CASE STUDIES FRAUD & GREED

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Warner Music Group
TODAY’S OBJECTIVES

• Facts & Figures
• Dissect cases of fraud motivated by greed:
  • Who committed the fraud
  • How did their greed manifest
  • What lessons can we learn from these greedy fraudsters
• Understand greed based behavioral red flags
• Takeaway ideas for your company
GREED – A DEFINITION

The inordinate desire to possess wealth, goods, or objects of abstract value with the intention to keep it for one's self, far beyond the dictates of basic survival and comfort. It is applied to a markedly high desire for and pursuit of wealth, status and power.

GREED CAN BE SEDUCTIVE – A LITTLE TASTE - THEN IT IS HARD TO STOP
2012 Marquet Report on Major Embezzlement shows that greed is a primary motivating factor in big frauds:

### 5 Year Aggregated Results

We determined with reasonable certainty the primary motivating factor for major embezzlers in 448 cases from our 5 years of data. These break down as follows:

<table>
<thead>
<tr>
<th>Motivation</th>
<th>Raw #</th>
<th>% total</th>
</tr>
</thead>
<tbody>
<tr>
<td>True need</td>
<td>8</td>
<td>1.8%</td>
</tr>
<tr>
<td>Sense of entitlement</td>
<td>2</td>
<td>0.4%</td>
</tr>
<tr>
<td>Finance business</td>
<td>23</td>
<td>5.1%</td>
</tr>
<tr>
<td>Gambling addiction</td>
<td>145</td>
<td>32.4%</td>
</tr>
<tr>
<td>Lavish lifestyle</td>
<td>250</td>
<td>55.8%</td>
</tr>
<tr>
<td>Romance</td>
<td>4</td>
<td>0.9%</td>
</tr>
<tr>
<td>Shopping addiction</td>
<td>4</td>
<td>0.9%</td>
</tr>
<tr>
<td>Substance addiction</td>
<td>10</td>
<td>2.2%</td>
</tr>
<tr>
<td>Support family member</td>
<td>2</td>
<td>0.4%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>448</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>
FACTS & FIGURES

• The U.S. Marshals Service manages and sells assets seized and forfeited by federal law enforcement agencies nationwide.

• Proceeds compensate victims, supplement funding for law enforcement initiatives and support community programs.

• The Marshals Service manages various types of assets; real estate, vehicles, commercial businesses, cash, financial instruments, jewelry, art, antiques, collectibles, vessels and aircraft.

<table>
<thead>
<tr>
<th>2013 U.S. Marshall Data</th>
</tr>
</thead>
<tbody>
<tr>
<td>23,122 Assets Managed</td>
</tr>
<tr>
<td>Distributed to victims/claimants in 2012</td>
</tr>
<tr>
<td>Equitable sharing of proceeds distributed since 1985</td>
</tr>
</tbody>
</table>

GREED VS. NEED
1,483 cases that caused in excess of $3b in losses
David Brooks (58):

- Owner of a company, DHB Industries, that supplied body armor to the US military and law enforcement
- Orchestrated schemes involving $200m
- August 2013 – Sentenced to 17 years prison, 5 years supervised release
- $8.8m fine and forfeiture of $65m in illegally gained profits – still finalizing restitution
According to the US Attorney he was ‘a selfish man who looted his company, defrauded investors, lied to the SEC and investing public, and sought to profit through insider trading right before the collapse of his house of cards.’:

- **Overstated Gross Profit Margins** to meet analyst expectations - reclassified > $22m in expenses associated with the cost of producing goods to expenses that didn’t impact gross profit margins (R&D, Samples)

- **Overvalued Inventory** - > $7m by using a related 3rd party entity to ‘sew vest components’ so it was not on hand - $2m inventory schedule was subsequently revised to show $9m
BROOKS – SO WHAT HAPPENED?

- **Overvalued Inventory** - Inflated the carrying value of their primary product – the ‘Interceptor’ vest by $6m to $8m – bullied an employee that challenged the valuation

- **Non-Existent Inventory** – Fraudulently added 62,975 units of a vest component valued at $7m to make up for a shortfall in earnings and profit margin in one period:
    - Subsequently included them in an inventory reduction as part of a product discontinuance program
    - When auditors wanted to inspect the items they were told ‘they were destroyed in a hurricane’

- **Unauthorized and Undisclosed Executive Compensation** – Fraudulently diverted millions of dollars to himself, his family and companies that he controlled
BROOKS – SO WHAT HAPPENED?

- **Unused Vacation Pay** - $382k – double pay for vacation
- **Related Party Scheme** – Tactical Armor Products (TAP) – private company whose only customers were DHB businesses – owned by his wife – run by Brooks – purchases more than $29m of goods and services generating a $9m profit for TAP – also paid TAP employee bonuses through DHB
- **Insider Trading** – On two occasions, a few days after SEC filings with misrepresentations and omissions Brooks sold $69m and $116m in stock knowing that the stock price was artificially inflated to $20 – after those sales the stock plummeted to pennies per share and was delisted
**BROOKS – WHERE DID THE MONEY GO?**

<table>
<thead>
<tr>
<th>Description</th>
<th>~ Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Horse Vitamins</td>
<td>$106,062</td>
</tr>
<tr>
<td>Family Vacations</td>
<td>$300,000</td>
</tr>
<tr>
<td>Bentley</td>
<td>$194,044</td>
</tr>
<tr>
<td>Face Lift for Wife</td>
<td>$7,900</td>
</tr>
<tr>
<td>Pool &amp; House Renovations</td>
<td>$66,500</td>
</tr>
<tr>
<td>Mother’s Condo Charges</td>
<td>$18,098</td>
</tr>
<tr>
<td>Leather Invitations</td>
<td>$40,000</td>
</tr>
<tr>
<td>Acupuncture</td>
<td>$11,240</td>
</tr>
</tbody>
</table>

Mom’s Burial Plot, Kid’s Summer Camp, Armored Vehicle...
SO WHAT CAN WE LEARN FROM DAVID?

How to throw a very cool party!

• Account reclassifications close to a period end that impact earnings/profits should be deeply scrutinized

• Ask multiple people (at all levels) about account valuations that contain judgmental aspects

• My dog ate my homework aka the inventory was destroyed in a hurricane should be corroborated – insurance claims, hauler bills, etc.

• Inventory at a 3rd party should be inspected/verified – check created and modified dates in spreadsheets

LOOK AT THE BACKUP FOR BUSINESS EXPENSES!
JANE DOE DIDN’T REMAIN ANONYMOUS

Caroline Richardson (54):

- Controller – Colombo Candy & Tobacco (MLB Logistics) – 2010 to 2012
- Embezzled $4.1m over about 2 years to gamble
- Company sued the casino & previous employer
- April 2013 – pleaded guilty – sentenced to 14-20 yrs
- Already was serving 5-10yrs for tax evasion

<table>
<thead>
<tr>
<th>Month</th>
<th>Embezzled</th>
<th>Casino visits</th>
<th>Net loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>$241000</td>
<td>22</td>
<td>$54000</td>
</tr>
<tr>
<td>February</td>
<td>$156000</td>
<td>18</td>
<td>$32000</td>
</tr>
<tr>
<td>March</td>
<td>$217000</td>
<td>25</td>
<td>$108000</td>
</tr>
<tr>
<td>April</td>
<td>$170000</td>
<td>17</td>
<td>$226000</td>
</tr>
<tr>
<td>May</td>
<td>$140000</td>
<td>18</td>
<td>$140000</td>
</tr>
<tr>
<td>June</td>
<td>$280000</td>
<td>24</td>
<td>$226000</td>
</tr>
<tr>
<td>July</td>
<td>$240000</td>
<td>24</td>
<td>$173000</td>
</tr>
<tr>
<td>August</td>
<td>$250000</td>
<td>27</td>
<td>$89000</td>
</tr>
<tr>
<td>September</td>
<td>$400000</td>
<td>19</td>
<td>$280000</td>
</tr>
<tr>
<td>October</td>
<td>$300000</td>
<td>16</td>
<td>$168000</td>
</tr>
<tr>
<td>November</td>
<td>$200000</td>
<td>29</td>
<td>$107000</td>
</tr>
<tr>
<td>December</td>
<td>$180000</td>
<td>12</td>
<td>$156000</td>
</tr>
<tr>
<td>Totals</td>
<td>$2774000</td>
<td>251</td>
<td>$1759000</td>
</tr>
</tbody>
</table>
RICHARDSON – SO WHAT HAPPENED?

• Was recommended for the job by her former employer and Colombo’s accountant, Thomas Brune:
  • Allegedly knew she had embezzled $1m from a prior employer
  • Didn’t catch this embezzlement
• Originally brought in as a consultant to look into suspicion of embezzlement of another employee:
  • He left the company and went to prison after his golf course construction company defrauded lenders and insurers of $6.8m
  • After that work she was hired as Controller for $62k a year
RICHARDSON – SO WHAT HAPPENED?

- Quickly reduced her team of 5 accountants under her to 0 – she had complete control and oversight:
  - Electronic transfers into her own accounts and then covered them up by inflating inventory, invoices, and accounts receivable
  - Made fraudulent payroll transfers to herself
- Schemes were detected after Nebraska state officials selected Colombo for a routine tax audit:
  - Colombo’s bank demanded a review and Brune was brought in to support Colombo
  - In suit against Brune, Colombo claims Brune delayed the bank review to adjust accounting entries to cover up Richardson’s actions
SO WHAT CAN WE LEARN FROM CAROLINE?

When gambling with other people’s money, the odds are against you!

• Radical organization changes such as reducing a team of 5 to 0 should raise a red flag
• Businesses that rely solely on others for financial expertise can be particularly vulnerable to fraudsters
• It is penny wise and pound foolish not to invest in background checks (including credit checks if legal in your state) for those that have access to the cash

Teach financially allergic managers how to look for fraud!
HIS GAMBLE DIDN’T PAY OFF

Navin-kumar Aggarwal (47):
- Hong Kong’s biggest fraud $HK8.5b (USD$1.2b)
- Partner K&L Gates – Betting & Gaming Practice
- Over 4 years he forged signatures and ordered accounting staff to transfer money into a dormant client account he had access to
- 12 years

"Dear David, I am really sorry about everything. I am not sure if its possible but I really hope the firm survives all this caused by me. I know the gravity of the crime committed. I can't live with this."

"I am very sorry that you and the others have to face all this and clear the mess,"

"The money that I stole was used to pay my gambling losses that I have accumulated over the years. I was using one 'escrow' to cover the other. I don't know what the devil got into me. Sorry."
SO WHAT CAN WE LEARN FROM NAVIN?

When gambling with other people’s money, the odds are against you!

• Temptation is hard to resist – in tempting businesses encourage third parties to be your eyes and ears

• Hotlines and other mechanisms that encourage people to come forward if they think something is wrong should be actively marketed – the accountants may have come forward

• Look at documents with signatures as part of your fraud techniques – potential forgeries may be easier to spot than you think
ACFE 2014 Report to the Nations:

- ‘Most occupational fraudsters exhibit certain behavioral traits that can be warning signs of their crimes, such as living beyond their means or having unusually close associations with vendors or customers’

- ‘In 92% of the cases we reviewed, at least one common behavioral red flag was identified before the fraud was detected’
BEHAVIORS AND TRAITS

Proportionate Greed: It's all relative - not all greed manifests in BIG frauds - the desire for 'wealth, status and power' is relative to the individual's station in life.

"It took us 20 years to accumulate those funds,"

Kimberly Sue Ross  
$200k in 4 yrs  
Non-Profit  
Free services to low income families

Wrote 232 fraudulent checks:
- Furniture
- Jewelry
- Entertainment
- Amusement Parks

"Lived an $80,000 income lifestyle while earning an average annual salary of $40,000"
"They treated me like royalty"

- Shoes
- Clothing
- Jewelry
- Other luxury items

"I can’t remember when I began making my own personal purchases. It started out small. Buying things made me feel better for a while, then I would feel terrible for I had done so I would buy more things to feel better again"
PAY ATTENTION TO THE PEOPLE!

Can greedy behavioral red flags indicate potential fraud?:

- Who are the individuals that are living life in the fast lane and does their lifestyle make sense?
  - Big house, lots of high end decorations
  - Exotic vacations
  - Expensive cars
  - Expensive clothes, jewelry
  - Expensive hobby – horses, flying
  - Over the top parties – very showy
  - Big expensive home renovations
- Who recently ‘won the lottery’ or got a inheritance?
PAY ATTENTION TO THE PEOPLE!

Can greedy behavioral red flags indicate potential fraud?:

- Who is trying to fast track their way up the corporate ladder?
- Who is arrogant, controlling, ego driven, ultra-confident?
- Who gets angry, defensive or makes others feel foolish when they are asked questions?
- Who are the big showy philanthropists?
- Who has a personality that is larger than life?
- Who dominates decisions in the organization?
- Who are the big gamblers?
PAY ATTENTION TO THE PEOPLE!

• Frequent travel to gambling destinations
• Lying, making excuses for or trying to hide visits to casinos
• Someone that always finds an excuse to borrow money
• Lots of talk about gambling, chasing losses or claims that they will stop when they hit it big
• People who use gambling as an escape from whatever is bothering them
IDEAS TO TAKE AWAY

- Scrutinize top side entries and account reclassifications – particularly those made at period end

- When account balances or methodologies are subject to judgment talk to multiple people at various levels to corroborate the validity of the judgments

- Check document and spreadsheet properties to see creation and modification information

- Think about ‘proportionate greed’ behavioral red flags – who is exhibiting those?

- All payments should have solid documentation – look!
IDEAS TO TAKE AWAY

- Determine if there is anyone in the company that has access to all aspects of the cash

- Partner with HR to determine if there are any rumors or observations about lifestyle changes and/or gambling problems

- Look into areas where organization changes occur that reduce internal control capabilities (segregation of duties, review controls)

- Encourage third parties to be your eyes and ears and come forward if something is unusual
IDEAS TO TAKE AWAY

- Actively market hotlines encourage people to come forward

- Look for trends, patterns and anomalies in data

- Don’t focus only on things that ‘look bad’ look for things that are ‘too good to be true’ – they probably are

- Is there anyone that is making your job more difficult – difficult, disrespectful, reluctant to provide information

- Are there any finance activities supervised by financially allergic managers?
PARTING TAKE AWAYS

- Horses don’t come cheap! Neither do over the top parties, private performances by big name entertainers…
- It’s easy to be generous when it is not your money…
- Don’t forget to pay your taxes
- When you gamble – it’s hard to really be a winner all the time
- No crime is really a new crime – fraudsters do the same things over and over and over again…