Eye on fraud — employee corruption fraud... what’s the big deal?

Issued by AICPA FLS Fraud Task Force
Lead Author: Elizabeth Woodward, CPA/CFF

Corruption is defined as “dishonest or illegal behavior, especially by powerful people (such as government officials or police officers).”¹ This publication is not intended to address political or international corruption; rather, we intend to address the insidious nature of employee corruption that keeps forensic accountants up at night — that is, our experience, education and training combine to absolutely convince us that the “depravity, decay and decomposition” (also part of Merriam-Webster’s definition stated previously) embodied by corrupt individuals will likely always be the strongest opponent we face in our fight to prevent fraud.

Forensic accountants believe that for fraud to occur, three factors generally need to be present:

---

¹ Merriam-Webster; merriam-webster.com/dictionary/corruption
² The fraud triangle is generally credited to Donald Cressey. Donald R. Cressey, Other People’s Money (Montclair: Patterson Smith, 1973) p.30.
Corporate fraud is apparent at all levels, including supervisors, management and even executives. The problem for forensic accountants is that if a person is "corrupt," they will always have the ability to rationalize theft. Some of the most troubling projects that an investigator pursues can involve employee theft via violations like expense report abuse, improper vendor relationships and low-dollar bribes. Perhaps what makes these offenses so unpleasant is that they show a diseased corporate culture where employees feel entitled to "extra" benefits. Imagine the manufacturing engineer who awards million-dollar contracts for factory maintenance, and that same engineer has a barn built at his personal residence for free, or at a very low cost using his employer’s resources or discounts from vendors (which, his employer would pay for indirectly via higher prices). "It doesn’t hurt anybody" is never a true defense. When personal gain is factored in to business decisions, the employee is not acting in the best interest of his or her employer and the business is harmed.

It should be noted that corrupt activities may be either committed acts such as defalcation of records or misrepresentation of work performed, or omitted acts such as "looking the other way" or failing to enforce policies or regulations in exchange for something of value.

Examples of employee corruption

Payroll and ghost employees
"Ghost" employees are individuals who receive paychecks but do not exist, or exist but are not legitimate employees. In the first instance, they are fictitious employees who are entered into the payroll file. In the latter, they may be associates of an existing employee or former employees who continue to receive checks after their employment is terminated. For this fraud to occur, employment files are created or altered. Work activity records (like time cards) are maintained. Payroll checks, or more conveniently, direct deposits, are diverted to an account controlled by the perpetrator.

Billing and fictitious vendors
This fraud scheme is perpetrated by issuing disbursements to either a fictitious vendor or to a legitimate vendor for fictitious goods/services. The fictitious vendor is entered into the vendor master file and receives payment for goods and services not actually provided. Legitimate vendor accounts may also be used to commit fraud. Payments to legitimate vendors for fictitious goods/services may be intercepted and converted, or employees...
can collude with existing vendors to create inflated invoices or false invoices and provide kick-backs or bribes to the employee.

Please see “Vendor Fraud” in the Spring 2017, Issue 3, edition of FVS Eye on Fraud for more information.

Expense reimbursement

As mentioned previously, expense reimbursement is one of the most prevalent forms of corruption because it is so easy to commit compared to other frauds. Some common examples include:

- Submitting personal expenses as business expenses (for example, dinner with a spouse is submitted as dinner with a client)
- Writing in overstated amounts for blanks on a receipt (for example, a $20 taxi ride from the airport is submitted as a $40 ride)
- Duplicating reimbursement (for example, a board member is reimbursed mileage from the organization and from their employer)
- Masking true nature of expense to one that is allowed by company policy (for example, submitting “discrete receipt” from a “gentlemen’s club,” to make an outing appear to be dining, rather than non-allowed adult entertainment)

Examples of employee corruption (continued)

Case study No. 1 — Ghost employees
Payroll specialist pleads guilty to embezzling from a Washington, DC, consulting firm

In April 2017, KaShaun Perkins of Upper Marlboro, MD, was sentenced to 21 months in prison for embezzling $275,000 from a global consulting firm through a payroll scheme. Perkins managed external payroll records and had access to employee salaries, bank accounts, and Social Security numbers. Perkins admitted that between January and July of 2015, he created “ghost” employees by altering files of terminated workers. Automatic salary payments to these ghost employees were deposited directly into two of Perkins’ personal bank accounts.


Case study No. 2 — Fictitious vendor
Former administrator of Los Angeles law firm sentenced for embezzlement

In December 2015, Esterlina Santos was sentenced to 60 months in prison and ordered to pay $3,300,000 to her former employer and $781,000 to the IRS. While working as the firm administrator of a law firm, Santos used QuickBooks software to generate checks from the law firm to her personal credit card accounts. She altered the accounting records to indicate that the money was paid to vendors of the law firm for services provided. Santos admitted to receiving more than $2,400,000 between 2007 and 2010. SOURCE: IRS.

Case study No. 3 — Expense reimbursement fraud
Former Johns Hopkins University School of Medicine physician defrauds employers

On July 7, 2017, Dr. Jean-Francois Geschwind pleaded guilty to federal mail fraud charges for illegally obtaining travel expense reimbursements from the Johns Hopkins University School of Medicine. Geschwind admitted that, between 2007 and 2015, he made misrepresentations and omissions in expense reports to get reimbursements to which he was not entitled. He would declare family vacations and meals as business expenses. Additionally, he was seeking two, sometimes three, reimbursements for the same expense. In one instance, Geschwind traveled to a conference in Japan and obtained reimbursements for the same expenses from the Johns Hopkins University School of Medicine, a French life sciences firm, and the Yale School of Medicine, which he had recently joined as chair of their Department of Diagnostic Radiology. Prosecutors say the aggregate proceeds of Geschwind’s scheme totaled hundreds of thousands of dollars. His scheme was discovered during an extensive internal audit at Johns Hopkins University. He faces up to 20 years in prison. SOURCE: United States Attorney’s Office — District of Maryland.
Some slightly more sophisticated examples of employee corruption

Bid rigging

Bid rigging occurs when participants work together, also referred to as colluding, to make it appear as though several competitive bids have been received, when in fact the process is “rigged” to favor a higher-than-necessary price. This is often accomplished through employees inside an organization’s procurement department working with accomplices to set up sham “business” entities. These employee-controlled “businesses” work in coordination to fabricate the bids. Of course, an enterprising procurement employee may work with individuals outside the company as well.

The element of collusion can make fraud much more difficult for a forensic accountant to detect. However, the involvement of more than one participant can sometimes cause the scheme to unravel — when one participant feels shortchanged, they may turn on the others.

Kickback

The barn built for the manufacturing engineer mentioned previously is an example of a nonmonetary kickback. Although the engineer’s employer does not directly lose cash, the company is likely paying more than they need to for the maintenance service in this case. In other cases, the cost of whatever good or service the vendor is providing may be inflated due to the “extras” that have been provided to the employee awarding the contract(s).

Case study No. 4 — Bid rigging

Former bank executive sentenced for role in conspiracy and fraud involving investment contracts

On May 18, 2015, Phillip D. Murphy, a former Bank of America executive, was sentenced to 26 months in prison for conspiracy related to bidding contracts for the investment of municipal bond proceeds and other municipal finance contracts. Murphy conspired with employees of a municipal contracts broker and others to increase the number and profitability of contracts awarded to Bank of America. Murphy submitted intentionally false certifications that were relied upon by municipalities and the IRS. The certifications indicated that the bidding process had been competitive and conducted in accordance with U.S. Treasury regulations. SOURCE: IRS.

Case Study No. 5 — Kickback

Former Department of Veterans Affairs official sentenced for taking $1.2 million in kickbacks

On June 30, 2015, in Trenton, NJ, Jarod Machinga, of Hopewell, was sentenced to 46 months in prison and 1 year of supervised release. Machinga previously pled guilty to wire fraud and engaging in a monetary transaction in criminally derived property. According to court documents, Machinga, a former Department of Veterans Affairs (VA) employee, worked as a supervisory engineer at the VA’s campus in East Orange. As a supervisory engineer, Machinga had the authority and influence to direct certain VA construction contracts to particular companies. Machinga partnered with another individual to set up three companies that could be used to obtain VA work. He then directed more than $6 million worth of VA construction projects to those companies. Machinga admitted he accepted $1,200,000 in kickbacks in exchange for his official action and influence between 2007 and July 2012. Additionally, Machinga defrauded the VA by falsely representing that one of the contracting companies was owned by a service-disabled veteran when it was not. SOURCE: IRS.
Kickbacks can also be in the form of cash. For example, a hiring manager negotiates with a potential recruit and offers them a high-paying position, as long as 5% of the new salary is secretly given back to the hiring manager.

Bribery
This scheme involves the corrupt payment of money, gifts or other rewards to influence the action of another person. Generally, in order to investigate bribery, a forensic accountant must understand a company’s compliance program and the applicable laws and regulations.

The U.S. Foreign Corrupt Practices Act (FCPA) prohibits corrupt payments to foreign officials and requires that books and records be maintained in a manner to assure that such corrupt payments are not made. Companies with international agents or operations are subject to extensive controls and monitoring responsibilities. The provisions of FCPA are beyond the scope of this publication. For guidance, see sec.gov/spotlight/fcpa/.

How does this happen?

Hiring practices
All too often employers just do not do enough to properly vet new employees. See the “Practice Tips — Pre-Employment screening” insert for some suggestions.

Case study No. 6 — bribery
Former Tennessee airport official sentenced for fraud and bribery scheme

On April 11, 2016, in Nashville, TN, John T. Howard was sentenced to 24 months in prison. Howard was also ordered to pay restitution of $1,400,000 and to forfeit the proceeds of his crime. Howard previously plead guilty to conspiring to commit wire fraud, soliciting and receiving a bribe, and money laundering. According to court documents, Howard, who had been an assistant vice president of the Metropolitan Nashville Airport Authority (MNAA), conspired with certain MNAA contractors to submit fraudulent invoices to MNAA for construction and repair work that they had not performed, overseen or verified. Howard also asked a contractor to purchase more than $49,000 in airline tickets to Las Vegas for players, coaches, and others affiliated with a youth basketball organization run by Howard, in return for awarding an MNAA cleaning job to this contractor. SOURCE: IRS.
Failure of fraud victims to report theft

As forensic accountants, we often hear after the fact that a fraudster had actually stolen before, but the theft had not been reported. Unfortunately, this hesitancy is widespread and occurs for different reasons. Some organizations do not want the reputational harm of being known as a victim. Some fear the reaction of investors, donors, employees, or the community at large.

Lack of training/corporate culture

There should be no question regarding what a company believes is the appropriate use of funds. Leaders establish the tone at the top by embodying the values of the entity. If a CEO buys expensive wine with employees present at the company’s expense, those employees will likely mimic the behavior if given the opportunity. See “Practice Tips — Tone at the top.”

Lack of internal controls surrounding accounting and procurement processes

Internal controls around key accounting (cash disbursements and cash receipts) and procurement (purchase orders and receiving) processes help mitigate the risk of employee corruption. Segregation of duties and secondary reviews within these processes are examples of controls that will prevent and detect various fraud schemes.

References

FVS Practice Aid – Forensic Accounting – Fraud Investigations; Written by 2012-2014 FLS Task Force
Case Study No. 1: justice.gov/usao-dc/
Case Study No. 2: irs.gov/uac/
Case Study No. 3: justice.gov/usao-md/
Case Study No. 4: irs.gov/compliance/criminal-investigation/
Case Study No. 5: irs.gov/compliance/criminal-investigation/
Case Study No. 6: irs.gov/compliance/criminal-investigation/