Control Fraud: The Need to Think Outside the Fraud Triangle

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Two Topics

I. Introduce you to modern criminology, particularly ‘control fraud’
II. ‘Thinking within the (fraud) triangle’ is not simply limiting, but disastrous

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Recurrent, Intensifying Crises

The two key questions: why do we suffer recurrent, intensifying crises

1st Question: What is the true cause?

2nd Question: What prevents us from learning from our mistakes/successes?

Ideology creates dogmatic blinders

“Theoclassical” economics is criminogenic

Concentration on smaller frauds

What is “Control Fraud”?

Criminology: The persons controlling a *seemingly legitimate* entity use it as a **“weapon”** to defraud. *The Best Way to Rob a Bank is to Own One* (Black 2005)

Big Money Crime: Calavita, Pontell & Tillman (1997) & NIJ Study (1993)

Economics (Akerlof & Romer 1993): Looting: Bankruptcy for Profit; NCFIRRE

‘Seeming Legitimacy’’

The essence of fraud is that I get you to trust me, and then I betray that trust to get you to give me something of value

The hard part is getting people to trust you. That is where ‘seeming legitimacy’ and ‘elite status’ come in – powerfully.

Power to Manipulate

The persons controlling a seemingly legitimate entity (CEO, for brevity) can also use all the power of the entity to aid their frauds. They are not passive. They can use their power to change the firm's internal and external environment to aid frauds.

Control Frauds: Catastrophic

Cause greater financial losses than all forms of property crime – combined

Hyper-inflate financial bubbles

Cause recurrent, intensifying crises

Can become epidemic

Control fraud begets “echo” fraud epidemics

Suborns controls & democracy

Maim & kill and harm environment

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Three Key Concepts

In financial frauds, accounting is the 'weapon of choice' – the 'secret sauce'

A "criminogenic environment" – an environment in which the perverse incentives are so powerful that fraud will become epidemic

The 'Gresham's' dynamic: bad ethics drives good ethics from the markets

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‘Accounting Control Fraud’ (aka ‘Looting’) ‘Recipe’

1. Grow extremely quickly, by
2. Making/buying terrible loans at a premium *nominal* yield
3. While employing extreme leverage, and
4. Grossly inadequate allowances for loan and lease losses (ALLL)

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“Gresham’s” Dynamic

“[D]ishonest dealings tend to drive honest dealings out of the market. The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost also must include the loss incurred from driving legitimate business out of existence.” George Akerlof (1970).

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Swift, J. *Gulliver's Travels (1726)*

"The Lilliputians look upon fraud as a greater crime than theft. For, they allege, care and vigilance, with a very common understanding, can protect a man's goods from thieves, but honesty hath no fence against superior cunning. . . where fraud is permitted or connived at, or hath no law to punish it, the honest dealer is always undone, and the knave gets the advantage."

The Recipe's Three Sure Things

1. The lender/loan purchaser will report record income in the near term
2. Modern executive compensation will promptly make the CEO wealthy
3. The lender (buyer) will suffer very large losses because the loans have a "negative expected value"

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Accounting Control Fraud = Genius

Even after CEOs defraud, bankrupt, and loot ‘their’ firm through fraud it is extremely difficult to prove that they defrauded ‘their’ firm. Banks fail, and their assets are frequently overvalued, so courts do not allow any negative inference from firm failure, massively overvalued assets, or huge gains to CEO. Also, no “clawback.”

Note Key Concepts

Never think in terms like “the bank wants.” The bank is not a person, it has no desires and no ability to protect itself. People have desires, incentives, and the ability to act or block action. Always focus on **human** motivations and incentives.

The ‘recipe’ works for the loan originators and the secondary market purchasers’ **officers**, while harming both firms.

Try Counterfactual to Test Theory

Assume you follow the fraud ‘recipe’ for a lender, but make **high** quality loans instead.

How many Americans with great credit scores and income are unable to get home loans? How can I grow > 50%, only by ‘buying market share’ by slashing my interest rates. How will my competitors respond? What will this do to all of our profits?

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The Problem with Pronouns

"Benjamin Wagner, a U.S. Attorney who is actively prosecuting mortgage fraud cases in Sacramento, Calif., points out that banks lose money when a loan turns out to be fraudulent. 'It doesn't make any sense to me that they would be deliberately defrauding themselves,' Wagner said."

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Accounting Fraud = Sure Thing

"[M]any economists still [do] not understand that a combination of circumstances in the 1980s made it very easy to loot a [bank] with little risk of prosecution. Once this is clear, it becomes obvious that high-risk strategies that would pay off only in some states of the world were only for the timid. Why abuse the system to pursue a gamble that might pay off when you can exploit a sure thing with little risk of prosecution?" (Akerlof & Romer 1993: 4-5

Fraud in the S&L Debacle

“The typical large failure [grew] at an extremely rapid rate, achieving high concentrations of assets in risky ventures…. [E]very accounting trick available was used…. Evidence of fraud was invariably present as was the ability of the operators to “milk” the organization” (NCFIRRE 1993)

“Now we know better”

“Neither the public nor economists foresaw that [S&L deregulation was] bound to produce looting. Nor, unaware of the concept, could they have known how serious it would be. Thus the regulators in the field who understood what was happening from the beginning found lukewarm support, at best, for their cause. Now we know better. If we learn from experience, history need not repeat itself” (George Akerlof & Paul Romer.1993: 60).

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Over 1000 Felony Convictions

- “Major” S&L cases, not the tellers
- Over 30,000 criminal referrals
- “Top 100” priority list
- Our #2 agency priority: after fraud closure
- 1000 FBI agents: 90% conviction rate
- Several thousand enforcement actions; roughly 800 civil & “freeze” actions

Enron era Control Frauds

- Accounting = weapon of choice
- Consistently able to suborn "controls"
- Clean opinions from top tier auditors
- No deposit insurance, so private market discipline was supposed to make accounting control fraud impossible
- Concern for "reputation" can increase fraud

Enron-era frauds

http://www.risk.net/energy-risk/opinion/2330358/risk-managers-should-learn-from-the-mistakes-of-others

"Risk managers should learn from the mistakes of others"

Author: Vincent Kaminski

Doing enough detective work to discover whether companies are really rotten to the core may be challenging for busy risk managers. But bad eggs usually come with early warning signs, which are easier to spot, writes Vincent Kaminski

Kaminski's Enron Regrets

"There is one particular book I wish I had read in the early days of my business career, which would have saved me and the firms I worked for a lot of money.

Many companies that have eventually gone bankrupt have been very successful at projecting the image of unstoppable success for a long time."

His Reading Recommendation

"The book, entitled The best way to rob a bank is to own one: how corporate executives and politicians looted the S&L industry, was written by William Black, associate professor of economics and law at the University of Missouri-Kansas City. It is based on his experience as a regulator of savings and loans (S&L) institutions during the S&L crisis of the 1980s and early 1990s."

Kaminski Gets the Tradeoff

"Within its pages, Black introduces the concept of 'control fraud' – effectively, a very simple recipe for great riches and limited civil and criminal liability."

Trivial Loss Reserves

Reserves must track risk: GAAP

Bank risk was skyrocketing

A.M.Best (2/06; 3/07): “new record lows for the last four years.” Matches low in 1985: last disaster

Reserve ratio (2005): 1.21% of loans

Losses on foreclosed nonprime loans are running >50% for S&Ls

Mortgage fraud = accounting fraud

Gresham's dynamic: appraisers

Art is to suborn, not defeat, "controls"

"From 2000 to 2007, a coalition of appraisal organizations … delivered to Washington officials a public petition; signed by 11,000 appraisers…. [I]t charged that lenders were pressuring appraisers to place artificially high prices on properties [and] "blacklisting honest appraisers" and instead assigning business only to appraisers who would hit the desired price targets."(FCIC 2011: 18)

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FBI's twin 2004 warnings

Mortgage fraud becoming "epidemic" and will cause a financial "crisis" if it is not contained

MARI's 5 Warnings: 2006

- Stated income loans "are open invitations to fraudsters"
- Study: fraud incidence is "90 percent"
- "[T]he stated income loan deserves the nickname used by many in the industry, the 'liar's loan.'"

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MARI Warnings.2

- “It appears that many members of the industry have little … appreciation for the havoc created by low-doc/no-doc products that were the rage in the early 1990s. Those loans produced hundreds of millions of dollars in losses….”
- “Federal regulators of insured financial institutions have expressed safety and soundness concerns over these loans….”

Liar’s Loan Crisis

“This is not a subprime crisis. This is a stated-income crisis,” said Robert Simpson, chief executive of Investors Mortgage Asset Recovery in Irvine, Calif., which works with lenders, insurers and investors to recover losses related to mortgage fraud.

Empirical Fraud Studies

Liar's Loans, Mortgage Fraud, and the Great Recession

Prof. Thomas Herndon, Loyola Marymount

July 2017 (Good summary of research)

Data problems: No official definitions of anything (subprime, Alt-A, etc.)

By 2006, ½ of loans called 'subprime' were also 'liar's' loans – not mutually exclusive

Systematic & Underwriting

“At originating institutions, there was a systematic abandonment of underwriting standards in order to increase the volume of loans originated, with no regards to quality. Mortgage fraud through the falsification of borrower financial information helped to increase origination volume through allowing institutions to originate larger loans than otherwise possible (Taub, 2014; Black, 2013; FCIC, 2011; Hudson, 2010).”

Appraisal Fraud (Again)

"For example, (Griffin and Maturana, 2016b) found that roughly 48% of securitized loans included misrepresentation along just three easy to measure dimensions, misreported owner occupancy status, unreported second liens, and appraisal value inflation, and that these loans were 51% more likely to default."

Liar’s loans = 70% of Losses

“Losses on Liar’s Loans account for roughly 70% of total losses in the data…. Scaled to the level of the entire market, this implies that no/low documentation loans can account for approximately $345 billion of the $500 billion in losses in this market….”

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Lenders put the lies in liar's loans

"[Many originators invent] non-existent occupations or income sources, or simply inflat[e] income totals to support loan applications. Importantly, our investigations have found that most stated income fraud occurs at the suggestion and direction of the loan originator, not the consumer." Tom Miller, AG, Iowa, 2007 testimony to Fed.

DOJ: re Wells' Liar Loans

"Wells Fargo sold at least 73,539 stated income loans that were included in RMBS between 2005 to 2007, and nearly half of those loans have defaulted, resulting in billions of dollars in losses to investors."

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Wells Fargo

WKB: Typical default rates on conventional mortgages averaged, for decades, around 1.5 percent. The Wells Fargo liar's loans defaulted at a rate 30 times greater. Wells' 4506-T audit confirmed that over half of its liar's loans had materially false income disclosures – and that its leaders reacted to the audit by greatly increasing liar's loans as 'Courageous Underwriting.'

Countrywide

Also did a 4506-T audit finding fraud incidence > 50% and top management reacted to the audit by greatly expanding liar's loans, calling it internally "Extreme Alt-A."

Gresham's Dynamic v. Irony

"[A]ll reputable intermediaries involved in the sale of mortgages were engaged in systematic misrepresentation (Griffin and Maturana, 2016b; Piskorski, Seru and Witkin, 2015)."

What is the Best Explanation.2

“In my reading of the literature, the most convincing interpretation that is able to explain the pattern of extreme executive compensation, despite the abandonment of underwriting standards resulting in the bankruptcy of their firms, comes from fraud expert Bill Black, who argues that executives looted their companies.”

“

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IAS 39: criminogenic

"The higher reported profits also enabled increased dividend and remuneration distributions during the Period. All of this led to reduced provisioning buffers…."

"the incurred-loss model [IAS 39] also restricted the banks' ability to report early provisions for likely future loan losses as the crisis developed from 2007 onwards." (Nyberg 2011: 42-43

Right, "the banks" ***wanted*** to report higher provisions in Nyberg's alternate reality. Listen to the Anglo Irish tapes.

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Ireland’s 0.4% ALLL

“The composite provisioning level for the covered banks at end 2000 was 1.2% of loans…. If this 1.2% provisioning level had been applied at the 2007 year end by the covered banks, aggregate provisions would have increased by approximately €3.5bn (i.e. from the €1.8bn actual to €5.3bn).” (Nyberg 2011: 43)

Irish banks had twice the leverage, and one-third the ALLL of U.S. banks – and were heavily in CRE. Three strikes; you’re out.

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Such Frauds Can Maim & Kill

- Chinese infant formula + melamine
- New York inspector: asbestos & lead
- Turkish/Chinese/Bangladeshi buildings
- Fake anti-malarial drugs
- China's private coal mines
- Unlawful disposal of toxic waste and other environmental assaults
- Lead in toys & antifreeze in cold syrup

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Varieties of Control Fraud

Classified by primary intended victims

- Accounting: creditors & shareholders
- Anti-purchaser
- Anti-public: tax fraud; environmental
- Anti-worker

Classified by timing:

- Opportunistic
- Reactive

Control Frauds' Unique Risks

Only the CEO can:

1. Suborn all "controls" into allies
2. Optimize firm as fraud vehicle
3. Create "echo" control fraud epidemics
4. Create regulatory "black holes"
5. Loot using "normal" corporate pay

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PART II: Fraud Triangle

One of Sutherland's students, Donald Cressey, interviewed low social status imprisoned embezzlers, primarily female ('pink collar' crime). He never used the term, or drew the graphic, but he inspired Albrecht's term: the "fraud triangle."

https://www.fraud-magazine.com/article.aspx?id=4294999117

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Sutherland Proves Correct

- Edwin Sutherland: top of his field
- Knew economics & was empirical
- Coined term & field: white-collar crime: ‘39
- Legitimacy + control + power + status = unique dangers from elite fraud
- Couldn’t get the names of corporations violating the law published for 25 years
- Falsified efficient markets hypothesis 25 years before it was formed

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ACFE Claims re Triangle

John Gill: “Dr. Donald Cressey’s Fraud Triangle has endured because it’s correct and simple. However, the ACFE has never stated that the triangle can explain every case of fraud. So, be careful when you use the Fraud Triangle in court. The judge might reject it. The Fraud Triangle is a useful tool to help us understand why and how people commit fraud, but it’s not a scientific theory.”

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Albrecht: “Metaphor”????

“Iconic Fraud Triangle endures: Metaphor diagram helps everybody understand fraud.” (July/August 2014.) By W. Steve Albrecht, Ph.D., CFE, CPA, CIA. https://www.fraud-magazine.com/article.aspx?id=4294983342

“Universally Accepted”????

“All students of anti-fraud principles — whether in higher education or on the job —eventually learn about the seminal Fraud Triangle. We can find this diagram in fraud examination, accounting, auditing and marketing literature. The Fraud Triangle is universally accepted in almost every setting in which fraud is described or analyzed.

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It Made The ‘West Wing’

Episode 2.6 -- "The Lame Duck Congress“
Original Air Date: November 8, 2000

SAM: This is from an independent study that I have faith in. 30% of workers plan to steal from their employers, 30% give in to 5% will commit fraud regardless of circumstances, 85% will commit fraud given the circumstances.

“It’s called the fraud triangle”

LEO: Just out of curiosity, what are the right circumstances?

SAM: Need, opportunity and the ability to rationalize their behavior, it's called the fraud triangle. Leo, it's going to help us out when we want to raise the minimum wage. It's small business owners who are most opposed to wage hikes.

Triangle ‘turns’ Sam

LEO: You weren't going to go the other way on this?

SAM: Yeah, I was.

LEO: You got turned around?

[Ainsley, the Republican lawyer who just joined the White House staff turned him.]

SAM: Yeah.

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Triangle + ACFE ‘Stats’ Triumph

LEO: Okay, good. Thanks.

[There is no clear description of the bill, but it appears to preempt state laws barring private employers from requiring job applicants to submit to fingerprinting.]

And the morals of the story are

Fraud is primarily committed by the employees of small firms

The firms = victims, not fraud ‘weapons’

The CEOs are the (unmentioned) presumptive good guys trying to stop fraud

The flaky ACFE non-stats = stats one should “have faith in.”

Democrats should adopt Republican views

Gender in Elite v Petty Fraud

"My colleagues and I studied accounting malpractices like security fraud, insider trading, and Ponzi schemes in America's public companies to find out just how involved women were in these conspiracies. The Corporate Fraud Task Force indicted 436 individuals involved in 83 such schemes during July 2002 to 2009."

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Citations & Links

Jennifer Schwartz, Washington State University, Darrell Steffensmeier and Michael Roche, "Gender and 21st Century Corporate Crime: Female Involvement and the Gender Gap in Enron-Era Corporate Frauds" published in the June 2013 issue of the *American Sociological Review.*

https://gendersociety.wordpress.com/2013/12/13/women-need-not-apply-gender-and-corporate-crime-conspiracies/

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Pink Collar Crime

"I expected the share of women in corporate fraud to be low – definitely less than the near-half that are women among (low-profit) embezzlers arrested each year– like your bank teller or local non-profit treasurer."

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Elite Female Fraudsters Rare

"However, I was surprised that women corporate fraudsters were about as rare as female killers or robbers – less than 10% of those sorts of offenders. Only 37 were women of the 400+ indicted for corporate fraud."

Minor Roles in Elite Frauds

"Most of these frauds were complex enough to require co-conspiracy over several years and a criminal division of labor. Often, women weren't included at all in these groups. When they were, they were nearly always in the minority, often alone, and most typically played rather small roles."

Enron

"The Enron conspiracy led to over 30 indictments; three were women and each played a minor role. The five women indicted among 19 in the HealthSouth fraud were in accounting-related positions and instructed by senior personnel to falsify financial books and create fictitious records."

One (Smaller) Female Ringleader.1

“Women were almost never the ringleader or even a major player in the fraud. Only one woman CEO led a fraud – the smallest fraud we studied – and two women with their husbands.”

One (Smaller) Female Ringleader.2

“One reason surely must be that women are not as often in positions to lead these schemes. However, even when we compared women and men in similar corporate positions, women were less likely to play leadership roles in the fraud. The ‘glass ceiling’ in the white-collar crime world?”

Big Risk, Tiny Reward.1

"What most surprised me, however, was how little the women benefited from their illicit involvement. The wage gap in illicit corporate enterprise may be larger than in the legitimate job market. Over half the women did not financially gain *at all* whereas half the men pocketed half a million dollars or more."

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Big Risk, Tiny Reward.2

"The difference in illicit-gains persisted even if we compared women to their co-conspirators. Males profited much more. Women identified 'gains' such as keeping one's job."

Albrecht Warps Cressey

“The triangle states that individuals are motivated to commit fraud when three elements come together: 1) some kind of perceived pressure 2) some perceived opportunity and 3) some way to rationalize the fraud as not being inconsistent with one's values.”

State of the Art Criminology --

“The person who should get the most credit for developing the fraud triangle was Donald Cressey — a co-author with and student of Edwin Sutherland. In both a November 1951 article, "Why Do Trusted Persons Commit Fraud? A Social-Psychological Study of Defalcators," in the Journal of Accountancy,

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….Circa 1951 and 1953

and on page 973 of his 1953 book, "Other People's Money, A Study in the Social Psychology of Embezzlement" (published by Patterson Smith)…."

Cressey: “Trusted Persons”

“[Cressey] defined the fraud problem as a ‘violation of a position of financial trust’ that the person originally took in good faith. To quote from his book:

– ‘Trusted persons become trust violators when they conceive of themselves as having a financial problem that is non-sharable, are aware that this problem can be secretly resolved by violation of the position of financial trust, and…

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Cressey: Need all 3 Elements

– they're able to rationalize their dishonest actions….'

He wrote that none of these elements alone would be sufficient to result in embezzlement; instead, all three elements must be present."

Cressey: ‘Pink collar’ Crime

“He developed this theory based on in-depth interviews with those convicted of trust violations. He claimed that all the cases he studied conformed to the three-step process.”

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Albrecht: Cressey Careful

“While he identified the three elements that we now refer to as the Fraud Triangle, he never drew or referred to them as a triangle nor used the term ‘fraud triangle.’ He also limited his discussion to embezzlement and not to fraud in general.”

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Albrecht's Key Error

The problem is not the phrase "fraud triangle." The problem is that Albrecht and ACFE **generalized** Cressey's work on a **unique** form of fraud committed by low social status, primary female embezzlers who stole tiny amounts in the 1940s (70+ years ago) to "almost every setting in which fraud is described or analyzed." **That is insane.**

Cressey re “Non-Sharable”

Cressey used the phrase “non-sharable problems” to mean scandalous. In the 1940s, if your man was a drunk, addict, gambler, or so dissolute that he wasted the family’s resources on his mistress or prostitutes it was a scandal. The office manager would find it too humiliating to share her husband or lover’s scandalous behavior with her boss.

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Let’s Take a Poll

How many of you think that a Great Depression era office manager of a nine-employee firm of plumbers who embezzled $3,000 because her jerky husband had racked up $3,000 in gambling debts engaged in fraud for the same reasons Enron’s senior managers looted Enron

Low Status & Power Matter

Cressey claimed every low social status embezzler he interviewed in prison said that she committed her crime because she had a need that Cressey characterized as “a non-sharable problem.”

Cressey Wanted Low Status

He deliberately interviewed low social status embezzlers who overwhelmingly stole relatively small sums. The office manager was the quintessential inmate Cressey interviewed because she was the 'bookkeeper' in a firm so small that it had neither internal nor external controls – other than the office manager. She controlled the check book & the records.

Minor Embezzlers' Traits

Minor embezzlers (1) have no defense when their fraud is discovered, (2) often confess immediately when accused, and (3) often say something to the effect of 'thank God it's over!' CEO's running *sophisticated* control frauds have none of these characteristics.

Albrecht & ACFE Erred

Cressey did *not* make the mistake of generalizing his work on this unique subset of minor circa-1940s fraudsters to all fraudsters – Albrecht and the ACFE made that mistake.

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Triangle is Absurd

It was facially ridiculous, of course, to claim that the elite, male CEOs running control frauds like Enron engaged in fraud because their spouses were failed gamblers. Similarly, it is absurd to claim that all elite fraudsters "originally took [the position of financial trust] in good faith."

Triangle is Dangerous.1

The *implicit* implications of the fraud triangle are exceptionally and dangerously benign. First, the ACFE presents fraud risk as *idiosyncratic*. The focus is the individual perpetrator, ignoring "criminogenic environments." Second, no one sets out to be a fraudster in this model. Third, the fraud losses are likely be minor for no elite officer is on the make looking for fraud opportunities.

Triangle is Dangerous.2

Fraud is solely reactive – prompted by an acute non-sharable need. Fourth, fraud losses are likely to be small because it is unlikely that the low status employee will be able to enlist senior confederates or suborn internal or external controls. Fifth, the fraud triangle ignores power and 'seeming legitimacy' – the characteristics that allow CEO to commit vastly larger frauds – with impunity.

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Reality is Malign.1

- The reality is that control fraud can become epidemic – and that even individual control frauds can cause catastrophic losses.
- The reality is that control frauds cooperate with each other and are adept at suborning internal and external controls.

Reality is Malign.2

The reality is that the business world has transformed since the 1940s and is vastly more criminogenic because of (1) limited liability firms have replaced true partnerships with joint and several liability and

Reality is Malign.3

(2) modern executive compensation (a) greatly increases the amount of firm money senior executives can convert to their personal benefit through seemingly normal corporate mechanisms (salary & bonus) with virtually no fear of 'clawback,' (b) allows CEOs running control frauds to create perverse incentives to induce employees, agents, and officers to engage in fraud and predation,

Reality is Malign.4

(c) allows CEOs running control frauds to ‘signal’ their desire that more junior officers and employees engage in accounting fraud to ‘make the number’ – while providing the CEO with ‘plausible deniability’

Warping Cressey.1

Note the subtle, but critical change that Albrecht and the ACFE made in Cressey's first supposedly essential element of what Albrecht twisted into the 'fraud triangle.' Cressey's first essential was "a financial problem that is non-sharable."

Warping Cressey.2

Albrecht and the ACFE corrupted that into this vague and incorrect essential: fraudsters must feel “(1) some kind of perceived pressure [to defraud]….”

Warping Cressey.3

No one serious believes that. To state what is as obvious to you as it is to us, business elites overwhelmingly defraud not because they are “pressure[d]” to do so, but because they wish to be even wealthier, higher status, and more powerful

The ‘Metaphor’ Becomes Irony

. The sad irony is that the fraud triangle is the only aspect of criminology that has entered the formal accounting literature. GAAS (SAS 99). The accountants who assigned the task of operationalizing the ‘fraud triangle’ into actual accounting literature plainly recognized that the fraud triangle made no sense in their context.

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Think Outside the Triangle

- Albrecht generalized triangle from study of largely pink collar embezzlers
- Among the most unusual fraudsters
- Excluded control frauds from his sample
- Triangle does not describe control frauds
- But it was adopted by fraud examiners & accounting literature – very damaging
- Modern white-collar findings ignored

Auditors got Stuck in Past

Fraud Triangle – Donald Cressey/Albrecht

Cressey: intellectual leader of the ACFE

Emphasis on non-elite frauds

No concept of control fraud

GAAS: Not very useful fraud flags: SAS 99

Treadway/COSO: Control fraud assumed to be a danger posed by small firms

Based on SEC enforcement actions, but SEC enforcers pick on the small to rack up numbers.

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Fraud Experts Fooled

Two types of fraud are addressed in this book fraudulent financial reporting, also known as **"Treadway" fraud**, usually originating in the top management sector; and "asset-theft" fraud, the more common and more costly type, likely to be practiced by virtually anyone, including outsiders. Treadway fraud is being adequately detected by independent auditors (CPAs) in their annual audits. **Accountant's Guide to Fraud Detection and Control, 2nd Edition (March 2000).**

Ouch! Enron cometh.

SAS 99 & The Triangle.1

“.07 Three conditions generally are present when fraud occurs. First, management or other employees have an incentive or are under pressure, which provides a reason to commit fraud.”

Everyone has “an incentive … to commit fraud,” so it’s useless as a fraud “flag.”

SAS 99 and the Triangle.2

"Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an opportunity for a fraud to be perpetrated."

Fraud: only possible when possible. Control fraud is always possible, so flag is useless..

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SAS 99 and the Triangle.3

“Third, those involved are able to rationalize committing a fraudulent act.”

Only those willing to commit fraud will commit fraud. Second tautology; third useless flag.

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SAS and the Triangle.4

"Some individuals possess an attitude, character, or set of ethical values that allow them to knowingly and intentionally commit a dishonest act. However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them. The greater the incentive or pressure, the more likely an individual will be able to rationalize the acceptability of committing fraud."

Suspect everyone! Let God sort 'em out!

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SAS 99 and Management

“.08 Management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.”

Sadly, “management” also hires and fires the auditor and suborns rather than “overrides” controls, creating fraud allies.

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SAS 99: Professional Skepticism

“**.13** Due professional care requires the auditor to exercise professional skepticism. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. [P]rofessional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.”

SAS 99: Fraud Risk Factors

".31 [T]he auditor may identify events or conditions ["fraud risk factors"] that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists."

Fraud risk factors are always present due to the risk of control fraud.

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SAS 99: Fraud Flags

".35 [O]bserving that individuals have the requisite attitude to commit fraud, or identifying factors that indicate a likelihood that management or other employees will rationalize committing a fraud, is difficult at best."

It is "difficult." So what do we know about humans when it comes to performing an analytical task that is very difficult and would harm the audit partner's self-interest?

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SAS 99.36: Death to the Triangle

"[T]he significance of incentives/pressures may result in a risk of material misstatement due to fraud, apart from the significance of the other two conditions. For example, an incentive/pressure to achieve an earnings level to preclude a loan default, or to "trigger" incentive compensation plan awards, may alone result in a risk of material misstatement due to fraud."

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SAS 99.36 (continued)

"In other instances, an easy opportunity to commit the fraud because of a lack of controls may be the dominant condition precipitating the risk of fraud, or an individual's attitude or ability to rationalize unethical actions may be sufficient to motivate that individual to engage in fraud, even in the absence of significant incentives/pressures or opportunities."

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SAS 99.37

“The auditor's identification of fraud risks also may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. [I]n … a larger entity, the auditor ordinarily considers factors that generally constrain improper conduct by management, such as the effectiveness of the audit committee and the internal audit function, and the existence and enforcement of a formal code of conduct.”

Seriously? A “code” adopted by Ken Lay “generally constrain[s] improper conduct by management”? On what planet?

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SAS 99.39

"Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management."

[.39 also warns of "complex accounting principles"]

Control frauds cluster because CEOs cause the firm to operate in these areas that optimize fraud.

Only One Fraud Presumption

“A Presumption That Improper Revenue Recognition Is a Fraud Risk

.41 Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues….”

Management Override Risk

"A Consideration of the Risk of Management Override of Controls

.42 Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk…."

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SAS 99.54

"In addressing an identified risk of material misstatement due to fraud involving accounting estimates, the auditor may want to supplement the audit evidence…. (For example, [in] evaluating the reasonableness of management's estimate of the fair value of a derivative), it may be appropriate to engage a specialist or develop an independent estimate for comparison to management's estimate."

SAS 99.63: Manager bias

"In preparing financial statements, management is responsible for making a number of judgments or assumptions that affect significant accounting estimates and for monitoring the reasonableness of such estimates on an ongoing basis. Fraudulent financial reporting often is accomplished through intentional misstatement of accounting estimates."

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SAS 99.65: Make the Number

"[I]nformation coming to the auditor's attention may indicate a risk that adjustments to the current-year estimates might be recorded at the instruction of management to arbitrarily achieve a specified earnings target."

SAS 99 Appendix: Fraud Flags

Reactive v. opportunistic control fraud

c. "[M]anagement … is threatened by the entity's financial performance [due to]:

Significant financial interests in the entity

Significant … compensation … contingent upon achieving aggressive target

d. [E]xcessive pressure on management or operating personnel to meet financial targets"

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Fraud flags: Opportunities

"b. There is ineffective monitoring of management as a result of the following:

— Domination of management by a single person or small group"

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Fraud flags: Rationalizations

“Known history of violations of securities laws or other laws and regulations, or claims … alleging fraud or violations of laws and regulations

- Excessive interest by management in … the entity's stock price or earnings trend
- Management failing to correct known significant deficiencies …in internal control on a timely basis”

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Upper Management Flags

"Fraudulent financial reporting by upper-level management typically involves override of internal controls within the financial reporting process. Because management has the ability to override controls, or to influence others to perpetrate or conceal fraud, the need for a strong value system and a culture of ethical financial reporting becomes increasingly important."

Assuming Ethical Leaders

“The potential for management override also increases the need for appropriate oversight measures by those charged with governance….”

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Audit Committee Fantasy.1

"An entity's audit committee also should ensure that senior management (in particular, the CEO) implements appropriate fraud deterrence and prevention measures…."

Audit Committee Fantasy.2

"The audit committee … can [deter] senior management [from fraud] by ensuring [that] any attempt by [them] to involve employees in committing or concealing fraud would lead promptly to reports from such employees to appropriate persons, including the audit committee)."

Broad ethical challenges

Traditional business ethics assumes (implicitly) that the CEO is honest

Perverse compensation incentives designed to create ethical pressure

Increases pressure v. blowing the whistle

Degrades professional ethics

Will anti-fraud experts take on the CEOs?”

Conventional Ethics Fails

Implicit assumptions are dangerous

CEOs assumed to set the right tone

Fraudulent CEOs set a corrupt tone

Fraudulent CEOs don’t need to develop a new skill set – managerial incentives

Perverse incentives are easier to create

Ego, status & money: triumphal trio

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Ethical Pressures

Target all levels through broad bonuses

Target line, controls, professionals & execs

Hire, fire, promote, pay, praise & slam

Creating a corrupt culture

Resistance is futile: bypass the honest

Enron: self-selection by personnel – the most amoral people in the room

Fraudulent is the new normal

Squash the Whistleblowers

- Whistleblowers = greatest danger to control frauds. Ask why Richard Bowen and Michael Winston are unemployable.
- Broad bonus programs discourage them
- It's not just their loss of income, it's their peers' loss of income if they warn
- CEO can direct the firm's full resources v. whistle-blowers: retaliation is inevitable

Degrade the Professionals

- The art is to suborn, not defeat, controls
- Professionals = most valuable fraud allies
- Gresham's dynamic
- Don't need to suborn everyone
- Professional corruption is likely to spread beyond the particular fraudulent firm
- Highly influential with Congress & juries

Auditors v. Control Frauds?

Implicit ethical question rarely asked

The CEO poses the central fraud risk

No CEO is eager to hire anti-fraud experts who target fraudulent CEOs

No firm has me talk about control fraud

Auditors rarely emphasizes control fraud

Anti-fraud experts emphasizing control fraud puts their career at risk

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Speak truth to power

Auditors don’t focus on the worst frauds

Does not warn v. criminogenic environment

Does not teach how to detect control fraud

Does not push for prosecutions

Does not push for effective regulation

Does not push back v. theoclassical economics

Why no Chief Criminologists?

Regulators have huge numbers of economists, lawyers, and accountants

They often have no anti-fraud experts

Virtually never in senior positions

No one thinks about whether they're creating a criminological environment

No one to train staff to detect control fraud

Sutherland Channels Bastiat

"When plunder becomes a way of life for a group of men living together in society, they create for themselves in the course of time a legal system that authorizes it and a moral code that glorifies it."

- Frederic Bastiat

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Gresham’s & the Auditors

“[A]busive operators of S&L[s] sought out compliant and cooperative accountants. The result was a sort of "Gresham's Law" in which the bad professionals forced out the good.” (NCFIRRE 1993)

Same pattern: credit rating agencies, appraisers & stock analysts

Ask the experts how it’s done

Don't just say: "If you hit this revenue number, your bonus is going to be this." It sets up an incentive that's overwhelming. You wave enough money in front of people, and good people will do bad things.

Franklin Raines: CEO, Fannie Mae

Do as I say, not as I do

"By now every one of you must have 6.46 [EPS] branded in your brains. You must be able to say it in your sleep, you must be able to recite it forwards and backwards, you must have a raging fire in your belly that burns away all doubts, you must live, breath and dream 6.46, you must be obsessed on 6.46…. After all, thanks to Frank, we all have a lot of money riding on it…. We must do this with a fiery determination, not on some days, not on most days but day in and day out, give it your best, not 50%, not 75%, not 100%, but 150%."

The anti-canary

"Remember, Frank has given us an opportunity to earn not just our salaries, benefits, raises, ESPP, but substantially over and above if we make 6.46. So it is our moral obligation to give well above our 100% and if we do this, we would have made tangible contributions to Frank's goals." (Mr. Rajappa, head of Fannie's internal audit, emphasis in original.)

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