

Fifty Shades of Fraud

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FACILITATORS:

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John Hanson, CPA, CFE, CCEP





Michael East

'87

- ▶ **Manager, Fraud & Forensics within Risk Advisory Services (RAS)** of Cherry Bekaert- Certified Fraud Examiner (CFE)
- ▶ **Special Agent In Charge (Ret.) – NC State Bureau of Investigation**, Financial Crimes Unit. Concentrating on Corruption, Embezzlements, Obtaining Property by False Pretenses, State Property Crimes, and the Elder Fraud Abuse Task Force. Trained the Police Inspectorate of Kosovo.
- ▶ **Assistant Special Agent In Charge leading investigations in Homicide**, Officer Involved Shootings, State and Federal Drug Trafficking, Dignitary Protection, Crisis Negotiation, Murder Un-Solved Team (MUST), and Child Fatality Prevention Team.
- ▶ **Certified Instructor** for NC SBI, FBI, United States Secret Service, NC Highway Patrol, and various federal, state & local agencies.

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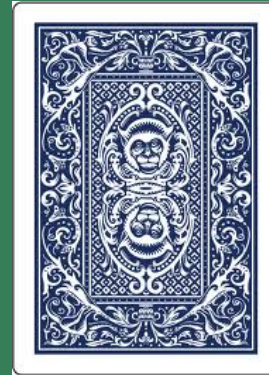
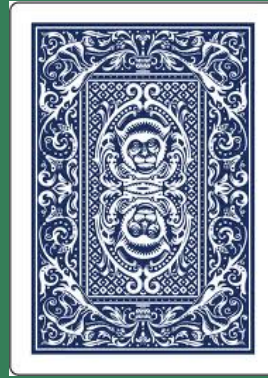
- ▶ **Executive Director** – AFFS (7 yrs)
- ▶ **Special Agent** – FBI (10 yrs)
- ▶ **Director** – Forensic & Litigation Support Practice of a large publicly traded international consulting firm (5 yrs)
- ▶ **Director of Internal Audit & Quality Control** – Privately held mortgage company in New Orleans (5 yrs)
- ▶ **Founder & President** – International Association of Independent Corporate Monitors (3 yrs)



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Pick a card, any card...



Pick a card, any card...



Your Risks?

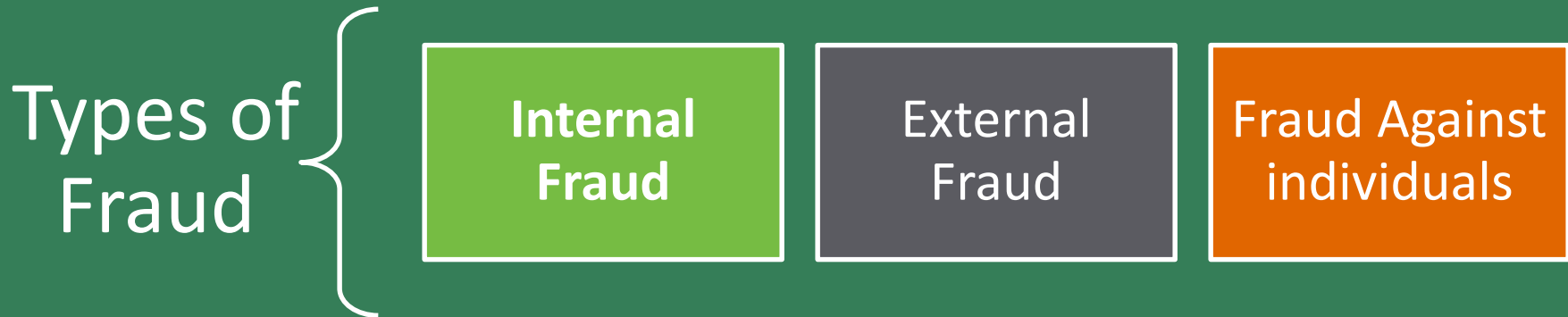
What are hot or key fraud or compliance risk areas/challenges within your organization?



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.*¹

Consequently, fraud includes any intentional or deliberate act to deprive another of property or money by guile, deception, or other unfair means.²



¹ Bryan Garner, ed., *Black's Law Dictionary. 8th Ed. (2004)*, s.v., "fraud."

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

1. Seducers

- Run forever & whipped by demons

2. Flatterers

- Buried in human feces

3. Simoniacs

- Trapped in burning holes

4. Sorcerers

- Heads are backwards on their bodies

5. Political Corruption

- Trapped in a lake of burning pitch

6. Hypocrites

- Carry heavy lead cloaks

7. Thieves

- Chased by & turned into venomous snakes

8. Evil Counselors & Deceivers

- Eternally trapped in fire

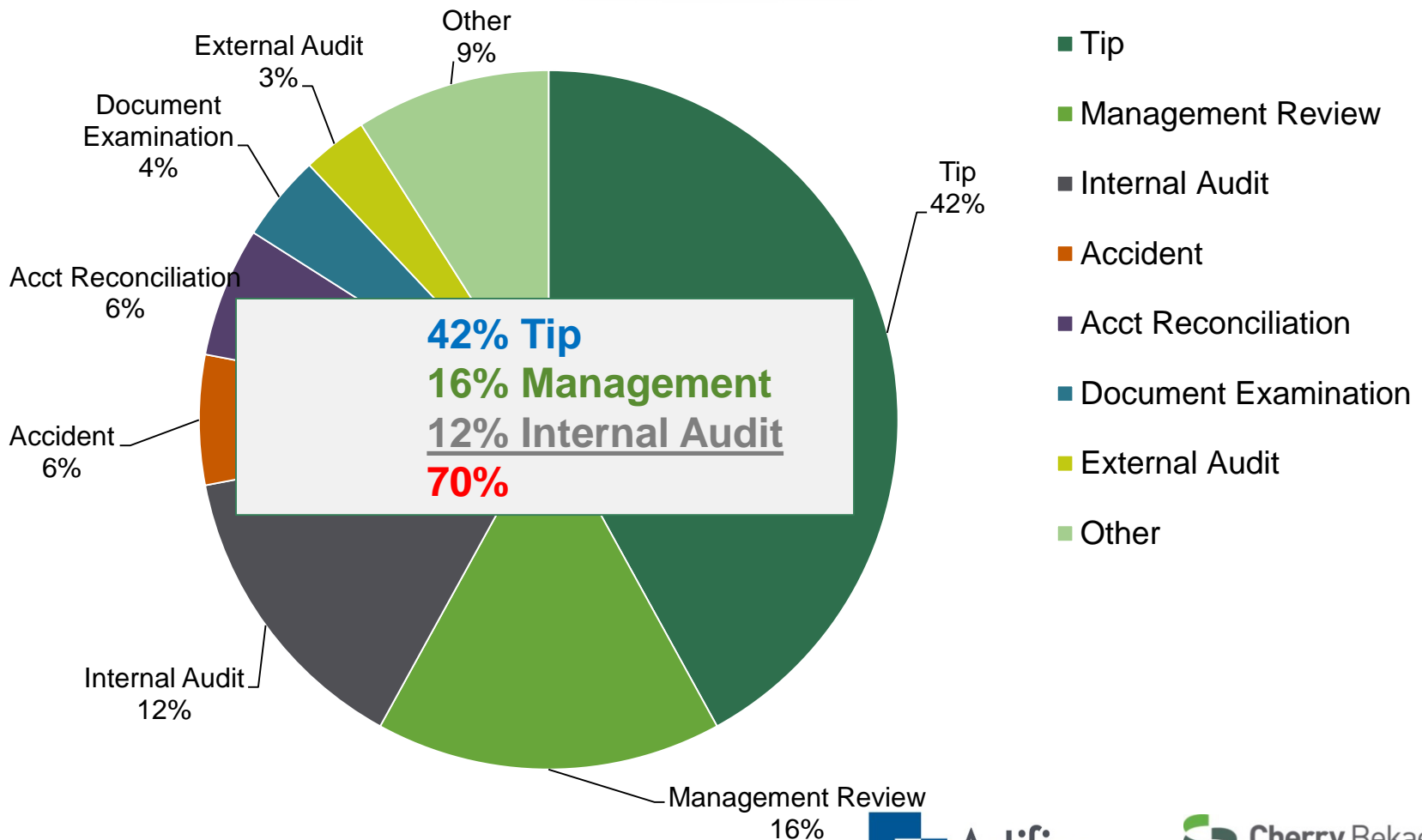
9. Sowers of Scandal & Discord

- Bodies ripped apart

10. Falsifiers

- Cursed with disease

How is Fraud Discovered?



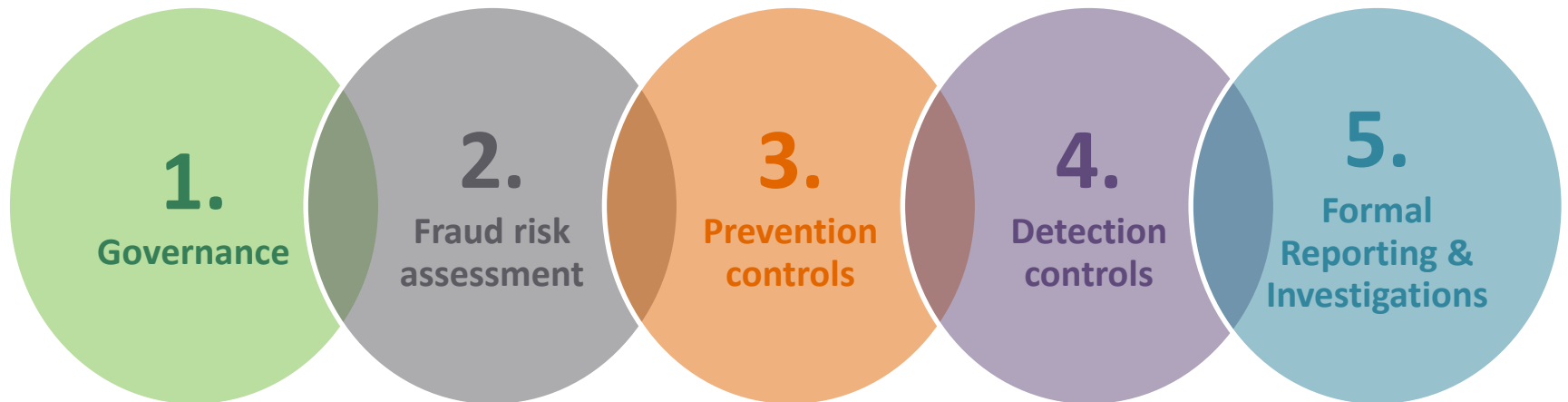
Irregularities & Defalcations

...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



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

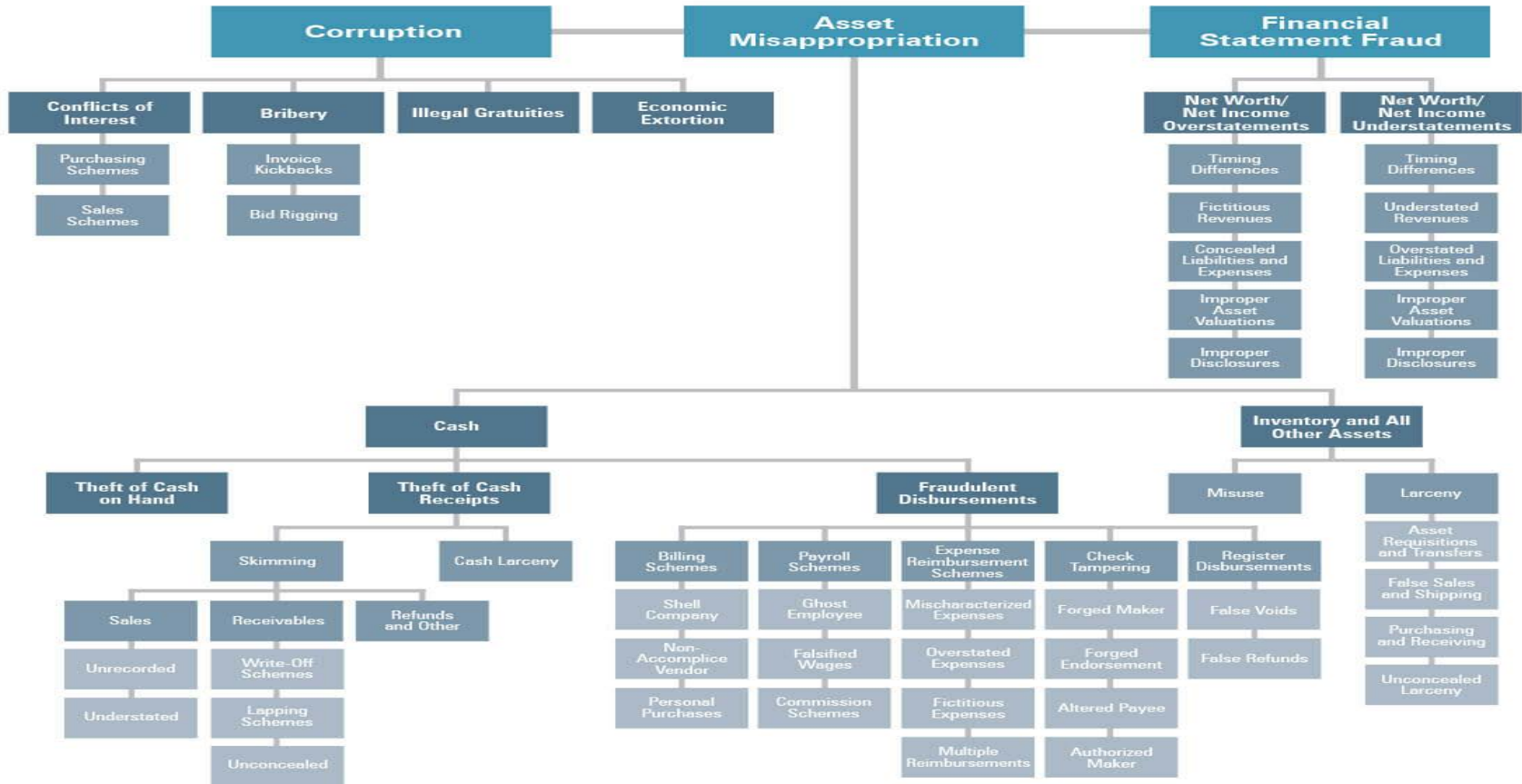
- Asset misappropriation schemes are frauds in which the perpetrator steals or misuses an organization's resources

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



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

Figure 44: Industry of Victim Organizations (Sorted by Median Loss)

Industry	Number of Cases	Percent of Cases	Median Loss
Mining	20	0.9%	\$500,000
Wholesale Trade	36	1.6%	\$450,000
Services (Professional)	60	2.7%	\$310,000
Agriculture, Forestry, Fishing, and Hunting	44	2.0%	\$300,000
Oil and Gas	74	3.4%	\$275,000
Construction	86	3.9%	\$259,000
Technology	74	3.4%	\$235,000
Communications and Publishing	16	0.7%	\$225,000
Real Estate	41	1.9%	\$200,000
Manufacturing	192	8.8%	\$194,000
Telecommunications	62	2.8%	\$194,000
Banking and Financial Services	368	16.8%	\$192,000
Transportation and Warehousing	68	3.1%	\$143,000
Government and Public Administration	229	10.5%	\$133,000
Health Care	144	6.6%	\$120,000
Insurance	85	3.9%	\$107,000
Utilities	40	1.8%	\$102,000
Other	153	7.0%	\$100,000
Services (Other)	70	3.2%	\$100,000
Retail	104	4.8%	\$85,000
Religious, Charitable, or Social Services	52	2.4%	\$82,000
Arts, Entertainment, and Recreation	37	1.7%	\$75,000
Education	132	6.0%	\$62,000

Wanted: Mining Theft Gang

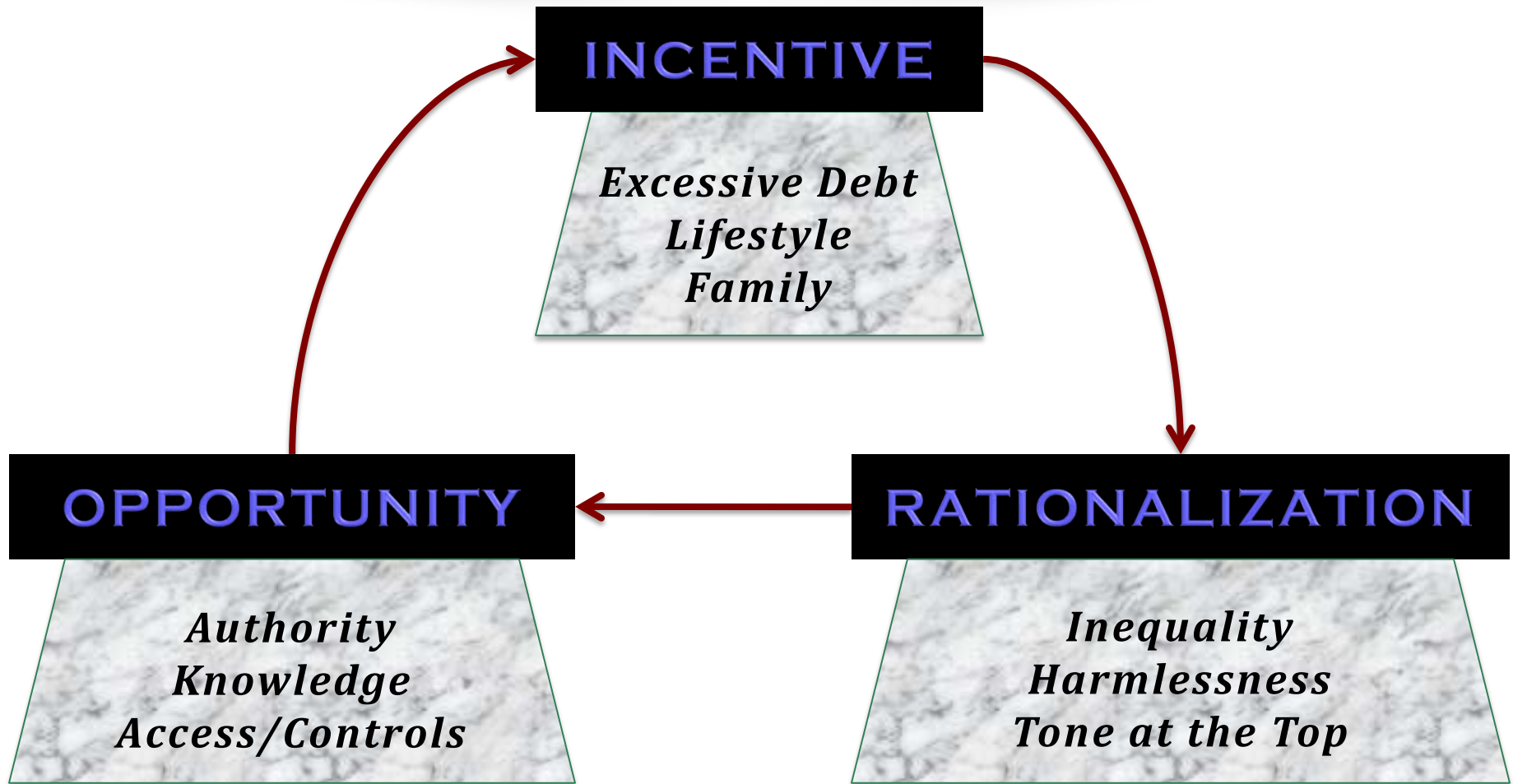


Battle of the Sexes...

Figure 81: Gender of Perpetrator—Median Loss



The Fraud Triangle



Overriding Factor:

The Perception Regarding Getting Caught

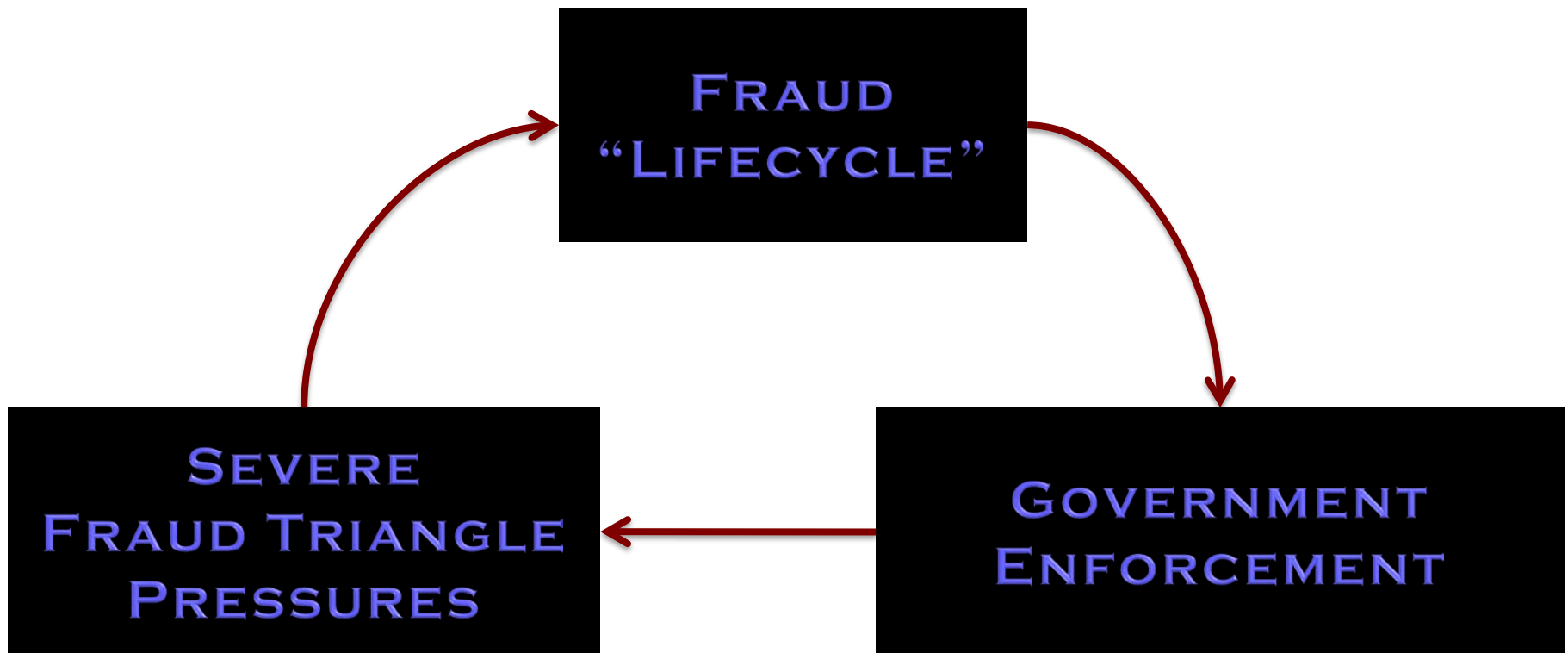


Current Landscape

The “Perfect” Storm



The “Bermuda” Triangle



Ethical Tone

2013 National Business Ethics Survey

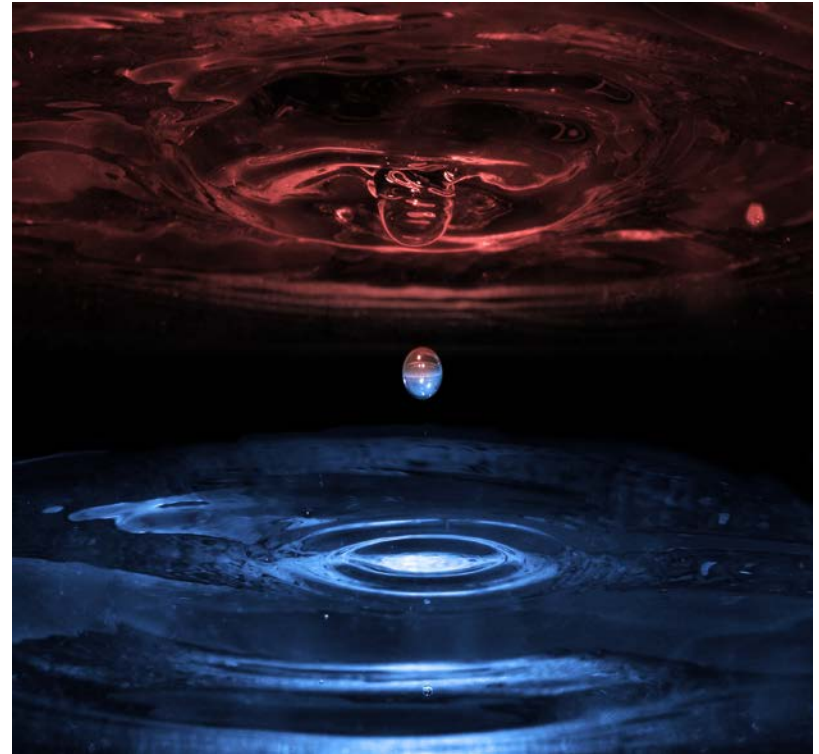
- ▶ 41% reported observing misconduct
- ▶ 63% reported the observed misconduct
- ▶ 60% of observed misconduct involved Management, of which 24% was Sr. Mgt.
- ▶ 1/3 of those who observed misconduct chose not to report it
- ▶ Retaliation rate at 21%
- ▶ Pressure to compromise standards at 9%
- ▶ 26% of 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?

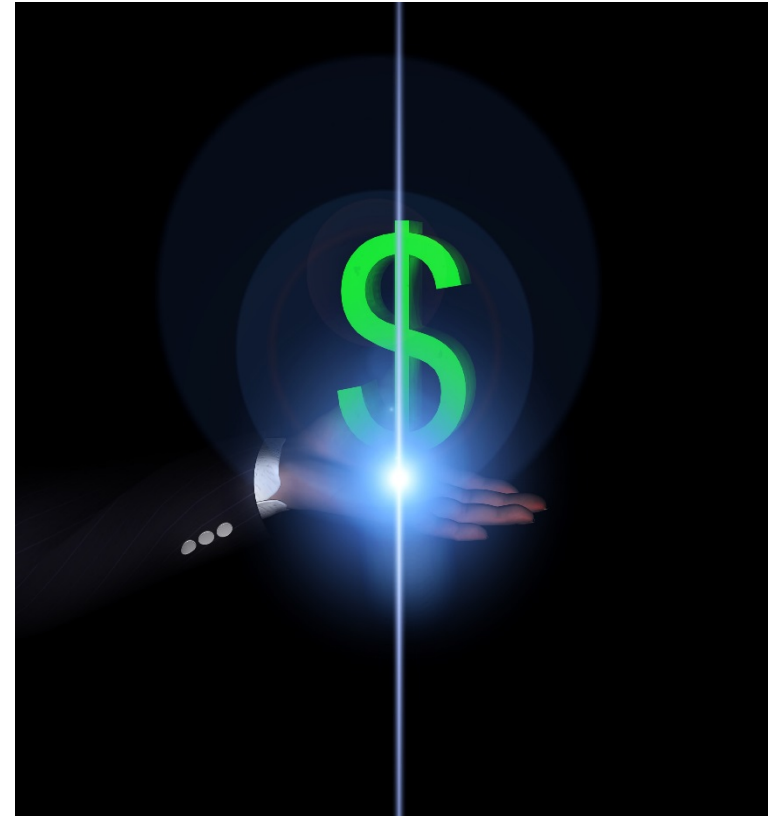
Potential Risks/Penalties

- ▶ 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 Skepticism² (“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

RATIONALIZATION

*Inequality
Harmlessness
Tone at the Top*

- ▶ 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

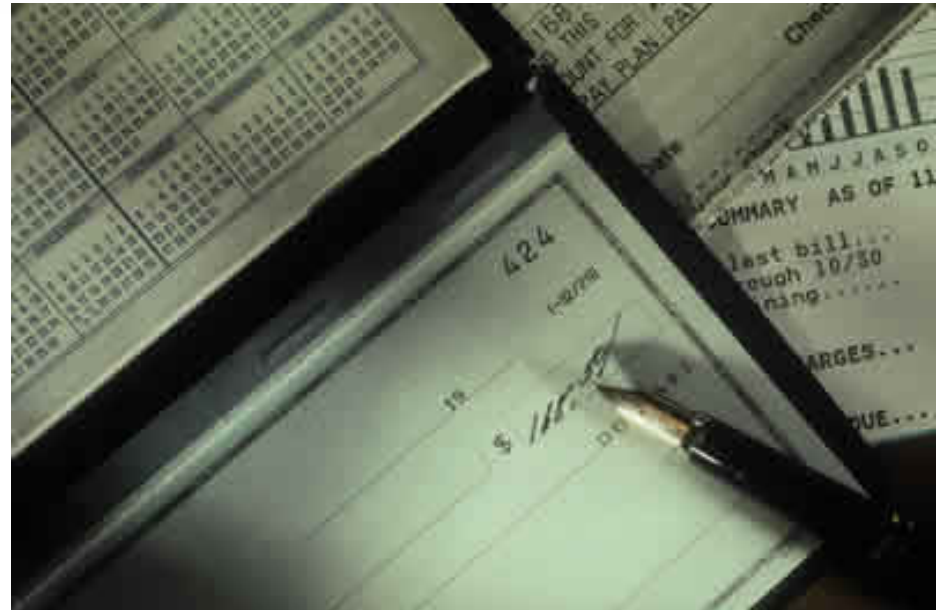


Fraud Detection

- ▶ 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



Recording an Interview

The Law:

*Virginia is a
single party consent state.*

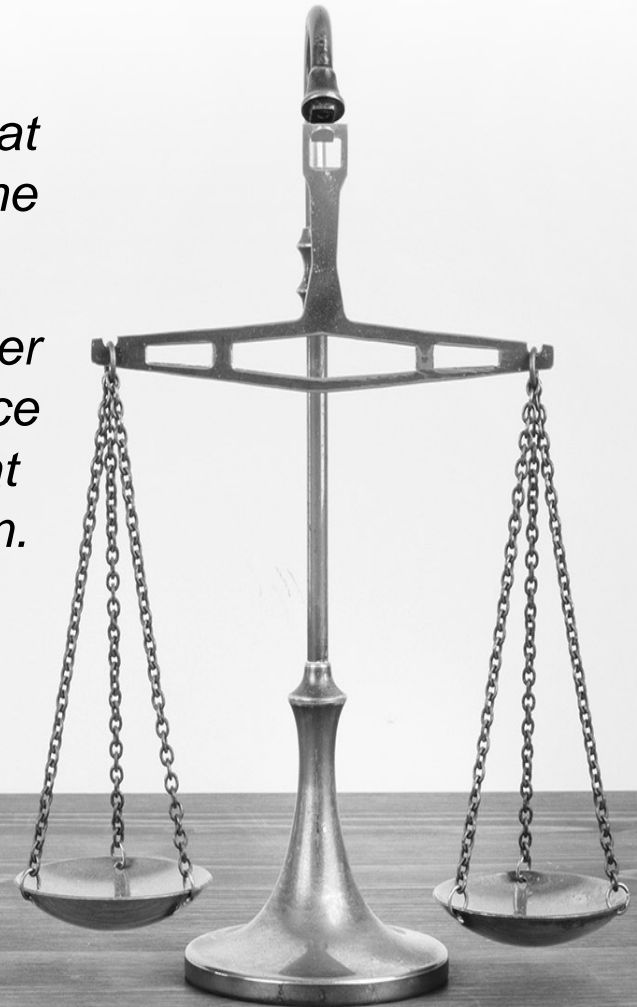


Recording an Interview

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 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.

IT'S A STATE & FEDERAL CRIME!



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

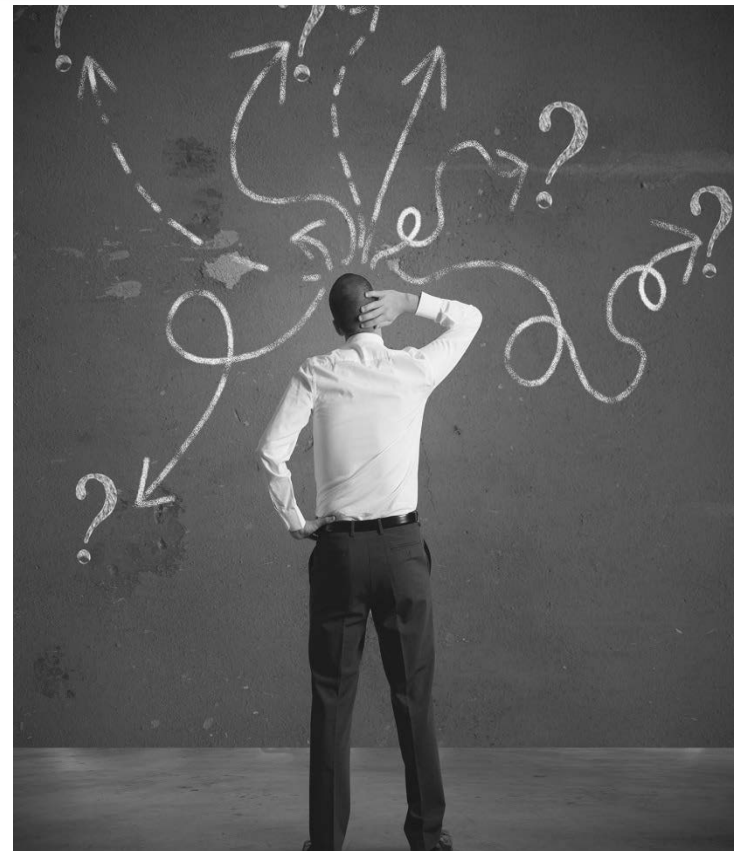
Things to Know About Witnesses

- ▶ Role & Responsibilities
- ▶ Command of Relevant Facts
- ▶ Likes/Dislikes
- ▶ Family & Friends
- ▶ Religious Beliefs
- ▶ Ethical Tone
- ▶ Hobbies
- ▶ Political Views



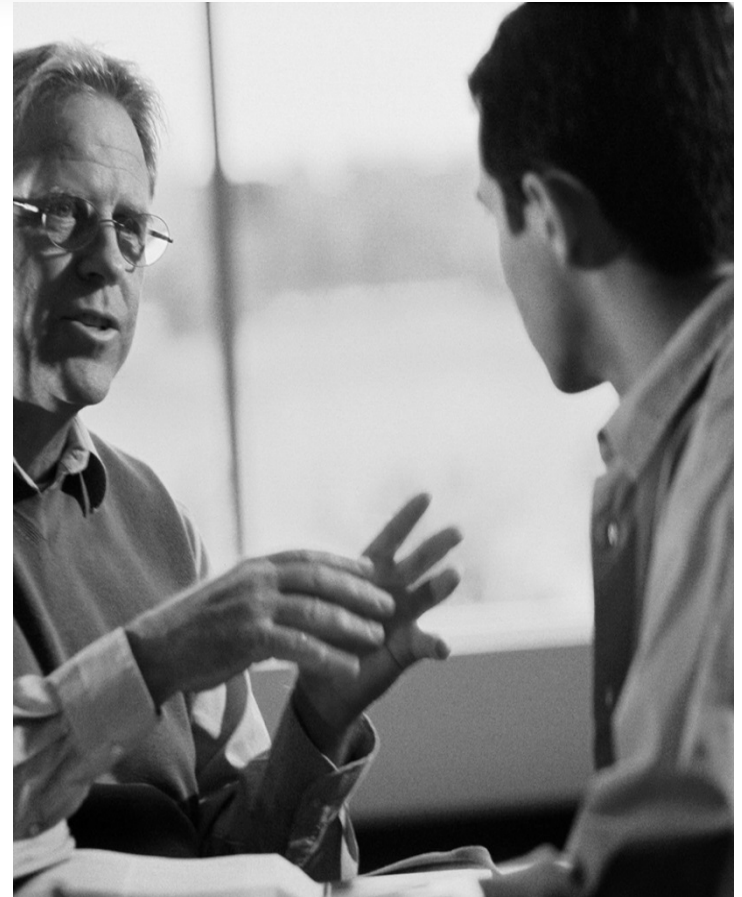
Things to Know About Witnesses

- ▶ 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



Curve Balls

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)?”

1

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?”

2



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



Anxiety ≠ Deception

- ▶ 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



EASY WAY

HARD WAY

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

Dana Cope - SEANC

- ▶ 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



Dana Cope - SEANC

▶ 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

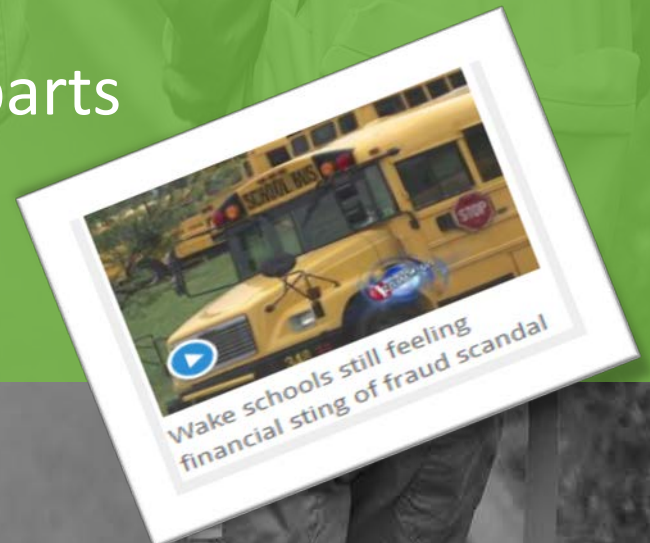
- ▶ Looking at large volumes of data quickly to determine patterns and outliers
- ▶ Data Analytics serves as a pointer, identifying individuals, accounts, transactions and other places to look to get behind the numbers (Bus #235)
- ▶ Running analyses such as:
 - Benford's Analysis
 - Linear Regression
 - Missing Data & Duplicate Data
 - Classification & Stratification
 - Identification of Error Conditions

Wake County School Board

Multi-million dollar scheme

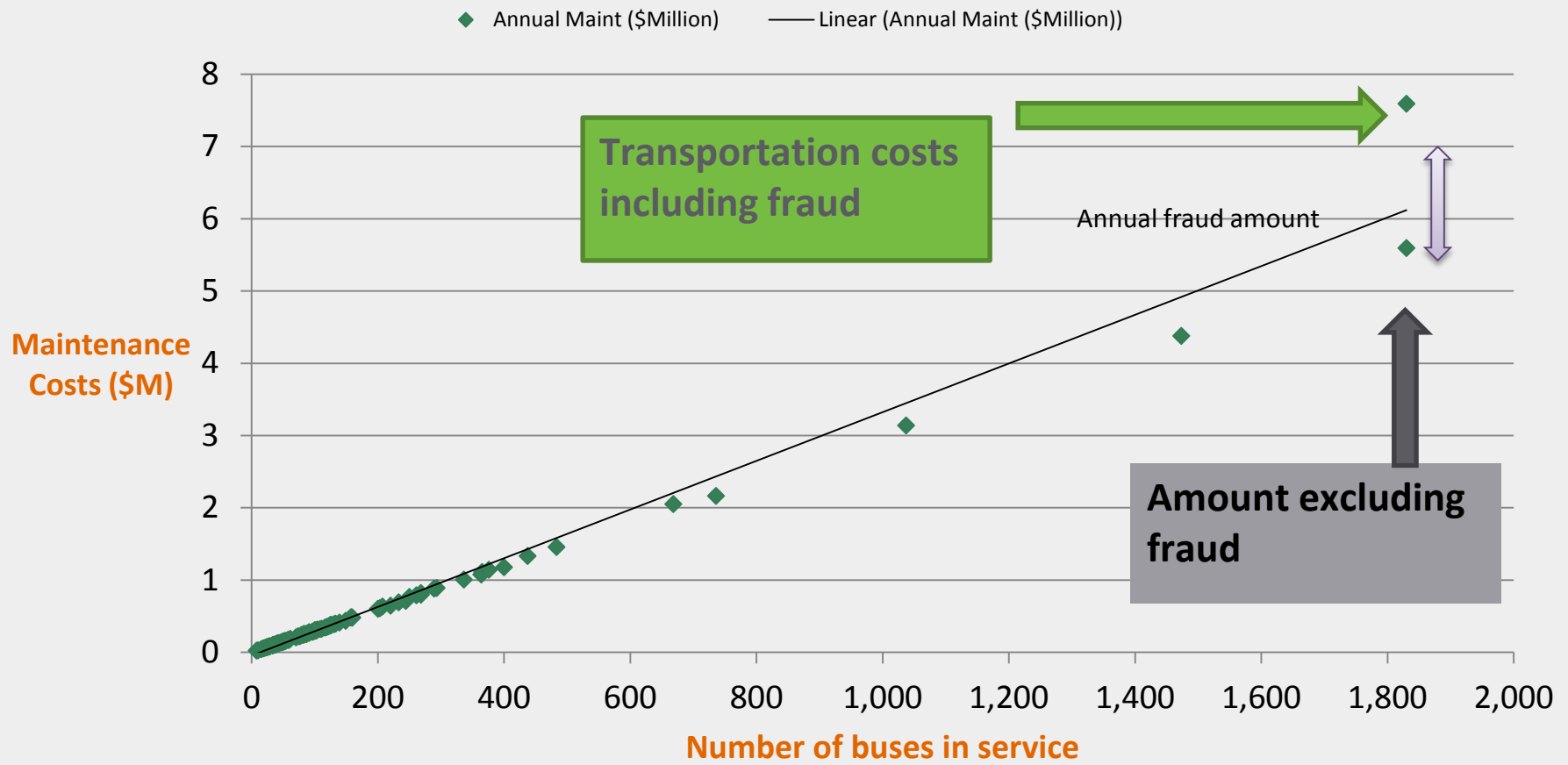
Kickbacks

Fake orders for auto parts



Linear Regression WCPSS

Annual School Bus Maintenance (\$Million)



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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