

### A Case of Client Fraud – Part 3

By Stephen Hollander, CFE, MIPI, CGA – December 2006

(Note: some edits to update the original content for current day standards were made in 2016)

This is the third and final article in our series on fraud and error. Let's review what occurred in the prior two articles. In the first article, your long-time client, Joe Wittering, came to you with a suspected fraud incident. The article discussed what to consider when asked by a client to investigate a suspected case of fraud.

In the second article, Joe, for the purpose of obtaining enhanced assurance, engaged you to perform an audit of his company rather than the usual review engagement. During the course of that audit, you performed a routine check of vendor invoices using Audit Command Language (ACL®). Your initial findings were that:

- One vendor, Speedy Electronics, submitted 12 invoices during the year, totaling approximately \$18,000, excluding taxes, with only two gaps in the invoice-number sequence;
- These invoices, which had been approved by the office manager, were for on-site maintenance and repair work on photocopiers, computers and peripherals, video projectors, and so on;
- The vendor does not appear in the phone directory; and
- A call to the phone number printed on the invoices reached a voice mail system.

The article ends with you presenting these initial findings to Joe, together with your observation that these findings might be indicative of some form of procurement fraud.

#### **Additional Case Facts**

*Joe has now authorized you to extend the scope of your investigation for the purpose of determining whether a fraud was, in fact, being perpetrated. The findings of your subsequent investigation are:*

- *Most of the electronic equipment that is owned by Joe's company, and that is of the type serviced by Speedy Electronics, was purchased within the last three years and is still under warranty;*
- *Enquiries to the equipment vendors indicate that Speedy Electronics is not authorized to perform warranty service on their products;*
- *Review of the records of Joe Wittering's company shows that no expenses were incurred for maintenance of electronic equipment, other than the amounts paid to Speedy Electronics; and that, in prior years, expenses for such services had been minimal. [Author's note: Why didn't someone in the accounting department pick up on the sudden jump in equipment maintenance expenses?];*
- *The GST registration number printed on the Speedy Electronics invoices is unknown to the Canada Revenue Agency;*
- *Speedy Electronics is not registered as a business entity with the provincial government, either for corporate or tax purposes;*
- *Municipal records indicate that no business license has been issued to Speedy Electronics, either at the address shown on the invoices or at any other address;*
- *The visitors' register at Joe's business premises, for the dates of the invoiced services, showed no entries for anyone from Speedy Electronics;*

- *The service address for the telephone number printed on the invoices is the residence of a Denise Sabotaggi;*
- *Background checks indicate that Ms. Sabotaggi works as a waitress at a restaurant two blocks away from Joe Wittering's business premises;*
- *Background checks further indicate that Ms. Sabotaggi works part-time, and that her annual earned income is approximately \$20,000;*
- *The cheques issued in payment of Speedy Electronics' invoices were negotiated at a branch of the Miners' and Merchants' Credit Union located a block away from Joe Wittering's business premises. They were endorsed with a rubber stamp. Eleven of the cheques had been deposited to account number 3984872, and one of them had been cashed. The cashed cheque was endorsed "D. Sabotaggi."*
- *Employee records for the office manager, Fred Cheatham, indicate that:*
  - *Mr. Cheatham separated from his wife approximately one year ago;*
  - *His current address is not the same as Ms. Sabotaggi's; and*
  - *Court papers have been served on the company ordering it to produce information regarding Cheatham's pay and benefits in connection with a matrimonial action filed by Cheatham's wife.*
- *Information obtained from the superintendent of the building where Ms. Sabotaggi lives is that:*
  - *Ms. Sabotaggi rents her apartment, paying \$1,200 per month, including parking and GST;*
  - *She has lived in the building for approximately one year; and*
  - *She frequently has a male visitor. When shown a photo array (including Fred Cheatham's employee photo), the superintendent identified Cheatham as this visitor.*
- *Cheatham's cellular phone and PDA are his own, and not the property of the company.*
- *A scan of Cheatham's workplace phone logs and e-mails disclosed two phone calls were made from his desk to the restaurant at which Ms. Sabotaggi works during the period under investigation.*

### **Decide Whether to Pursue the Investigation**

So far, all of the steps in your investigative process have been carried out without making either Fred Cheatham or Denise Sabotaggi aware of the fact that an investigation was being conducted. Although there are a few more such steps that you could take (such as surveillance of Cheatham and/or Sabotaggi), you are now more or less at the point where, if the investigation is to be pursued, overt action will be required. Overt action would involve such steps as:

- A search of Cheatham's desk, locker, and similar areas where evidence may be found;
- Confronting and interviewing Cheatham for the purpose of extracting a confession; and
- Confiscation of Cheatham's laptop computer (owned by the company) for forensic analysis.

Needless to say, no such action should be taken without first consulting competent litigation counsel (readers may remember that advising the client to engage competent litigation counsel was one of the steps recommended in the first part of this series). This will help to prevent the occurrence of a situation in which evidence gathered by the investigators is inadmissible in court, or worse, a situation in which

the company may itself become vulnerable to legal action by the alleged perpetrator of a fraud (as also discussed in the first part of this series).

### **Considerations Before Taking Further Action**

Some steps to take before beginning overt action include:

Work with your client to firm up the objectives of the investigation. At the beginning of this investigation, before any hard evidence was available, the objectives could be formulated only in fairly general terms. It should now be possible for the client to articulate specific objectives that will, to some measure, govern the overt actions that will henceforth be taken. Possible objectives include:

- Quantifying damages;
- Dismissing or suspending Cheatham, or negotiating his resignation of employment;
- Taking of other disciplinary action;
- Identifying recoverable assets of Cheatham and Sabotaggi;
- Negotiating financial recovery from Cheatham (possible), Sabotaggi (unlikely) and other parties (such as fidelity insurers);
- Assessing business implications of investigative results;
- Requesting law-enforcement authorities to file criminal charges against Cheatham and/or Sabotaggi;
- Providing litigation support to counsel in criminal and civil proceedings;
- Conducting audits of other business units for vulnerability to similar misconduct; and
- Developing controls to deter recurrence \*

Consider your own expertise, and your ability to perform the tasks required in the overt-action phase. Once again, you have a legal and ethical obligation to know what you're doing. Unless you have had special training, you are likely not familiar with matters such as:

- Securing and documenting evidence for presentation in court, and ensuring and documenting continuity of custody; and
- Conducting forensic interviews of an uncooperative subject.

Accordingly, you may find that, at this point, it will be in the client's best interest, and in yours, to turn the file over to a firm of professional investigators, if one has not already been involved in the covert phase of the investigation.

Review internal control systems to determine whether the fraud occurred as a consequence of:

- Inadequate control systems in place;
- Circumvention of control systems; or
- Control systems not operating as intended.

As a consequence of your findings, you will want to develop a plan for improving the control systems to prevent recurrences of the suspected fraud.

Initiate investigative steps to detect similar schemes.

- Conduct a comprehensive review of expenditures incurred in areas under Cheatham's signing authority.
- Note that, if one manager exploited a control weakness for the purpose of perpetrating a fraud, this same weakness may have been discovered and exploited by other managers as well.
- Conduct a comparative survey of expenditures incurred for services in other
- responsibility centres. This would involve year-to-year comparisons of expenditures within each centre, as well as comparisons between centres.
- Perform other tests, as indicated, to determine whether there are signs that fraudulent-invoice schemes may have been carried on elsewhere in the organization. \*\*

If advised by counsel, assist the company in preparing formal notification to its fidelity insurers (if any), and begin preparation of statement of proof of loss.

The date of discovery of loss is the trigger for a number of terms and conditions in this type of policy. In Canada, the weight of authority appears to be that discovery, for commercial crime insurance purposes, occurs at "that time when the insured gains sufficient factual knowledge, not mere suspicion, which would justify a reasonable man in charging another with dishonesty."

Commercial crime insurance policies typically require losses to be reported to the insurer (statement of loss) immediately upon discovery. Within a specified period of time thereafter, the insured is required to produce a "proof of loss," setting out the full particulars of the claim.

Because the question of when a loss is considered to be "discovered" may be pivotal, competent counsel should be consulted early in the investigative process to ensure that the loss, once it is discovered (as opposed to merely suspected), is reported as required by the statutory conditions in the company's insuring agreement.

Prepare initial estimates of quantum of loss. These estimates should be broken out into the following categories:

- Direct losses  
This would be the total of the amounts embezzled.
- Secondary losses  
This would include consequential losses, such as lost interest.
- Investigation costs  
All persons involved in the investigation, both internally and externally, should maintain time sheets and expense logs.
- Legal and other professional fees  
All fees incurred in pursuing remedies against alleged perpetrators should be documented, since these might be recoverable from fidelity insurers.

This categorization is important if litigation is contemplated, since these categories will correspond to the heads of damage in your client's statement of claim. Also, if there is a fidelity insurer in the picture, the classification of losses will make a difference in the application of amounts recovered.

**ILLUSTRATION:**

A cashier embezzles \$80,000. The costs of the investigation are \$24,000. Opportunity costs are estimated at \$5,000. In addition, since the fraud was accomplished by lapping accounts receivable, there is a loss of customer goodwill estimated at \$20,000. The limit on the fidelity insurance policy is \$100,000 per incident, with a \$5,000 deductible. The perpetrator currently has about \$40,000 in recoverable assets.

Fidelity insurance policies typically do not cover investigation costs or secondary losses. If, however, the client recovers \$40,000 from the perpetrator, the client should be able to credit this amount, first to investigation costs (\$24,000), and then to secondary losses (\$5,000), leaving \$11,000 to be applied to primary loss. The insurance claim would then be for \$64,000 (\$80,000 embezzled less \$11,000 recovered and applied, less \$5,000 deductible). If the client had not accounted for the losses separately, the insurance company might be obliged to pay only \$35,000 (\$80,000 embezzled less \$40,000 recovered, less \$5,000 deductible), with no chance of recovering secondary losses or investigation costs.

Consider how the results of any fraud discovered will impact on the company's financial reporting for the period(s) in question.

This may involve restatement of figures for periods prior to the one under investigation.

A number of considerations may come into play with regard to materiality. Particularly if the victim company is not closely held, it is arguable that all discovered fraud should be considered material, regardless of dollar amount. The opinion of counsel should be sought in any given case.

### **Summarization of Fraud Article Series**

In the three articles in this series, we have discussed:

- Initial considerations when a client has raised suspicions regarding possible fraud within his or her organization;
- Courses of action to take when you discover red flags of fraud during the conduct of an assurance or other engagement; and
- Your involvement in the investigation of a suspected fraud, and support that you can provide to the recovery process.

These three brief articles have allowed for only relatively cursory coverage of these topics. Readers who would like to canvass these matters in depth may want to consider taking appropriate courses offered by the Economic Crime Studies area of BCIT's Centre for Forensic and Security Technology Studies.

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~~The two previous articles in this series can be found in previous issues of Technical Toolbox:~~

~~A Case of Client Fraud – Part 1 (February 2005 Technical Toolbox)~~

~~A Case of Client Fraud – Part 2 (October 2005 Technical Toolbox)~~

\*Adapted from Roman L. Weil, Michael J. Wagner, and Peter B. Frank, *Litigation Services Handbook: The Role of the Financial Expert*, 3d ed. New York, Wiley, 2001.

\*\*A canvass of the possible tests for fraudulent-invoicing schemes is beyond the scope of this paper. Readers who are interested may wish to consider enrolling in the forensic accounting courses offered at BCIT.

#### **DISCLAIMER**

The information in this article is not legal advice. The relevant law and practice can be expected to vary widely from one jurisdiction to another, and from time to time within any jurisdiction. Also, circumstances alter cases. Accordingly, you should not rely solely on this material if you are considering taking any action, or refraining from taking any action, that may affect your rights or those of others. To inform yourself of the possible legal consequences of any contemplated acts or omissions, you should consult legal counsel, who will be fully informed of the circumstances of your particular case and who will be under professional obligation to act in their clients' (that is, your) interest.