

Alba Advisors, LLC

Fraud and the Forensic Matrix
South Carolina School Boards Insurance Trust
North Myrtle Beach, SC
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Fraud

- It's one of those “generally accepted” things. Like GAAP.
- It's one of those “PC” things.
- It's one of those “vigilante justice” things.

???



Defining difficult topics...

“I shall not attempt to define the kinds of material I understand to be (pornographic)... but I know it when I see it.”

Potter Stewart
US Supreme Court Justice
1964

“Personal doctrine of fairness.”



How big is Fraud?

- **ACFE - USA Fraud \$1 trillion annually, 5% of all revenues. (*2018 Report to the Nations*)**
- **Fraud hits >85% of businesses each year. (*2017/18 Kroll Global Fraud and Risk Report*)**
- **CAIF - Insurance Fraud costs each American household \$1,000 a year.**



Why isn't Fraud prosecuted?

From a law enforcement perspective:

- Lack of resources.
- Priorities.
- Lawyers.



Why isn't Fraud prosecuted?

From a business perspective, based on circumstance and interpretation Fraud might be:

- Tolerated.
- Condoned.
- Required.



Why isn't Fraud prosecuted?

From a personal or moral perspective:

- Sympathy.
- Adverse publicity.
- Restitution.



How is Fraud found?

- More than 53% of Fraud is found by accident.
- 4% is found by external audit.
- #1 anti-fraud measure (listed by 80% of companies) is external audit.

Association of Certified Fraud Examiners
2018 Report on Occupational Fraud & Abuse

Why don't external audits find Fraud?

Three things are usually required to find Fraud:

- There has to be Fraud.
- You have to look for it.
- You have to stay until you find it.

Say what?



There has to be Fraud

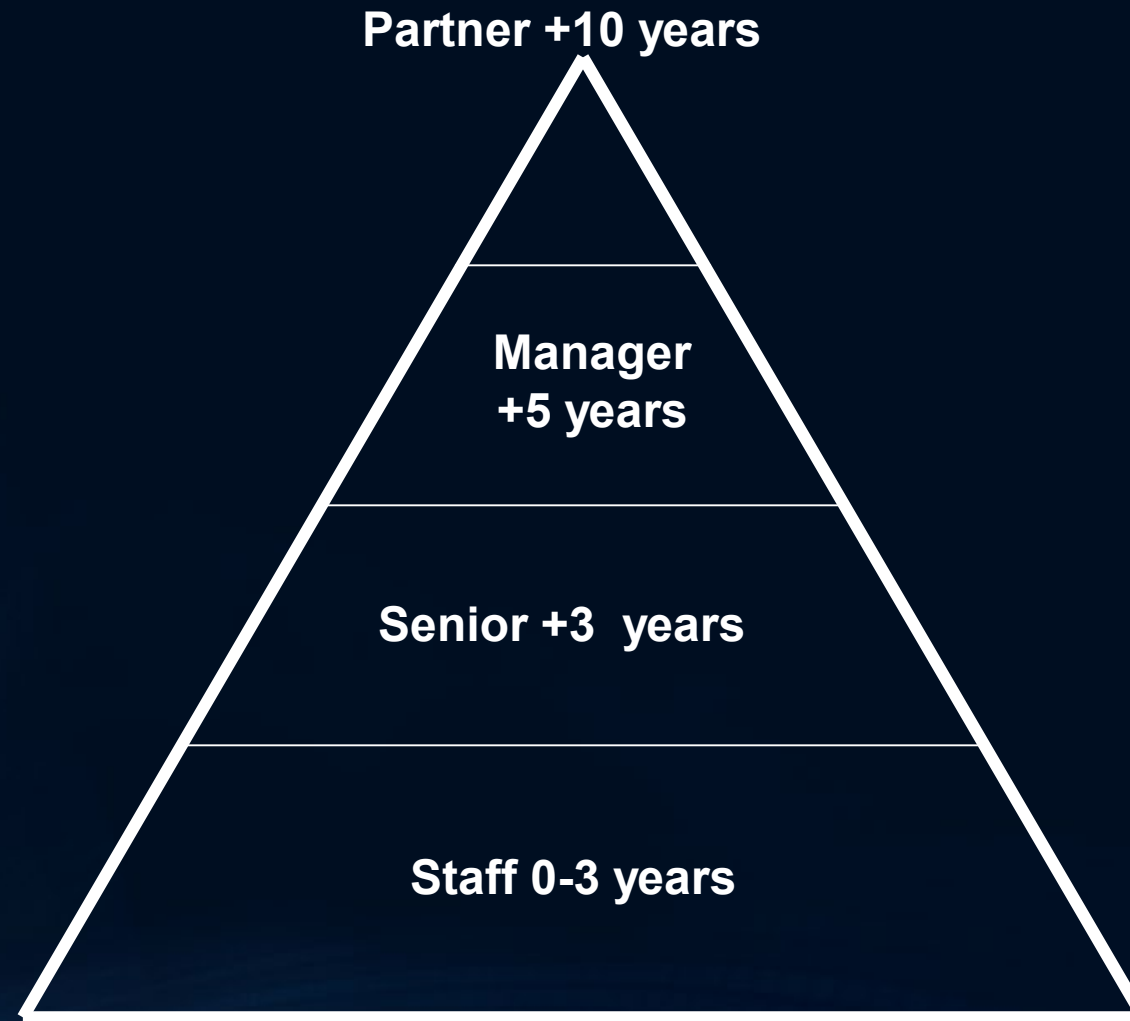
- Overwhelming % legitimate transactions.
- Judgment call.
- Not material.



You have to look for it

- Audits are painful.
- Require a spirit of cooperation.
- Youth, inexperience and ego.

The structure of large accounting firms





Stay until you find it

- Audits are expensive.
- Incentive to be timely and efficient.
- Disincentive to cause trouble.



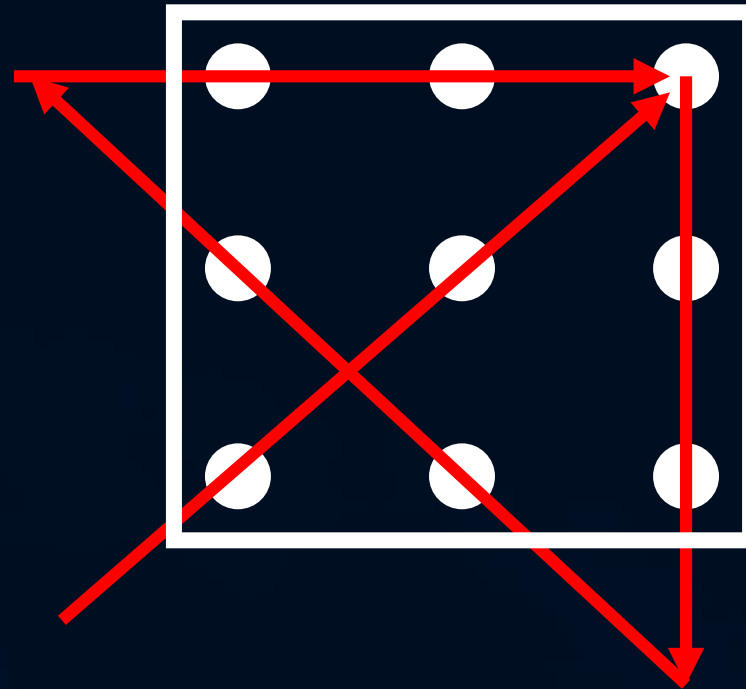
Addressing the challenges of finding Fraud

- Finding Fraud is easier if it's always there.
- Don't be too smart.

Price Waterhouse?



Out-of-the-Box Thinking (and other clichés)





A different perspective...

- Reading between the lines.
- Gut instinct.
- Exercising mental agility.



Inferential Thinking

Inferential thinking is the reasoning involved in drawing conclusions based on evidence and prior knowledge rather than observation.

Uncommon use of common sense!



Inferential Thinking in Practice

$$\begin{array}{ccc} A & = & B \\ & ? & \\ B & = & C \end{array}$$



Looking for “IT”

- Not always obvious where “IT” is.
- Don’t always know what “IT” is.

No preconceived notions!

 If a computer gets wet...



.... all is lost.



Which balance sheet do you prefer?

	<u>Version # 1</u>	<u>Version # 2</u>
Cash	<u>\$1,000,000</u>	
A/R		<u>\$1,000,000</u>
R/E	<u>\$1,000,000</u>	<u>\$1,000,000</u>

 **Fraud is like a magic trick...**

Incredibly baffling.



Until you know the secret.



Addressing the challenges of finding Fraud

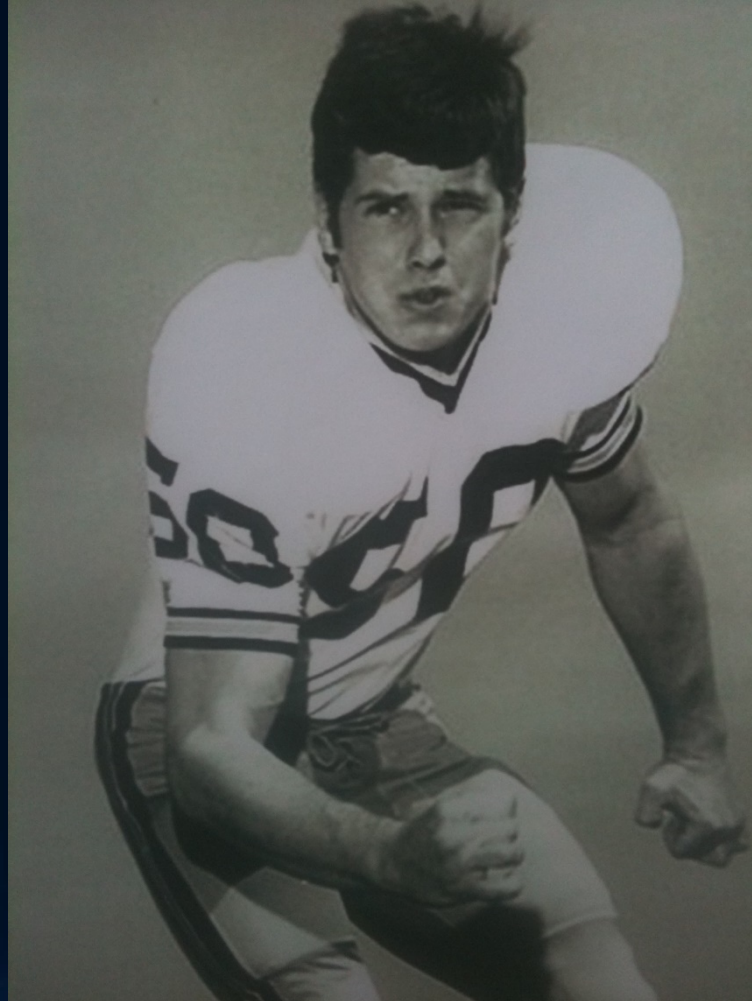
- Finding Fraud is easier if it's always there.
- Don't be too smart.
- Finding the story behind the numbers.



Numbers

The language of business.

A future accountant?







The Analytical Game Plan

- Objective process to analyze information.
- Subjective process to adapt to the current situation.



The Basic Playbook

The Mechanical Process of Analysis





Accumulate

- Establish universe of available information.
- Bank records, financial statements, tax returns.
- Bankruptcy?
- Google.
- People.
- Other ancillary information.



Select

- What are we trying to prove or find?
- Recurring, large or unusual items.
- Things that don't fit.
- Focus on things that are relevant to the circumstances.

What is relevant in the circumstance?

Audit Opinion

To the Board of Directors and Shareholders of XYZ Company, Inc.:

We have audited the accompanying balance sheet of XYZ Company, Inc. as of December 31, 19XX and the related statements of income, retained earnings and cash flows for the year then ended.

We conducted our audit in accordance with generally accepted auditing standards. Those standards overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company, Inc. as of December 31, 19XX and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

PriceWaterhouse & Co.
PriceWaterhouse & Co.

January 9, 19XX



What does this # mean to you?

\$10,000,000

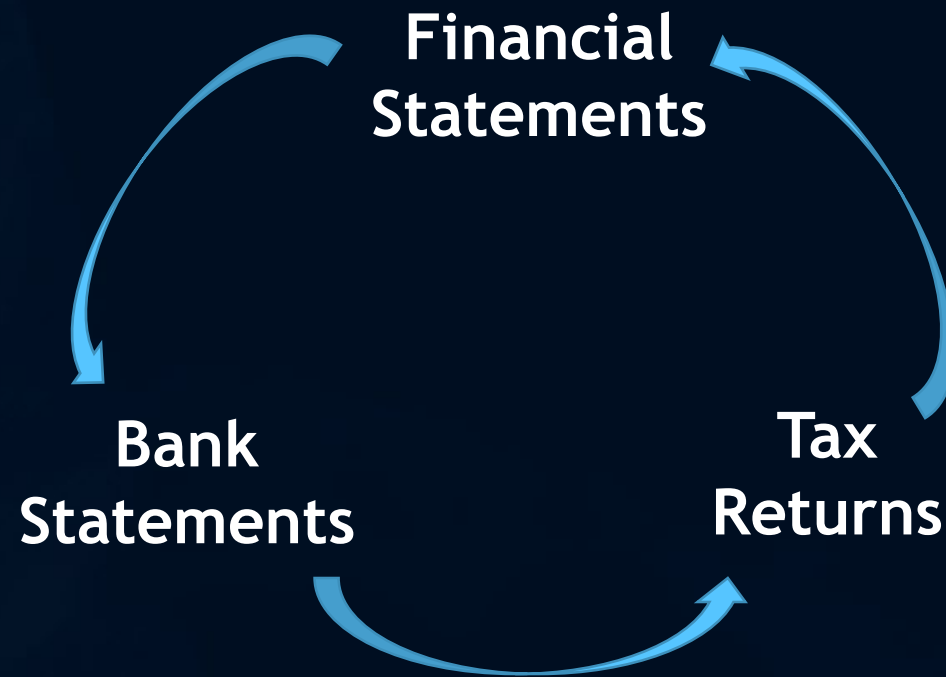
Compared to what?



Relate

- What does normal look like?
- Get a feel for trends or patterns.
- Identify things that don't fit.
- Look for contradictions.

Logical Relationships



STOP

FUN COMPANY, INC.

Comparative Income Statement

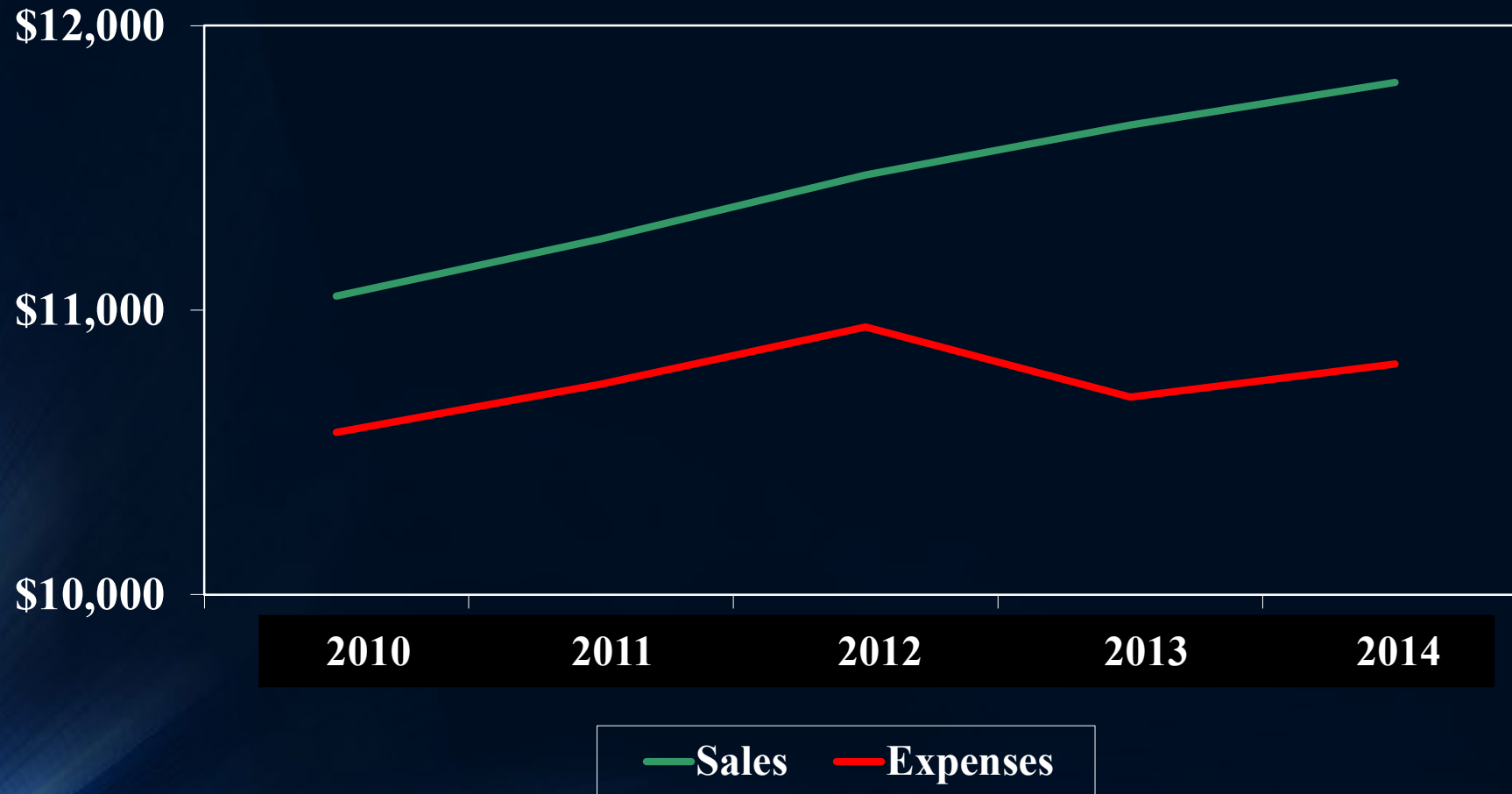
2010-2014
(000's)

for the period ending December 31	2010	2011	2012	2013	2014
Net Sales	\$ 11,050	\$ 11,250	\$ 11,475	\$ 11,650	\$ 11,800
Cost of Sales/Operating Expenses:					
Cost of Goods Sold	\$ 9,005	\$ 9,175	\$ 9,350	\$ 9,105	\$ 9,220
Depreciation	275	270	280	280	275
Selling Expenses	700	695	705	695	710
Administrative Expenses	590	600	605	615	605
Total COS and Oper Exp	\$ 10,570	\$ 10,740	\$ 10,940	\$ 10,695	\$ 10,810
Operating Profit	\$ 480	\$ 510	\$ 535	\$ 955	\$ 990

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Analyzing Relationships

**Ask questions.
Continually.**



Evaluate

- What is the analysis saying?
- Is it logical?
- Does it demonstrate the issue?
- Is more work required?

Evaluation - Is it logical?



How does it feel in your gut?



Finding the story behind the numbers

Adapting the analytical process

- Capital - Money.
- Capacity - Range of performance.
- Conditions - Environmental issues.
- Character - Integrity.



Capital - Money

- Rule #1 - Follow the money.
- Rule #2 - See rule #1.
- Determine the “value proposition.”
- How much?
- Where is it going?
- Who has access?



Capacity - Range of Performance

- Determine a reasonable range.
- Is something too good to be true?
- Is something too big or too small?



Conditions - Environmental Issues

- Internal or external factors with extreme influence.
- Circumstances that cause people to act the way they do.
- Incentives. Who wins? Who loses?
- Out of the ordinary occurrences.



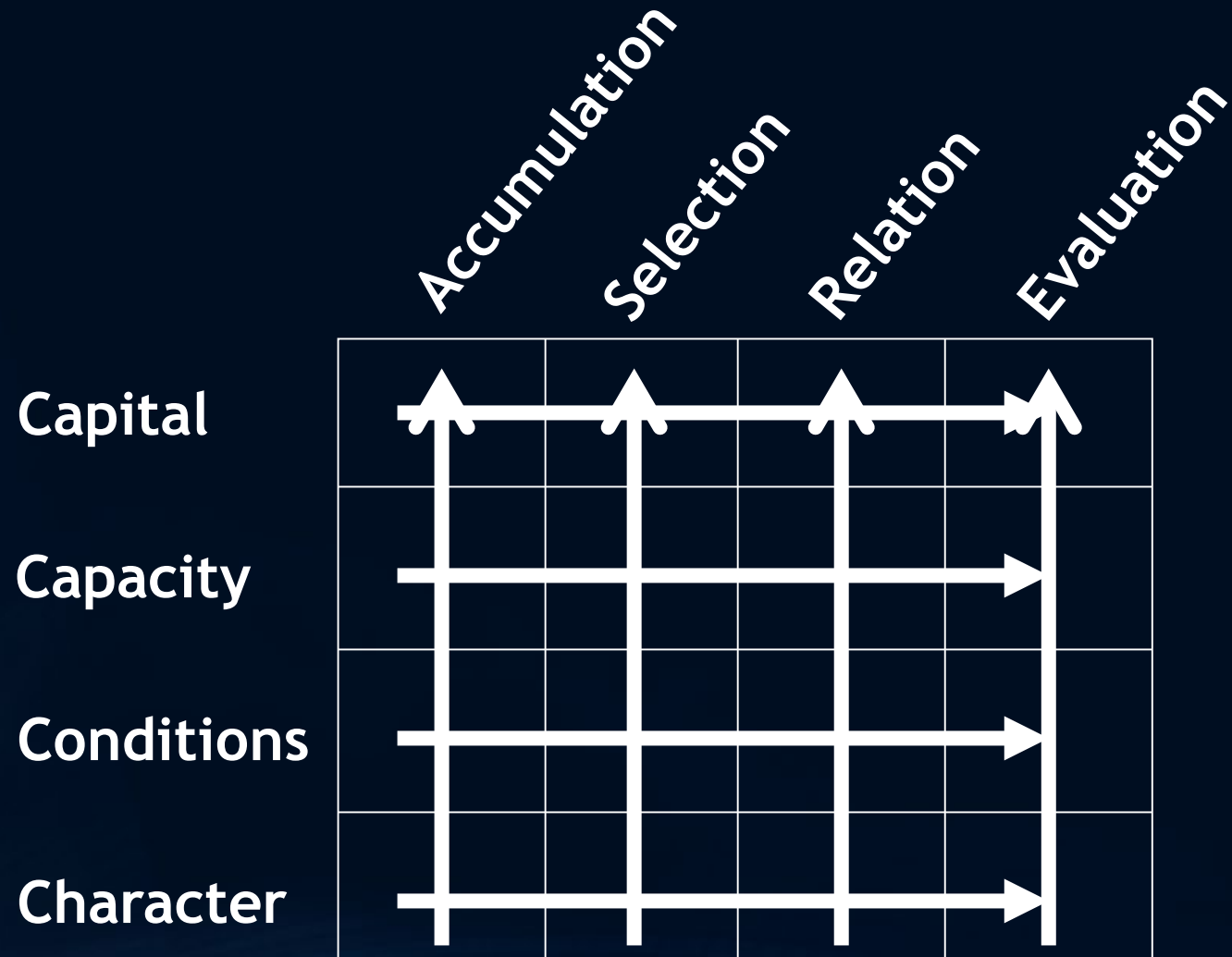
Character - Integrity

- Reputation.
- Do you like them? Do they like you?
- Subtle clues.
- Sometimes, you just know.

Jim & Tammy Fay Bakker



The Forensic Matrix





The Future of Forensic Accounting?

Divorce



Can widespread Fraud be stopped?

Politicians



Can widespread Fraud be stopped?

- Post Civil War.
- The 20's - Ponzi, stock market crash.
- The 80's - Ivan Bosky and Michael Milken.
- The 90's - the DOT-Comers.
- The early 2000's - World Com and Enron.



Today's Old News

**Bernie Madoff
with \$50 Billion**



Today's Old News

Government Auditor: “We may never know where all the bailout money went.”



Today's Old News

LIBOR Scandal

"This dwarfs by orders of magnitude any financial scams in the history of markets."

Andrew Lo, Professor of Finance, MIT

"The entire global financial system is riddled with systemic fraud."

The Guardian, July 14, 2012



Today

**Prominent Florida eye doctor
convicted of Medicare fraud**

**Collected \$105 million between 2008 and 2013.
Frequently billed for tests and treatment of
prosthetic eyes.**

**Associated Press
April 28, 2017**



Today

Nursing home operator from Chicago jailed as feds allege \$1 billion scheme

**“...the largest single criminal health care fraud
case ever brought against individuals by the
Department of Justice.”**

**Chicago Tribune
Oct 4, 2016**



Today

Wells Fargo Fined \$185 Million for Fraudulently Opening Accounts

**New York Times
Sept 8, 2016**



Today

**Facebook connecting old friends and
new criminals.**

**Researchers uncover >70 Facebook groups
openly selling black-market cyberfraud services.**

**NBC News
April 5, 2019**



The “New Normal”?

“(Executives surveyed said) Fraud, cyber and security incidents are now the ‘new normal’ for companies across the world”

2017/18 Kroll Annual Global Fraud and Risk Report



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