say you?" "We the jury, in the case of the *United States v. Bernie Smith*, find the defendant guilty on all counts."

That is how the case typically ends. The case will likely have begun with a complaint from the victim to law enforcement. Progressing from a complaint to a conviction takes a lot of effort. The case will only be successful if the evidence is gathered in a legally appropriate and sufficient manner and introduced into court under the rules of evidence. If an expert witness testifies, various professional standards and rules will apply. To have a successful case, I always start with the end in mind.

Our legal system is based on a lot of rules. In criminal cases, the U.S. Constitution plays a significant role. For any case, the attorney, investigator, or forensic accountant needs to know how the case will likely end. Is the case a civil or a criminal matter? If it is litigated, will the case be tried in federal or state court or in an administrative hearing? The answer to each of these questions will dictate which rules of procedure and rules of evidence should be followed.

ACKNOWLEDGMENTS

This book is a compilation of my personal experiences and the knowledge that I have gained from my colleagues as well as those whom I have investigated. Many of my colleagues whom I mention below fall into multiple categories, so I will only mention them once.

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For those individuals whose case I investigated and assisted in their prosecution, I am grateful that many have been rehabilitated, have learned from their experiences, and have now become productive members of society. For the others, I extend hope. From all of these felons, I have gained a tremendous understanding about the mind of a fraudster.

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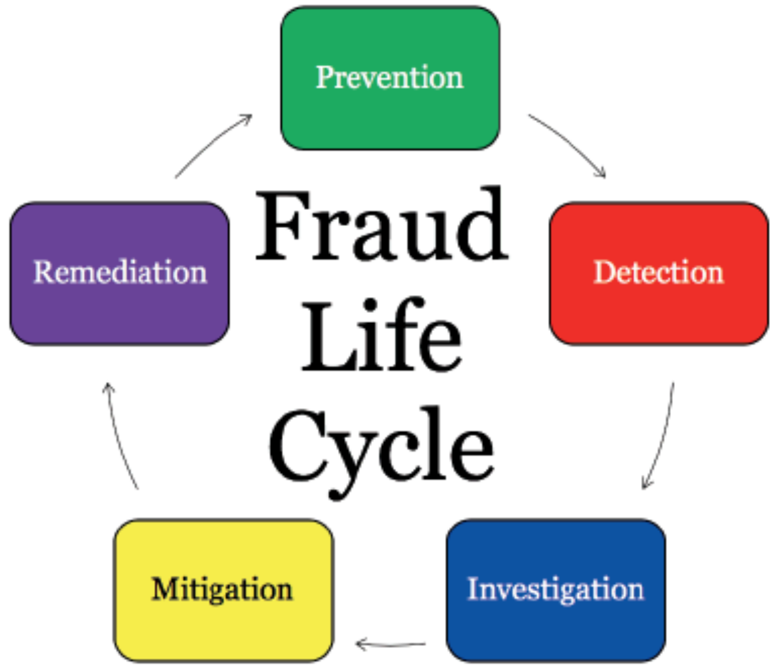

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Author's photo by Arthur Usherson.

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