Fifty Shades of Fraud

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VLGAA Fall Conference Richmond, VA

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Pick a card, any card...
Pick a card, any card...
Your Risks?

What are hot or key fraud or compliance risk areas/challenges within your organization?
What is Fraud?

**Fraud** is defined by Black’s Law Dictionary as: *A knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment.*

Consequently, fraud includes any intentional or deliberate act to deprive another of property or money by guile, deception, or other unfair means.

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**Types of Fraud**

- **Internal Fraud**
- **External Fraud**
- **Fraud Against individuals**

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2. According to Association of Certified Fraud Examiners (ACFE).
Fraud Classifications

**Occupational Fraud** — “Internal” fraud that is committed by an executive, employee or other agent of a company who takes advantage of their employment or occupational position for their personal benefit by intentionally misusing, misapplying or misappropriating an entity’s assets or resources (i.e. embezzlement, Financial Statement/Accounting fraud, etc.)

**Predatory Fraud** — “External” fraud, commonly associated with “con-artists” and other “outsiders” who devise schemes to deceive people or entities in order to enrich themselves.
Fraud Throughout the Ages

Dante’s “Inferno”

Takes place on March 24, 1300 A.D. before dawn on Good Friday...

Dante and the Roman poet Virgil descend to the center of the Earth to the Underworld....

On their journey they encounter many famous people throughout history as they pass through...

The 9 Circles of Hell...
The 9 Circles of Hell

1. **Limbo**  
   - For the virtuous non-Christians

2. **Lust**  
   - Violent winds blow allowing for no rest/peace

3. **Gluttony**  
   - Overindulgence in worldly pleasures

4. **Greed**  
   - People who hoard or spend lavishly

5. **Wrath**  
   - People who are angry or hateful

6. **Heresy**  
   - People who denied God

7. **Violence**  
   - 3 circles: against a Person, Self, or God

8. **Fraud**  
   - 10 Separate trenches...

9. **Treachery**  
   - Cain; Cassius & Brutus; Judas
## Fraud – 8th Circle
### Malebolge or Evil Purses

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>1. Seducers</td>
<td>• Run forever &amp; whipped by demons</td>
<td></td>
</tr>
<tr>
<td>2. Flatterers</td>
<td>• Buried in human feces</td>
<td></td>
</tr>
<tr>
<td>3. Simoniacs</td>
<td>• Trapped in burning holes</td>
<td></td>
</tr>
<tr>
<td>4. Sorcerers</td>
<td>• Heads are backwards on their bodies</td>
<td></td>
</tr>
<tr>
<td>5. Political Corruption</td>
<td>• Trapped in a lake of burning pitch</td>
<td></td>
</tr>
<tr>
<td>6. Hypocrites</td>
<td>• Carry heavy lead cloaks</td>
<td></td>
</tr>
<tr>
<td>7. Thieves</td>
<td>• Chased by &amp; turned into venomous snakes</td>
<td></td>
</tr>
<tr>
<td>8. Evil Counselors &amp; Deceivers</td>
<td>• Eternally trapped in fire</td>
<td></td>
</tr>
<tr>
<td>9. Sowers of Scandal &amp; Discord</td>
<td>• Bodies ripped apart</td>
<td></td>
</tr>
<tr>
<td>10. Falsifiers</td>
<td>• Cursed with disease</td>
<td></td>
</tr>
</tbody>
</table>
How is Fraud Discovered?

- **Tip**: 42%
- **Management Review**: 16%
- **Internal Audit**: 12%
- **Accident**: 6%
- **Acct Reconciliation**: 6%
- **Document Examination**: 4%
- **External Audit**: 3%
- **Other**: 9%

Total: 70%
Irregularities & Defalcations

...are just fancy words for lying and stealing

- A typical organization loses 5% of its revenues to fraud each year
- Corruption and billing schemes pose the greatest risks
- The industries most victimized:
  1. Banking
  2. Government & Public Administration
  3. Manufacturing

The presence of anti-fraud controls correlates with significant decreases in the cost and duration of the fraud schemes
5 Key Principles to Manage Fraud

1. Governance
2. Fraud risk assessment
3. Prevention controls
4. Detection controls
5. Formal Reporting & Investigations

Managing the Business - Risk of Fraud: A Practical Guide Joint Study conducted by The Institute of Internal Auditors, the American Institute of CPAs and the Association of Certified Fraud Examiners. Published July 2008
Common Types of Internal Fraud

Corruption
• Refers to schemes in which fraudsters use their influence in business transactions in a way that violates their duty to their employers in order to obtain a benefit for themselves.

Asset Misappropriations
• Asset misappropriation schemes are frauds in which the perpetrator steals or misuses an organization’s resources.

Financial Statement Fraud
• Involves the intentional misstatement or omission of material information from the organization’s financial reports; these are the cases of “cooking the books or figures.”
• Involves the reporting of fictitious revenues or the concealment of expenses or liabilities in order to make an organization appear more profitable than it really is.
THE FRAUD TREE
OCCUPATIONAL FRAUD AND ABUSE CLASSIFICATION SYSTEM

Conflicts of Interest
- Purchasing Schemes
- Sales Schemes

Bribery
- Invoice Redemptions
- Bid Riggering

Illegal Gratuities

Economic Extortion

Asset Misappropriation

Financial Statement Fraud
- Net Worth/Net Income Overstatements
  - Timing Differences
  - Fictitious Revenues
  - Concealed Liabilities and Expenses
  - Improper Asset Valuations
  - Improper Disclosures

Net Worth/Net Income Understatements
  - Timing Differences
  - Understated Revenues
  - Overstated Liabilities and Expenses
  - Improper Asset Valuations
  - Improper Disclosures

Cash
- Theft of Cash on Hand
  - Skimming
  - Cash Larceny
- Theft of Cash Receipts
  - Refunds and Other
    - Sales
    - Penalties
    - Write-Off Schemes
    - Understated
    - Lapping Schemes
    - Unrecorded

Fraudulent Disbursements
- Billing Schemes
- Payroll Schemes
- Expense Reimbursement Schemes
- Check Tampering
- Register Disbursements

Inventory and All Other Assets
- Mixups
- Larceny
  - Asset Requisitions and Transfers
  - False Sales and Shipping
  - Purchasing and Receiving
  - Unrecorded Larceny

2016 ACFE Report to the Nations
Quiz Question:

How long does the average fraud go on before it is uncovered?

a. 6 months  
b. 12 months  
c. 18 months  
d. 24 months
<table>
<thead>
<tr>
<th>Industry</th>
<th>Number of Cases</th>
<th>Percent of Cases</th>
<th>Median Loss</th>
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<tbody>
<tr>
<td>Mining</td>
<td>20</td>
<td>0.9%</td>
<td>$500,000</td>
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<tr>
<td>Wholesale Trade</td>
<td>36</td>
<td>1.6%</td>
<td>$430,000</td>
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<tr>
<td>Services (Professional)</td>
<td>60</td>
<td>2.7%</td>
<td>$310,000</td>
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<tr>
<td>Agriculture, Forestry, Fishing, and Hunting</td>
<td>44</td>
<td>2.0%</td>
<td>$300,000</td>
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<tr>
<td>Oil and Gas</td>
<td>74</td>
<td>3.4%</td>
<td>$275,000</td>
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<tr>
<td>Construction</td>
<td>86</td>
<td>3.9%</td>
<td>$259,000</td>
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<tr>
<td>Technology</td>
<td>74</td>
<td>3.4%</td>
<td>$235,000</td>
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<tr>
<td>Communications and Publishing</td>
<td>16</td>
<td>0.7%</td>
<td>$225,000</td>
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<td>Real Estate</td>
<td>41</td>
<td>1.9%</td>
<td>$200,000</td>
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<tr>
<td>Manufacturing</td>
<td>192</td>
<td>8.8%</td>
<td>$194,000</td>
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<tr>
<td>Telecommunications</td>
<td>62</td>
<td>2.8%</td>
<td>$194,000</td>
</tr>
<tr>
<td>Banking and Financial Services</td>
<td>368</td>
<td>16.8%</td>
<td>$192,000</td>
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<tr>
<td>Transportation and Warehousing</td>
<td>68</td>
<td>3.1%</td>
<td>$183,000</td>
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<tr>
<td>Government and Public Administration</td>
<td>229</td>
<td>10.5%</td>
<td>$133,000</td>
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<tr>
<td>Health Care</td>
<td>144</td>
<td>6.6%</td>
<td>$120,000</td>
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<tr>
<td>Insurance</td>
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<td>3.0%</td>
<td>$107,000</td>
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<tr>
<td>Utilities</td>
<td>40</td>
<td>1.8%</td>
<td>$102,000</td>
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<tr>
<td>Other</td>
<td>153</td>
<td>7.0%</td>
<td>$100,000</td>
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<td>Services (Other)</td>
<td>70</td>
<td>3.2%</td>
<td>$100,000</td>
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<tr>
<td>Retail</td>
<td>104</td>
<td>4.6%</td>
<td>$85,000</td>
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<td>Religious, Charitable, or Social Services</td>
<td>52</td>
<td>2.4%</td>
<td>$82,000</td>
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<tr>
<td>Arts, Entertainment, and Recreation</td>
<td>37</td>
<td>1.7%</td>
<td>$75,000</td>
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<tr>
<td>Education</td>
<td>132</td>
<td>6.0%</td>
<td>$62,000</td>
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</table>
Wanted: Mining Theft Gang
Battle of the Sexes...

Figure 81: Gender of Perpetrator—Median Loss

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The Fraud Triangle

INCENTIVE

Excessive Debt
Lifestyle
Family

OPPORTUNITY

Authority
Knowledge
Access/Controls

RATIONALIZATION

Inequality
Harmlessness
Tone at the Top
Overriding Factor:

The Perception Regarding Getting Caught
Current Landscape

The “Perfect” Storm
The “Bermuda” Triangle

Fraud “Lifecycle”

Severe Fraud Triangle Pressures

Government Enforcement
Ethical Tone

2013 National Business Ethics Survey

- 41% reported observing misconduct
- 63% reported the observed misconduct
- 60% of observed misconduct involved Management, of which 24% was Sr. Mgt.
- 1/3 of those who observed misconduct chose not to report it
- Retaliation rate at 21%
- Pressure to compromise standards at 9%
- 26% of reported misconduct was “on-going” and 12% was “company-wide”
Exercise: Create A Fraud

- Gather with those next to or around you
- Based upon your experience and existing controls
- Design a Fraud Scheme for your organization:
  - Target misappropriation of more than $50K
  - No collusion!
  - Likelihood of discovery low
  - How will you circumvent controls?
  - How will you avoid law enforcement detection?
Potential Risks/Penalties

- Program Suspensions
- Prosecution
- Reputational Harm
- Fines
- Loss of Revenue(s)
- Law Suits
- Settlement Agreements
Associated Costs

- Legal & Investigative Fees
- Collateral Litigation
- Operational Disruption
- Donor Support/Public Perception
- Remedial Measures
- Employee Turnover
- Imposed Oversight
Fraud Prevention

- Focus on the Fraud Triangle
- Professional Skepticism\(^2\) ("squared")
- Be Proactive
- Get Knowledgeable/Trained
- Know the Risk Areas
- Wear the “Black Hat”
- Create the Perception of Getting Caught
Fraud Prevention: Opportunity

- Sound and Reasonable Internal Controls
- Proper Employee Screening/Background Checks
- Know the Common Schemes
- Determine and Prioritize Fraud Risks
Fraud Prevention: Rationalization

- Engender & Maintain Positive Ethical Tone
- Exposure to Organizational and Personal Impact
- Awareness in Employee Performance Reviews
- Foster Equality and Fairness
- Code of Conduct and Mission Statement
Fraud Prevention: Incentive

- Know Your People
- Available & Trustworthy Employee Assistance Programs
- Management Education and Awareness
- Legal “Monitoring” of Organizational Assets
Fraud Detection

- Learn Common Schemes and Look for Them
- Coordinated Measures – Team Effort
- Job Rotations/Forced Vacation(s)
- Develop Network of Human Intelligence/Assets
- Involvement and Accountability of Management
- Encourage & Enable Reporting
- Prevent Retaliation
- Engage Experts
Common Schemes

- Accounts Payable:
  - False or Modified Vendors
  - Fraudulent Expenses
  - Check Tampering
  - Refunds
  - Personal Expenses
  - Conversion
Common Schemes

- Asset Conversion:
  - Equipment
  - Tools
  - Cash
  - Vehicles
  - Valuables
  - Stickers/Decals
  - Intellectual Property
Common Schemes

- **Purchasing:**
  - False Vendors
  - Related Parties/Conflicts of Interest
  - Kickbacks
  - Gifts & Gratuities
  - Bribery
  - Anti-Competitive Practices
    - Bid-Rigging
    - Market Segmentation
    - Bid Rotation
Common Schemes

Payroll:
- Ghost Employees
- Resurrected Employees
- Overtime
- Leave
- Withholding Diversion
- Bonuses
Common Schemes

- Accounts Receivable/Cash
  - Conversion/Theft/Skimming
  - Receivables Lapping
  - Write-Offs
  - Waivers
  - Discounts
  - Counterfeit Tickets
Responding to Fraud

- Consistent with Policy
- Halt & Containment
- Determine Risk(s) & Scope
- Internal or External Team
- Reporting/Disclosure
- Remediation of Controls and Compliance Program
Essential Tool: Interviews

Good Time for a Break!

Next segment will broadly cover effective interviews, a key tool in the arsenal of Fraud Examiners!
Interviewing

- Most interviews are procedural/information gathering, not confrontational
- Interviewing is an Art and a Science
- There is no such thing as a Human Lie Detector!
- The 10% Rule
Traits of an Effective Interviewer

- Self-Awareness
- Exceptional Listener
- Empathetic
- Patient
- Alert
- Knowledgeable
- Courteous
- Impartial/Objective
- Tactful
- Firm
- Sincere
- Honest
- Forthright
- Trained & Experienced
Principles of Effective Interviewing

- Let them tell the story in their own words
- "Walk-Throughs"
- Identify what are facts & what are suppositions/opinions
- **DO NOT** antagonize or grill the person on inconsistencies (a lie is just as valuable as the truth)
- Record and report all information provided, even if its contradictory
Principles of Effective Interviewing

- Conclude the interview in a manner where they can call or re-approach you, if they desire
- Memorialize the interview in writing and/or record it
- Prepare a well written, objective & thorough report
The Law:

Virginia is a single party consent state.
What That Means: You, as the interviewer CAN record either secretly or openly any conversation that you are participating in. You DO NOT have to tell the person they are being recorded.

What You CAN Do: You can not hide a recorder in a desk drawer, backpack, cabinet, bathroom, office or any similar location and record conversations that you are physically not present and/or participating in. That is a form of wire tapping & eaves dropping.
Principles of Effective Interviewing

The Foundation of Interviewing

- Establish and Maintain Rapport
  - Dictionary.com...
    "relation; connection, especially harmonious or sympathetic relation"
- Calibrate the witness
- How do you see yourselves when conducting an audit?
How do you see yourselves when conducting an audit?
- **Open Ended**: Used to promote conversation and gain a narration of events

- **Close Ended**: They are designed to generate short specific responses to the interviewer’s questions, and to clarify particular points

**Who, What, Where, When, Why & How**

**Questioning Basics**
Things to Know About Witnesses

- Role & Responsibilities
- Command of Relevant Facts
- Likes/Dislikes
- Family & Friends
- Religious Beliefs
- Ethical Tone
- Hobbies
- Political Views
Things to Know About Witnesses

- People tend to be either visually-oriented or auditorily-oriented.
- For the most part, witnesses are anxious or reluctant, especially when it comes to who is interviewing them and/or questions about co-workers.
- People tend to remember things in a sequential order by which events they assign significance to. Events aren’t always remembered in chronological order.
Things to Know About Witnesses

- Memories will fade over time depending on the perceived importance assigned to events
- Memories can be recalled by getting the witness to remember a triggering event
- Calibrate the witness – how does he/she respond to non-threatening questions?
- 100% Honesty is 100% False
1. What if they start asking me questions?
2. What can I tell them about the audit?
3. In what order should I ask my questions?
4. What if they give me a response I know is false?
5. When do I confront them with the facts and/or the lie(s) they have told?
6. What if they become emotional, angry or silent?
7. What happens after an admission?
2 Magic Questions

“What do you think ought to happen to the person who (allegation and/or crime)?”

Listen for the very first response.
2 Magic Questions

Conclude **every** interview with this question:

“Is there anything else of importance that I haven’t asked you about, or that you want to talk about?”
Anxiety ➙ Deception

- Anxiety can be caused by many things, including, but not necessarily, deception.
- There is no such thing as a “Human Lie Detector”.
- There is no “one size fits all” diagnostic for identifying deception – calibrate and compare.
- There are no “absolutes” of deception (e.g. body language, such as closed posture).
- Equivocating, deflecting or pretending not to understand.
- Invoking religion or the “good person” defense too early and/or too often.
Generally speaking, guilty people will not terminate the interview, even when pressed or accused

Statements made against the witness’s penal interest can generally be relied upon as true statements

Don’t fight the 10% rule

Facts trump feelings

For Sociopaths, the rules don’t apply

Calibration can help you spot signs of anxiety, but experience and skill is needed to determine what is creating the anxiety
Lying & Why

- Everyone lies
- Witnesses will intentionally fabricate information to intentionally deceive you (Lies of Commission)
- Witnesses will leave out a fact (Lies of Omission)
- Confessions are never 100%
- Witnesses will repeat what they hear and offer it to you as the truth even though they have no direct knowledge
- Witnesses will supply information to fill in gaps in an attempt to be helpful
- Witnesses will make suppositions and/or draw conclusions about what they know and/or what they THINK they know
Overcoming Objections

Controversial Issue!

- Determining and using “rationalizations”
- Once confrontation begins, minimize entrenchment
- Focus on the why, not the “did you?”
- Have exhibits ready
- Be professional and kind – “not everyone who steals is bad” (and that is 100% true)
- Always be honest and as transparent as possible
Overcoming Objections

Recent Example

- Not for profit
- $200MM/year
- 4 insiders and 12-20 outsiders
- Loss exceeding $200K
- 3 back to back Admission Seeking Interviews
- All admitted
The Interview: The Unusual Suspect
Watch & Listen
Attacked from the Top: Chief Executive Officer
Dana Cope - SEANC

- CEO for State Employees Association of NC (SEANC)
- Cope was CEO for 15 years
Dana Cope - SEANC

- Tip from former Treasurer
- Treasurer went to media first
- N&O published a story on Sunday
- Monday, Wake County DA announced that she had requested an SBI investigation
- Wednesday, Cope resigned
SEANC Counsel, the CFO and the Board never questioned Cope formally regarding the allegations.

The weekend that the story broke, the Counsel, CFO and a quickly empaneled “Ethics Committee” determined that Cope had done **nothing** wrong and put its findings on the website after 2 days of looking at credit card receipts and internal documents.

The Board allowed Cope to resign with a $200,000 severance package.

He created documents to cover his tracks during the days leading up to his resignation.
“He did nothing wrong...”

- $77,000: landscaping at his residence
- $4,565: trip to Bermuda
- $5,700: shutters/shades
- $3,000: iron fence
- $3,200: pool / patio furniture
- $3,613: audio system / DJ mixer
- $2,200: a sofa
- $1,400: garage shelving
- $618: massages at the Umstead Hotel
Questionable Credit Card Charges: $457,500
- Included: Plastic surgery, vacations, hotels, clothing, jewelry and home renovations

Fraudulent Check Purchases: $113,346
- Included: Flying lessons, vacations and landscaping
Impact:

- Cope was charged with 2 Class C Felony charges > $100,000
- He pled guilty
- He paid $165,000 in restitution at the time of the guilty plea
- Ordered to pay $510,500 in restitution
- He received active jail time: 50-82 months (4-7 years)
- CFO resigned
- In-house counsel resigned

What was the reputational damage to the organization?
Data Analytics

- Looking at large volumes of data quickly to determine patterns and outliers

- Data Analytics serves as a pointer, identifying individuals, accounts, transactions and other places to look to get behind the numbers (Bus #235)

- Running analyses such as:
  - Benford’s Analysis
  - Linear Regression
  - Missing Data & Duplicate Data
  - Classification & Stratification
  - Identification of Error Conditions
Wake County School Board
Multi-million dollar scheme
Kickbacks
Fake orders for auto parts
Linear Regression WCPSS

Annual School Bus Maintenance ($Million)

- Annual Maint ($Million)
- Linear (Annual Maint ($Million))

Maintenance Costs ($M)

Number of buses in service

Transportation costs including fraud

Annual fraud amount

Amount excluding fraud
Wake County Investigation Results

- Estimated loss of approximately $5 million
- On some days, receiving over 200 invoices from the same vendor
- Clustering of invoice amount just under approval limit for purchase orders
- Corruption
Questions?
How Can We Help?

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