

THE IMPACT AND REALITY OF FRAUD AUDITING GETTING STARTED WITH A FRAUD INVESTIGATION

This presentation addresses the fundamentals related to initiating a fraud investigation, including the handling of tips, determining whom to interview and how to time the interviews, dealing with company protocol, and identifying and gathering documents. The session will also include how to evaluate the information you have and make sound decisions based on your evaluation.

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Allen is a graduate of the University of Louisiana at Monroe and is a CPA and CFE and currently serves as Assistant Legislative Auditor for the Louisiana Legislative Auditor's Office. In this position, he oversees investigations and matters related to local government audits and issues. Allen has spent 18 years with the Legislative Auditor's Office and has participated in over 200 investigative audits. Results of these audits included felony convictions of four sheriffs, three of whom went to prison. As a result of an investigative audit of the Department of Elections, the statewide elected Commissioner of Elections was also convicted of felony charges and sentenced to prison, and over 25 others were indicted and convicted, including vendors from New Jersey, Florida, and Alabama. Subsequent to this project, the department was eliminated by the state legislature.

Allen's experience also includes 8½ years as Director of Internal Audit for the Louisiana Community and Technical College System. This System has 49 campuses throughout the state.

Prior to joining the Community & Technical College System, Allen was Practice Leader for Forensic and Investigative Services for the international firm of Deloitte & Touche. While with Deloitte & Touche he directed projects in the continental United States, Hawaii, Mexico, Bermuda, Morocco, and the United Kingdom. Allen also worked with one of the major U.S. law firms in three major lawsuits involving the tobacco industry.

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Four Things You Need to Be Successful

- ❑ Authority—You will need the authority to do what is necessary to get the job done. If you don't have the specific authority to do what needs to be done, team up with someone who does. You should draft audit charters that provide appropriate authority or, in government environment, consider drafting legislation; never give up. However, never exceed your authority—know when to stop and team up.
- ❑ Support—To succeed in fraud work you must have the unwavering support of those above you. When you walk out the door, you must know that the boss has your back. As long as you do your job legally and within policy you will be supported. If you call off the dogs, they soon learn that they are really just supposed to bark loudly and run around sniffing; they are not expected catch the prey.
- ❑ Skill—The necessary skills may be obtained through training and experience. Initially, one should participate in every fraud training opportunity that budget will allow. In addition to just sitting in class, much can be learned from other participants. Make it a point to meet others who do fraud work and ask them questions about how they do what they do. Never be afraid to say “I don't know; tell me how you would do it.”
- ❑ Courage—Once you have the authority, support, and skills, courage will naturally follow. If not, change professions. If you need to be loved and appreciated by all, you cannot be a fraud investigator.

Why Do People Commit Fraud?

There are as many reasons people commit fraud as there are fraudsters. People who make the decision to commit a fraudulent act are driven by pressures, desires, and needs.

Though never acceptable, some of these reasons are

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somewhat understandable. Some will make no sense at all to the fraud investigator.

Understandable Need

These are generally related to family issues and are issues that one would understand on a compassionate level. However, it is still fraud and must be addressed and dealt with as such. Examples would be using the stolen funds to care for a family member who is ill, providing help to a child with an addiction problem, or continuing to pay a mortgage after a spouse has lost their job. Again, we understand, but we do not accept.

Greed

This is simply committing the fraud to enrich one's self. The money is used to support a lifestyle beyond what the individual could sustain on his legitimate income. The individual may use the funds to pay for country club memberships, luxury cars, expensive homes, and vacations. In some instances, the funds may be used for the purpose of self-aggrandizement—looking important to others. For example, the fraudster may make large contributions to local charities or donations to schools and colleges.

Personal Issues

The fraudster is using the funds to sustain and addiction. This may include drugs, alcohol, and gambling. This may also include out of control debt.

Revenge

The fraudster may begin the fraudulent acts as an act of revenge. The individual may begin stealing as an act of revenge because they did not receive the promotion they believed they deserved. In some cases it may be

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something as simple as an act that caused them embarrassment or hurt feelings.

The Challenge

In some cases the individual simply sees it as a challenge. They understand the controls in place and start out to see if they can beat them. Once they determine that they can, they are tempted to use this knowledge to engage in fraud. This type of reasoning can be found anywhere in the company but is extremely dangerous in the area of IT.

Compensation Incentives

Some employees for major companies receive a salary plus incentive pay (bonus). In many instances the incentive pay is far greater than the salary. Usually this incentive is based on the performance/profitability of the company. This provides an individual with the incentive to cheat. This type of fraud will most likely be at the CEO or CFO level as these are the individuals most likely to receive bonuses based on performance. However, don't forget that these people rarely if ever make entries into the books. There are likely to be several clerk-level staff who are well aware of their schemes.

Reasons People Don't Commit Fraud

Personal Values

We all have a value system; however, these value systems differ from person to person. A person's value system is shaped by their parents, schools, religious beliefs, and peers. For the most part, employees value systems support the fact that fraud is wrong. However, not everyone would agree on acts that constitute fraud. This is why the challenge for management is to clearly

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define fraud and establish and support the value systems that exist during the workday.

Fear of Getting Caught

The fear of getting caught is a primary fear. The ACFE has consistently taught that increasing the perception of detection is one of the major fraud preventive steps a company can take. For the most part, if an employee perceives that their actions will be found out, they will most likely not take actions that are fraudulent. This should be the focus of a good internal control system. The internal controls should increase the perception of detection.

Fear of Punishment

Fear of punishment is a secondary fear. If you do not believe you will be caught, you do not fear the consequences. However, companies should make it clear that those who commit fraudulent acts will be punished. In some cases, the individual is far more afraid of the public embarrassment of getting caught than the actual punishment. To lose face with the country club crowd is more frightening than jail time.

Getting Started

Fraud investigations are the result of information. This information may come from an audit, analytical procedures, tips, or other sources. The fraud investigator then makes decisions based on the information received. The investigator begins to seek answers to who, what, where, when, and how. The investigator must always be aware that the initial information may be totally or partially inaccurate. You should proceed deliberately but with caution.

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Audits

If the information comes to the investigator as a result of an audit, the first thing the investigator should do is obtain a copy of the audit report. The investigator should study the report and understand the reasoning behind the allegation or suspicion of fraud. If the allegation is based on financial data contained in the report the investigator must understand the financial data or team up with someone who does.

In addition, the investigator should interview the auditors who prepared the report. Make sure you speak with the auditors who performed the actual field work and not just those tasked with reviewing, editing, and supervising. There is much learned during an audit that would not be included in the report and the field audit team would be able to provide that information. These individuals can provide information on where records are located, how they are filed, who has custody, who will cooperate, and who will not. In addition, they may verbally give you their opinion as to how the fraud may be occurring and who is involved.

Analytical Procedures

The predication for a fraud investigation may come from certain analytical procedures performed on the data. The first thing the fraud investigator should do is review the underlying data and the analytics. The emphasis is twofold. First you must determine that the data used in the analytical procedures is accurate and, second, that the analytical procedures were done logically and correctly. There is nothing worse than spending hours chasing what appears to be an anomaly only to determine the numbers driving the predication were wrong.

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Tips

Tips are one of the most frequent sources of information that drives investigations. Understanding what motivates the individual to provide the information is important. However, the individual's motive doesn't change the facts. For instance, an employee may provide information because he hates the boss. What is important to the investigator is whether the information is factual.

Understanding the tipsters' motive will be helpful to the investigator when communicating or working with the tipster.

Talking with the Tipster

Many companies now have a method by which a person may report suspected fraud. In most instances this method will allow for anonymous reporting. If you are taking information from an individual regarding possible fraud there are some important things that you should do.

First, let them talk. Understand that the individual is likely nervous—more likely angry and scared. In fact, it is likely that the individual's anger was such that it forced them to overcome their fear of calling. Attempt to calm their fears by reassuring them that the call is anonymous and they should take their time. You will not ask them for personal information.

Detail is what you want. Generally the caller will provide an initial "blurt" of information such as "Bob Jones is stealing." You should calmly ask questions such as: How is Bob stealing? When did it start? Who else may be involved? Who else knows about the issue? Who will cooperate and who will not?

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Once you have them focused on answering the specifics, continue obtaining more detail in a calm and deliberate manner. At this point you might ask more questions about the fraud scheme, such as: What documents would be involved and who has those documents?

The important thing is to get as much detail as possible from the person providing the tip. Understand that you will likely never speak with this person again. Even when the tipster is known, they may not want to talk with you ever again. Once they hang up the phone or walk out of your office they may think “what have I done?” It is similar to buyer’s remorse. That is why it is important to obtain as much decision-making information as possible during the first contact with the person providing the tip.

Hotlines

Hotlines provide a method for individuals to report suspected fraud without fear of retaliation. Hotlines increase the perception of detection. This is especially true as it relates to management. Without hotlines the rank and file employee is the one who is watched. With the implementation of a hotline, management knows that there are now many eyes watching them and that those watching have a means of reporting what they see.

If you have a hotline, you must manage the information logically and consistently. There should be a specific policy as to who receives and acts on the information. You must also understand that if people call and nothing happens they soon stop calling and see you as the problem. There should be a response to the call. The level of response will be related to the severity of the

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allegation. There must also be consistency in responding to information. Whatever your process is, follow it consistently.

Going in the Door

Knowing as Much as Possible

- From the tipster—You should have as much detail as possible from the person providing the tip. You may have great detail or you may have very little. However, you should have formed a hypothesis regarding the type of fraud scheme(s) that may be occurring. Your hypothesis (thoughts) will drive the investigative steps.
- Outside sources—Based on your hypothesis, you may need to talk with other sources. These conversations would be to:
 - Gain and understanding of the operations of and current market environment for a particular industry.
 - Identify any regulatory agencies that might become involved.
 - Gain clarification of certain legal issues.
 - Determine if there are union contracts or employment relationship issues that will have to be dealt with.

However, be careful that you do not give away information that would be detrimental to your investigation.

Based on the information and your assessment of the type of fraud scheme(s) address the following:

WHO?

Who is involved?

- The tipster may or may not have provided the name of the person of interest. If the name of

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the possible fraudster is not known, you will make a determination of who likely would be involved, based on the type of scheme. For example, if the allegation is that there is a kickback scheme related to purchases, you would focus on buyers, the purchasing director, and vendors. You go where your information leads you. Also, understand that the next bit of information may lead you in totally different direction.

Who will I need to talk with (protocol)?

- Before going in you should have identified who you will talk with first. This may be driven strictly by the information or there may be union contracts or employment contracts that drive this decision. Is there certain protocol that I must follow? For example, you may have to first talk with the university president, before talking with the director of purchasing, before talking with specific buyers. Just know this in advance and come up with a plan to deal with it. There is nothing worse than going in and having to stop because you did not prepare for the proper protocol.

Who has the records?

- Based on the possible scheme(s), who has the records that I will need? This information may drive your decisions about who to talk with first.

Who will I need to contact?

- Identify any external agencies, grantors, or regulators that you may be required to notify if you find fraud.

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WHAT?

Based on your information what documents and other evidence will you need? As best as possible, identify in advance those who have possession of the documents you will need.

- Invoices, PO's, requisitions, bid doc's, bank records
- Receiving reports, shipping information, payroll data, inventory records

Other issues related to records include:

- Are the records of a nature that the custodian will need high-level approvals before providing? Examples of this would be human resources or proprietary information documentation. You should have addressed this in advance.
- Will I need to take the records? If so, you should have a plan to do so. If you can't take the records, you should have a plan to address this. It always is a good idea to have a backup plan.

WHERE?

- Are the records at multiple locations? If so, will you need to take custody of all related records simultaneously?
- The volume and location of records will impact the resources needed to begin the investigation. It is possible you may need a large number of staff to begin the investigation. Once records and other initial logistics have been addressed the number of staff may be greatly reduced.

Order of Attack

As part of preparing for the project, the fraud investigator will make a decision as to the first steps to take regarding

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interviews and gathering documents or other evidence. No matter the order of the attack, all efforts must be taken to protect the evidence.

In most cases, there will be initial interviews. The investigator should have strategically planned these initial interviews. Based on what you know at the time, you should have determined who you will talk with first. Remember, that you are basing this decision on what you know at the time. Once you conduct your first interview everything may change—the order of interviews, document gathering, everything. Also, remember that there may be certain protocol that you will have to follow. Knowing this in advance you should be prepared.

Neutral Witness

A neutral witness is someone who is not involved in the fraud. These are people who can provide you with information related to process, procedure, and operations. However, remember that, initially, it is likely that you will not know the extent of any person's involvement. Simply be aware of this when interviewing.

Corroborating Witness

A corroborating witness is someone who can corroborate a fact. They saw something or heard something that is relevant to the case. For example, the accounting clerk tells you that he heard the director tell another clerk to change the sales figures. The clerk who changed the figures can corroborate the fact that the sales figures were changed.

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Co-conspirators

Co-conspirators are involved in the fraud. These individuals may be involved at a lesser level or were coerced into the scheme by a corrupt supervisor.

Special Person/Target/Person of Interest

This is the main character in the play—the person directing the fraud and the person the investigator is primarily focused on.

Obtaining the Documents

As has been stated earlier, you must protect the documents. There must be a method for obtaining the documents to ensure the process meets the legal tests to allow the documents to be admitted into court.

The first question is, may they be left in place or must the fraud investigator take custody? Another issue that will have to be dealt with is the volume of records. The investigator must be prepared in advance to address these issues.

The fraud investigator should be prepared to obtain electronic records. The investigator will need to plan for this in advance and, if needed, have an expert IT individual on the initial team. Be aware that there is software available that is relatively simple to use to image a personal computer. However, the individual who performs this task may likely be called as a witness to testify about how it was done. Attorneys know all the questions to ask regarding the obtaining and protecting the integrity of the data. It is recommended that the person doing the imaging be an expert in information technology, to be able to answer detailed questions regarding the software, the type computer, and so on.

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Chain of Custody

Chain of custody must be maintained from the time the evidence is obtained until it is presented in court. Chain of custody addresses who, what, where, when, and how as it relates to obtaining the evidence and the efforts taken to protect the integrity of the evidence.

It is important to first record information identifying documents. It may be a year or even two years before the matter goes to court, so you should record everything you can about documents. For example:

- Who gave you the document
- Where did you obtain the document
- The date and time you obtained it
- Identification of the document
- Why you obtained the document

If the document leaves your custody there should be a receipting process noting who you transferred custody to and the date of the transfer. Each time custody of the document changes, this receipting process should be conducted. The receipting document should be signed by the person giving up custody and the one receiving custody.

The Special Person

Are they still there? Do you want them there? There are two huge advantages for the fraud investigator in having the special person on site. The first is access. The fraud investigator has access to this person on a daily/hourly basis. The second advantage is that it gives the special person something you want them to have up until the end—*hope*. As long as the special person is at work, they are thinking, “I haven’t been fired; I may be able to survive this.” This hope will give them the incentive to talk with the fraud investigator. In addition, if the special person is

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present they are witnessing the investigator talk to others. This builds a “nervous curiosity” as to what others are telling the investigator and will further increase the incentive for them to consent to an interview.

Having said this, the fraud investigator must take steps to ensure that the fraud scheme is not continuing or, if it is continuing, the investigator is using the actions to build and substantiate the case.

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