

Lecture Notes on Forensic Accounting Investigations*

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1 Introduction

Fraud is a legal and not an accounting concept. For this reason, the accountants have traditionally chosen to treat it as a concept alien to them.

1.1 What is fraud?

There are four elements to any fraud:

- A false representation of a material nature (either misstatement or omission of a material fact)
- *Scienter*: Knowledge that the representation is false, or reckless disregard for truth
- *Reliance*: The person receiving the representation has reasonably and justifiably relied on it
- *Damages*: Such receiving party has sustained financial damages from all of the above

It is important to note that the under the securities laws, some of these conditions are relaxed.

1.2 Types of Fraud

- Misappropriation of assets (Retail Fraud)
- Financial Statement Fraud (Wholesale Fraud)

*These notes are based on the book *A Guide to Forensic Accounting Investigations* by Thomas W. Golden, Steven L. Skalak, and Mona M. Clayton. They are meant for the exclusive use of the students in the course Acc 551 at SUNY Albany

1.3 Gatekeepers

- Macro level
 - Standard setters
 - Market Regulators
 - Emerging Technologies
- Micro level
 - Board of directors
 - External Auditors
 - Analysts
 - Legal Profession

1.4 Fraud Deterrence Cycle

- Corporate Governance
- Transaction level control of processes (System of internal control)
- Audit of corporate governance and internal control
- Investigation/remediation of suspected alleged problems

1.5 Auditing History Timeline

- Pre-1929: GAAP determined primarily by common law
- 1929 stock market crash
- Securities Act 1933, Securities & Exchange Act 1934, and the establishment of the SEC
- Establishment of the Committee on Accounting Procedure (AICPA) 1939
- Accounting Principles Board (AICPA) 1959
- Trueblood Commission and subsequent establishment of the Financial Accounting Standards Board 1973
- Foreign Corrupt Practices Act 1977
- Sarbanes-Oxley Act 2002, Public Companies Accounting Oversight Board (PCAOB)

2 Auditor and the Forensic Accounting Investigator

The auditors' concerns include:

- Provide reasonable assurance that
- material misstatements do not exist and
- if they do exist, they are detected

Auditors generally concern themselves with deterrence only to the extent that lack of such deterrence can entail possibility of fraud. Auditors also are generally not concerned with investigations except in case of special engagements.

The Forensic Accounting Investigators' concerns, on the other hand, include:

- relatively narrow boundaries
- detailed development of factual information (from documentary as well as testimonial evidence)
- assessments of loss or damages based on the examination of the evidence
- recommendations to provide deterrence in the future

Forensic Accounting Investigator's findings and recommendations can be used in litigations as well as testimony before federal/state government and judicial agencies.

Both auditors and the forensic accounting investigators need to have:

- knowledge of the industry, the company and its business practices
- knowledge of GAAP in the jurisdiction
- skills in the interpretation of business documents and records
- independence and objectivity

Some observations:

- Generally, however, auditor/client relationships are not adversarial, but the relationship between the forensic accounting investigator and the client are adversarial
- Auditor is like a patrolman; a forensic accounting investigator is like a detective. Patrolman is always on patrol, a detective, however, is called on only when there is suspicion of fraud or fraud has already been detected

2.1 SPADE VFramework

- Skepticism
- Probing communication
- Analytics
- Documentation
- Evaluation

3 Psychology of the Fraudster

- An individual's propensity to commit crime is not related to personality. What is important are the situations and social bonds within organisations (Edwin Sutherland, 1939)
- Criminality is not confined to any specific class in society (Edwin Sutherland, 1939)
- Culture of competition promotes and justifies the pursuit of material self-interest, often at the expense of others and even in violation of law (James Coleman, 1987)
- Calculating (Predatory) criminals, Situation-dependent criminals, Power brokers

3.1 Calculating Criminals

- want to compete and assert themselves
- repeat offenders
- higher than average intelligence
- well educated
- begin life in crime at a later age than other criminals
- inclined to taking risks
- lack of feelings of anxiety or empathy
- "external locus of control" – lack of inner direction, self-confidence and self esteem
- motivated by their desire to fit in and to be accepted
- they define success by others' standards

3.2 Situation=dependent Criminals

- Ordinary people with no intent to harm others

3.3 Fraud Triangle

- Incentive/Pressure
- Opportunity
- Rationalisation

4 Financial Reporting and Capital Markets

4.1 Fraudulent Schemes

- attacked from within (rogue employee)
- attack from outside to obtain funds under false pretenses
- used an an unwitting participant to facilitate a fraudulent scheme perpetrated on others or for the benefit of others

4.2 Some Schemes

- Ponzi Scheme
- Bank frauds
- Pyramid Schemes
- "8-ball" model

5 Auditor Responsibilities and the Law

5.1 Common Law

- **Contract:** Negligence sufficient; privity needed. Malpractice.
- **Torts:** Gross negligence or Fraud. Third parties. Ultramares ruling establishes three things (Brady, Accounting Review, 1938):
 - Negligence is not sufficient for third parties to bring actions against accountants
 - Untrue certificate of fact is a sufficient basis for determining liability; express intent to deceive need not be shown (Gross negligence)

- Incorrect certificate of opinion is not a sufficient basis for determining liability unless the grounds for the certificate are so flimsy to suggest lack of good faith sufficient to raise inference of fraud

For the rest of this chapter see the handout on "Auditor Liability"

6 Independence, Objectivity, Skepticism

- Independence
 - Independence *in fact*
 - Independence *in appearance*
 - * Book-keeping services
 - * Financial systems design and implementation
 - * Appraisal and valuation services
 - * Actuarial services
 - * Internal audit outsourcing services
 - * Management functions
 - * Human resource services
 - * Broker/dealer, investment advisory, investment banking services
 - * Legal services and expert services unrelated to audit
 - * Any other services deemed impermissible by PCAOB
- Regulation of Forensic Accounting Services
 - Legal services and expert services unrelated to audit(Rule 2-01(c)(4)(x) of Reg-SX of SEC: No advocacy rule
 - Forensic services can be used to
 - * extend audit procedures
 - * "shadow" audit client's independent legal counsel and retained outside forensic accounting investigators
 - * perform combinations of the above two
 - Can investigate suspected illegal acts at the request of the audit committee in situations *not* involving litigation or regulatory proceedings
 - Forensic accounting investigative services to aid management or audit committee carrying out its corporate governance responsibilities
 - Forensic services already under way when government investigation commences so long as the auditor controls the work

- No services to client’s legal representative in connection with investigation by SEC’s Division of Enforcement, in litigation proceedings, or other government investigations
- Forensic accountants can not take direction from client’s counsel or aid such counsel in any way
- Integrity and Objectivity
- Professional skepticism

7 Forensic Investigations vs. Financial Audits

- Auditors *examine* the financial statements in accordance with GAAP and GAAS, while the Forensic Accounting Investigators deal with fraudulent financial reporting and misappropriation of assets
- The audit opinion is on the financial statements taken as a whole. The work of Forensic accountants, on the other hand, usually relates to heightened awareness of specific irregularities
- Auditors’ work serves public interest. Forensic accountants’ work, on the other hand, serves their interest of the parties that hire them.
- Auditor’s work stands on its own, but a Forensic accountant’s work supports the work of the legal counsel or the board.
- Auditors express an opinion, but forensic accountants also recommend changes
- Auditors are concerned with errors and irregularities; forensic accountants are concerned with distinction between errors of judgement & deliberate misrepresentations
- The relationship between the auditor and the client is one of openness and full candor; the relationship between the forensic accountant and the party investigated is usually adversarial
- Audit work usually does not disrupt work environment of the client; in case of forensic accounting investigations, the work can be disruptive
- Clients always have a full understanding of the scope and objectives of the audit. However, in case of forensic accounting investigations, the party investigated may not have such understanding of the work
- Audit work is usually coherent, coordinated, and efficient. Forensic accountant’s work can be messy with many blind alleys

- Auditors meet regularly on schedule with the audit committee and on an as-needed basis with the executive management; the forensic accountants have continual access to executive management and frequent but irregular contacts with the audit committee
- major differences in staffing between audits and forensic accounting investigations
- Auditors often use attribute sampling for tests of control and variable sampling for substantive tests (of transactions). Forensic accountants are more likely to use discovery sampling and dollar-unit sampling
- Audit work is not protected under attorney-client privilege. Most forensic accounting work is structured to be done in a privileged environment
- Auditors must work without indemnification protections. Forensic accounting work usually has both indemnification and hold-harmless protections
- Auditor determines the nature, scope, and extent of the audit. In case of forensic accounting investigations, they are determined by the client. It is because of this that the forensic accountant gets indemnification and liability protection from the client
- The auditor presumes the validity of the documents and information, but the forensic accountant does not
- At the end of the audit there is an opinion; at the end of a forensic accounting investigation there are findings and recommendations

8 Red Flags and Fraud Detection

- Points to keep in mind in forensic accounting investigations
 - Professional skepticism
 - Bear in mind the possibility of falsified documents
 - Be alert to potential red flags, outliers, indicators of irregularities
 - Request more documentation if necessary: Trust but verify
- SAS 99 steps to early identification, evaluation, and response to the risks of material misstatements due to fraud:
 - Discussions among audit team regarding fraud risk
 - Obtaining information relevant to identification of fraud risk
 - Identification of risk of material misstatements due to fraud

- Assessment of identified risks taking into account internal controls
- Responding to the results of the assessment
- Evaluating audit evidence
- **Fraud Risk Factors:**
 - Management characteristics
 - Industry characteristics
 - Operating characteristics and financial stability
 - Susceptibility of assets to misappropriation
 - Adequacy of controls
- **Fraud Risk Factors and Professional Skepticism**
 - ”Thoroughly probe the issues, acquire additional evidence as necessary, and consult with other team members and, if appropriate, experts in the firm, rather than rationalise or dismiss information or other conditions that indicate a material misstatement due to farus may have occurred” **SAS 99**
 - Keeping an open mind, developing a heightened awareness, making a critical assessment of evidence, and seeking corroboration
- **Analytic Procedures**
 - Types of Analytic Procedures:
 - Preliminary Analytic Procedures** To determine the nature, timing, and extent of audit procedures
 - Substantive Analytic Procedures** To analyse the evidence obtained during the substantive testing of account balances
 - Final Analytic Procedures** Analysis of all evidence to support the audit conclusions
 - **Analytic Techniques**
 - * Horizontal analysis (current period vs. prior periods)
 - * Vertical analysis (common size analysis)
 - * Comparison of details of totals with similar detail for prior years
 - * Ratio analysis and other financial relationships including comparisons with similar firms

8.1 Some Frauds

– Revenue Fraud:

Fictitious sales revenue Sale of non-existent goods, sales to non-existent customers

Inflated sales Shipping of goods not ordered, treating consignments as sales, ignoring shipping terms that deal with ownership transfer

Over-billing customers Billing customers above agreed upon price

Deceptive sales practices

Defective parts Sale of defective parts that will be returned subsequently

Reimbursement for services not provided or not covered under government programs

Underwriting fraud schemes Usually, rigging the research reports on companies to gain advantage in underwriting, eg., bullish reports by Smith Barney on AT&T to benefit in the underwriting of AT&T spinoff of its wireless subsidiary

Billing, collection, or recording of vendor allowances and support Earnings management by setting unrealistic sales targets, reporting underachievement to vendors, marking down prices, and claiming allowances from vendors to shore up revenues, eg., Saks case

Deceptive sales practices, including slamming Slamming is the practice of switching the long distance telephone service from one carrier to another without the customer's consent

Skimming abstracting cash by delaying the recording of transactions, or not recording it at all

Product diversion Diversion of products to markets/uses not intended; usually in export sales, promotional offers, excess merchandise destruction, charitable donations (www.investigation.com)

Inflated claims Often by Pharmacy Benefit Managers (PBM)

Round-trip Trading An action that attempts to inflate transaction volumes through the continuous and frequent purchase and sale of a particular security, commodity or asset. (<http://www.investopedia.com/terms/r/round-triptrades.asp>)

Ricochet trading, sometimes known as Megawatt laundering Arbitrage trading involving buying at a low price from one market and selling the same product in another market at a much higher price. Enron indulged in it by buying power in California below their ceiling prices to sell it at almost five times the price elsewhere (http://www.larry-adams.com/200507_article.htm)

Inter-positioning Specialist in a stock *inter-positioning himself* by trading separately with the buy order and the sell order rather than executing the

orders, thereby obtaining higher profits. Recently in July 2008, the US Court of Appeals (Second Circuit) set aside a guilty verdict under securities law, holding "that absent proof that the defendant actually conveyed a misleading impression to customers, finding securities fraud liability would invite litigation beyond the immediate sphere of securities litigation. United States v. Finnerty, 2008 U.S. App. LEXIS 15296 (2d Cir. July 18, 2008)

Trading ahead A specialist trading for his own account before trading for the public accounts. Recently in July 2008, the US Court of Appeals (Second Circuit) set aside a guilty verdict under securities law, holding "that absent proof that the defendant actually conveyed a misleading impression to customers, finding securities fraud liability would invite litigation beyond the immediate sphere of securities litigation. United States v. Finnerty, 2008 U.S. App. LEXIS 15296 (2d Cir. July 18, 2008)

Sim card cloning Selling of Cloned SIM cards of mobile phones

– **Asset Fraud:**

Theft of competitor secrets

Theft of 3rd party intellectual property

Manufacturing & Materials Fraud

Fraud involving revenue-sharing arrangements, reinsurance arrangements or transactions

– **Violations of law:**

Anti-trust violations/market rigging/price fixing

Violation of environmental laws and regulations

Violations of occupational health and safety (OSHA) laws

Late Trading and Market Timing Violations facilitating unlawful late trading and deceptive market timing of mutual funds by its customers and customers of its introducing brokers. (<http://www.sec.gov/news/press/2006-38.htm>)

9 Internal Audit: Second Line of Defense

9.1 COSO Internal Control Framework Components

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication

- Monitoring

9.2 The Internal Audit Migration Model

Value	Funct Focus	Skill Sets	Assurance
Value protec	Transactions	Fin/Compliance Auditing	Int Control Assurance
	Internal Control Processes	Operational Auditing]	
	Business Process Improvement	Product & Process Knowledge	
Value Enhance	Risk Mgt	Enterprise-wide Risk Mgt	Risk Mgt Assurance

9.3 Handoff to Forensic Accounting Investigators & Legal Counsel

- **When to handoff**
 - On any sign of fraud
 - On suspicion of fraud
 - After gathering preliminary evidence
- **Ractors determining when to handoff**
 - Management policy
 - Skillset and experience of the internal audit team
 - Legal counsel's policy
 - the emerging set of best practices
- **Reasons for recent failures to detect fraud**
 - Deference to senior management on complex financial transactions
 - Limitations on the information and scope provided for internal auditors
- **Thornburgh Report Recommendations:**
 - Maintain increased skepticism
 - Be wary of scope limitations on internal auditors
 - Support of the senior management, board and audit committee for the internal audit function
 - Evaluate financial statement fraud risk, specially in situations involving complex finances and organisation
 - Strive for adequate internal audit planning
 - Strive for real and active contact with the audit committee

- **Recommendations of the Special Investigative Committee of WorldCom Board of Directors (Beresford Committee):**
 - Strive for open communications between employees and the internal auditors
 - Focus on substantive interactions between the internal audit personnel and the external auditors

10 Financial Statement Fraud

Overstatement of revenue is the predominant form of financial statement fraud.

10.1 Revenue

- Accelerating shipments towards the end of the accounting period
- Keeping books open beyond the end of accounting period
- Treating consignments as sales
- Bill-and-hold transactions (auditors should question business purpose)
- Goods shipped on evaluation basis
- Sales where right of return exists
- Round-trip trades and swaps
- Related party transactions
- Overstating percentage of completion in long term contracts
- Understatement of returns, allowances, discounts, markdowns
- Fictitious sales
- alteration, falsification or backdating of sales/shipping documents
- channel Stuffing
- Partial shipments where the entire sale is recognised
- Early delivery of products
- Shipment of goods not ordered
- Recognition of revenue where contract calls for multiple deliverables (set up, installation, testing, etc.

- Misallocation of value in multiple-element revenue arrangements (sale + service ion software)
- up-front fees (subscriptions, maintenance contracts)

10.2 Criteria for recognition of revenue

- Persuasive evidence of an arrangement
- Delivery occurred or services rendered, title transferred, risk of ownership transferred
- Price to buyer is fixed or determinable
- Reasonable assurance that the receivable is collectible

10.3 Detection Techniques

- Audit of transactions close to the end of the accounting period (cutoff tests)
- Audit of large transactions
- Audit of transactions with new customers and related parties
- Audit of unprocessed returns
- Audit of returns at the beginning of the subsequent accounting period
- receivables confirmation (sometimes called circularisation)
- Manual sales entries in the books
- Audit of long term contracts (percentage of completion)
- Analytical tests of sales data

10.4 Inventory Misstatements

- Inflation of inventory on hand
- Inflation of inventory value by postponing writedowns
- Capitalisation of inventory

10.5 Investments Misstatements

- Fictitious investments
- Misclassification of equity investments (trading or available for sale)
- Misclassification of debt securities held as investments (trading, held to maturity, or available for sale); trading and available for sale investments in debt securities are stated at fair market value; unrealised gains/losses on trading securities are shown as part of income for the period, such gains/losses on those held as available for sale are shown as other comprehensive income. Held to maturity investments in debt securities are shown at amortised value.
- Failure to write down declines in the value of investments that are not expected to recover

10.6 Miscellaneous

- Fictitious assets
- Treatment of a part of the purchase price in mergers as in-process research & development so that they can be expensed by the acquiring company
- Capitalisation of start up costs
- Improper capitalisation of interest costs
- understatement of liabilities and expenses
- Off-balance sheet transactions
- Cookie-jar reserves and earnings management
- Improper and inadequate disclosures
- Check tampering
- Expense reimbursement padding
- Payroll schemes (phantom employees and falsification of time cards)

11 Financial Statement Fraud: Other Schemes & Misappropriations

See Section 10.

12 When and Why to call in Forensic Accounting Investigators

Auditors' skill sets: Prevention, Deterrence, Detection

Forensic Accounting Investigators' skill sets: Investigation, Resolution, Litigation

Auditors

- are NOT Forensic Accounting Investigators
- are NOT Authenticators
- have limited exposure to fraud
- are not guarantors (watchdogs, not bloodhounds)
- Audits are unpredictable

12.1 Potential Trigger Points for Fraud

- Anonymous allegations of fraud
- Whistleblowers
- Resignation of high-ranking officials under suspicions of fraud or illegal activities
- Client target of legal or regulatory investigation
- Client receives subpoena from law enforcement or regulatory agency
- Auditor believes (s)he has been provided misleading information or client has withheld (or altered) information or documents
- Discovery of the client suffering embezzlement, howsoever small
- Indications of fictitious vendors
- Indications of improper accounting
- Other indications of fraud

12.2 Securities Exchange Act (1934) sec 10A

The following is from a *PWC* Newsletter:

The US Private Securities Litigation Reform Act of 1995 added Section 10A to the Securities Exchange Act of 1934. Section 10A added the auditors' responsibilities in reporting fraud to the securities laws by requiring that:

- If an auditor becomes aware of a possible illegal act, the auditor must determine whether it is likely that an illegal act has occurred.
- If it is likely that an illegal act has occurred, the auditor must, as soon as practicable, inform the appropriate level of management and assure that the audit committee is adequately informed of such illegal act, unless the illegal act is clearly inconsequential.
- If the illegal act has a material effect on the financial statements, the auditor must, as soon as practicable, formally notify the board of directors if senior management has not taken, and the board has not caused management to take, appropriate remedial action. Section 10A also contains a "safe harbor" protecting an auditor from liability in a private action as a result of his or her reporting an illegal act to the SEC.

The amendment to Section 10A provides that notices by the board of directors and reports submitted by the auditor will be nonpublic and exempt from disclosure under the Freedom of Information Act (FOIA) to the same extent as the SEC's investigative records. An additional note has been added to the rule to notify registrants and auditors that they may apply for confidential treatment under additional FOIA exemptions in accordance with the SEC's normal procedures. Civil penalties for failure to report illegal acts for both the accounting firm and audit committee

The amendment impacts the Section 10A reporting requirement in two ways. First, the term "registered public accounting firm" replaces the term "independent public accountant," which has the effect of holding the entire accounting firm liable, rather than the individual accountant, for a failure to investigate and report illegal acts as required under Section 10A. Second, an audit committee is now directly responsible for the appointment, compensation, and oversight of the accounting firm for its audit-related work.

Failures to investigate and report illegal acts as required under Section 10A can have serious implications for the accounting firm:

- disgorgement of audit fees
- not accepting audit engagements of new Commission registrant clients for a year or longer

- permanent or temporary bar from appearing or practicing before the Commission as an accountant
- implementing new procedures for its audit system
- civil penalties up to millions of Dollars (\$ 10,000,000 in the case of SEC vs KMPG regarding Xerox, 2003)

13 Teaming with Forensic Accounting Investigators

Managements usually take any allegations of fraud personally, since if it did happen it would be under their watch. This leads to their defensive behaviour. It is important for the forensic accounting investigator to defuse the anxiety surrounding such behaviour.

It is important for the forensic accounting investigators to be a part of any investigation of fraud or those designed to meet section 10A requirements.

There is always pressure exerted on the forensic accounting investigators because of management anxieties or deadlines such as earnings announcements or regulatory filings. Even under such circumstances it is important that the forensic accounting investigator ensure that the investigation is balanced, objective, on time, on target.

13.1 Cooperation with Internal Auditors

The factors to consider in determine the way in which to cooperate with the internal auditors include:

- The focus of the internal audit function: compliance auditing or consulting
- Compliance with the standards of the Institute of Internal Auditors on risk assessment
- Forensic accounting competency of internal auditors
- Consensus in the organisation on the role of internal auditors
- If internal auditor recommendations are implemented
- The skills composition of the internal auditors
- Training of the internal auditors

The internal auditors bring a wealth of skills in auditing, know the organisation well, and have project management skills very useful in forensic work.

13.2 Cooperation with External Auditors

The factors to consider in determine the way in which to cooperate with the internal auditors include:

- The relationship between the external auditor and the client
- The knowledge of the client's business processes and control systems that the external auditors have
- Possibility of forensic services by external auditing firm under Regulation SX Rule 2-01 (c)(4)(x):

Expert services unrelated to the audit. Providing an expert opinion or other expert service for an audit client, or an audit client's legal representative, for the purpose of advocating an audit client's interests in litigation or in a regulatory or administrative proceeding or investigation. **In any litigation or regulatory or administrative proceeding or investigation, an accountant's independence shall not be deemed to be impaired if the accountant provides factual accounts, including in testimony, of work performed or explains the positions taken or conclusions reached during the performance of any service provided by the accountant for the audit client.**

- The external auditors must monitor the process and results of any investigations in order to fulfill their responsibilities under Section 10A of the 1934 Act.
- It is important for the forensic accounting investigators and the external auditors to cooperate since otherwise the audit field work may extend unduly beyond the investigative report date.
- It is important for the external auditors to know if investigation information has been withheld from them by way of asserting privilege

The factors to keep in mind in the investigations:

- Who is involved
 - Perpetrators
 - Co-conspirators
- Who ordered it? The supervisor?

- What is the financial impact of the fraud?
- When was the fraud perpetrated? What period?
- How did it happen? The chronology and the modus operandi
- How and by whom it was detected?
- What can be done to detect it earlier

The forensic accounting investigators take directions from whoever hired them. If they are ordered to stop the investigations, it is appropriate to air their concerns, and in extreme cases, resign in protest.

Forensic accounting investigations are usually led by the audit committee. While the scope of the investigation is set by the audit committee, the determination of the sufficiency of the investigative procedures is at the discretion of the forensic accounting investigator.

14 Potential Missteps: Considerations when Fraud is Suspected

Direct confrontation of the suspect in an admissions-seeking interview before a complete investigation and in the absence of a witness is not advisable because (s)he can subsequently

- resign, making recovery difficult or costly
- destroy evidence, and that might weaken the case
- deny/recant any statements (s)he may make

It is important to consider that

- Adequate evidence is on hand at the time of the admission-seeking interview
- The forensic accounting investigator does not assume facts, but questions the suspect exhaustively
- Amounts that do not meet the threshold levels for materiality for detection risk by external as well as internal auditors may nevertheless be important
- Even though a misstatement uncovered may be immaterial, SAS 99 requires the auditor to consider the possibility that, if the task was performed by a higher level management employee, the misstatement may be an indication of a pervasive problem leading to a questioning of the integrity of the management
- importance of whistle-blowing and their investigation (roots in false claims act)

15 Investigative Techniques

Steps in the Investigative Process are:

- Relationship Review and Conflict Check
 - List of parties
 - Research on the client (Dunn-Bradstreet, public records, etc.) to determine the viability of the entity
 - Understanding of the potential risks
 - Conflicts of interest to maintain legal compliance
- Understanding with client regarding fees
- Engagement letter (client, scope, fee, indemnification, legal matters)
- Predication: Something that can be assumed as the basis for the investigation
 - Responding to regulatory action
 - Difficulties in financial reporting/Information/Disclosure
 - Issues involving customers or vendors
 - Matters relating to FCPA
 - Lifestyle red flags
 - Anonymous tips
 - Conflicts of interest
- Gaining an understanding to aid planning & gathering resources to execute the investigation
 - Time frame
 - Nature of concerns/allegations
 - Site, location, contacts, skills required for the investigation
 - Targets
 - Deadlines, reporting requirements, audit committee meetings, etc.
 - Information on other investigations that may have been conducted
 - Other entities that may be involved
 - Background checks on employees done?
 - How long has the problem existed?
 - Culture of corruption?

- Is the entity in compliance with laws/regulations?
- Profitability, industry trends.
- Growth/decline of the entity in relation to others in the industry.
- Recent acquisitions
- Does the company have a fraud policy?
- Gathering and securing information
 - What information is available for review before the field visit?
 - What information is available during the field visit?
 - What assets/evidence needs to be secured?
 - Where are those assets/information to be secured?
 - What public records should be searched?
 - Who should be interviewed?
 - How to handle the media?
 - Contact authorities?
- Coordination

15.1 Things to look for

- Unusual transactions
 - Time
 - Frequency
 - Places
 - Amount
 - Parties/personalities
- Internal control: Ineffective, unenforced or over-ridden by higher authorities
- Low employee morale, motivation, job satisfaction levels
- corporate cultural issues that tends to support unethical behaviour

16 Anonymous Communications

Federal statutes relating to whistle-blowing and anonymous reporting include:

- False Claims Act
- Sarbanes-Oxley Act

– **section 301(4)**

(4) Complaints.--Each audit committee shall establish procedures for--

(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and

(B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

– **section 806**

SEC. 806. PROTECTION FOR EMPLOYEES OF PUBLICLY TRADED COMPANIES WHO PROVIDE EVIDENCE OF FRAUD.

(a) In General.--Chapter 73 of title 18, United States Code, is amended by inserting after section 1514 the following:

Sec. 1514A. Civil action to protect against retaliation in fraud cases

(a) Whistleblower Protection for Employees of Publicly Traded Companies.--No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 781), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o(d)), or any officer, employee, contractor, subcontractor, or agent of such company, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee--

(1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders,

when the information or assistance is provided to or the investigation is conducted by--

(A) a Federal regulatory or law enforcement agency;

(B) any Member of Congress or any committee of Congress; or

(C) a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct); or

(2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.

(b) Enforcement Action.--

(1) In general.--A person who alleges discharge or other discrimination by any person in violation of subsection (a) may seek relief under subsection (c), by--

(A) filing a complaint with the Secretary of Labor; or

(B) if the Secretary has not issued a final decision within 180 days of the filing of the complaint and there is no showing that such delay is due to the bad faith of the claimant, bringing an action at law or equity for de novo review in the appropriate district court of the United States, which shall have jurisdiction over such an action without regard to the amount in controversy.

(2) Procedure.--

(A) In general.--An action under paragraph (1)(A) shall be governed under the rules and procedures set forth in section 42121(b) of title 49, United States Code.

(B) Exception.--Notification made under section 42121(b)(1) of title 49, United States Code, shall be made to the person named in the complaint and to the employer.

(C) Burdens of proof.--An action brought under paragraph (1)(B) shall be governed by the legal burdens

of proof set forth in section 42121(b) of title 49, United States Code.

(D) <<NOTE: Deadline.>> Statute of limitations.--
An action under paragraph (1) shall be commenced not later than 90 days after the date on which the violation occurs.

(c) Remedies.--

(1) In general.--An employee prevailing in any action under subsection (b)(1) shall be entitled to all relief necessary to make the employee whole.

(2) Compensatory damages.--Relief for any action under paragraph (1) shall include--

(A) reinstatement with the same seniority status that the employee would have had, but for the discrimination;

(B) the amount of back pay, with interest; and

(C) compensation for any special damages sustained as a result of the discrimination, including litigation costs, expert witness fees, and reasonable attorney fees.

(d) Rights Retained by Employee.--Nothing in this section shall be deemed to diminish the rights, privileges, or remedies of any employee under any Federal or State law, or under any collective bargaining agreement.''.

16.1 Investigation of anonymous communications

The steps include:

- Obtaining an understanding of the anonymous communication
 - How it was conveyed?
 - When the entity received it?
 - Where was it sent from?
 - To whom was it sent?
 - What are the allegations?
 - What are the motivations for the communication?
- Initial understanding of the allegations

- Determine if the allegations need immediate remedial action
 - if there are employee or property safety issues
 - if there are liability issues arising out of the alleged activity
 - it is important to protect the identity of the whistleblower (if known)
 - important to make the client aware of the whistleblower safety issues
 - need for protection of assets, documents and data
- Development & implementation of investigation strategy and the Investigation team
- Decisions regarding disclosures
 - any disclosures required under law?
 - when to disclose?
- Prioritize allegations
- Interviewing employees
 - Facts gathered should be sufficient to test the veracity of allegations before interviews are conducted
 - If the identity of the anonymous communication source can be established, interviewing the person can provide important information
 - It is important to monitor the treatment of the individual to avoid allegations of harassment (or retaliation) and also to avoid loss of services if the person occupies a key role in the company
 - Interviews are important because they help identify individuals who may have information, identify any other individuals who may need to be interviewed, and identify the evidence that should be obtained and secured
- Follow-up tips can arrive very late in the investigation and needs to be taken into account

17 Background Investigations

- Use of internet
- Use of Commercial databases
 - Dialog
 - Lexis/nexis

- Datastar
- Dow Jones
- Public Records
 - * Credit header files
 - * Incorporation records and DBA filings
 - * SEC filings (company filings as well as significant stock ownership filings)
 - * US Tax Court and IRS
 - * Bankruptcy petitions
 - * UCC filings/financial reports
 - * Vital records
 - * Social security numbers (restricted)
 - * Education records
 - * Voter registration records
 - * Driving history
 - * Company credit and information reports
 - * Professional licensing boards
 - * Criminal history records
 - * Civil courts
 - * Divorce court records
 - * Civil judgments (encumbrances)
 - * Environmental regulation reports
 - * Property ownership records
 - * Auto, aircraft, watercraft records
 - * Bibliographies and directories
- Commercial database providers
 - ChoicePoint
 - AutoTrak
 - PACER
 - CourtLink
 - CourtExpress
- Unique internet sources
 - Message boards, chat rooms
 - Home pages

- Credit reports
- Medical records (restricted)
- International Investigations

18 The Art of the Interview

18.1 Planning for the Interview

- Timing
- Location (No distractions)
- The importance of consultations with the legal counsel on legal issues in interviewing
- Recording (State laws)
- Polygraph
- Participants (usually two)
- Interview one subject at a time
- Concurrent interviewing when necessary

18.2 Interview Types

- Information-seeking interviews
- Admission-seeking interview
 - Important to have confidence that the witness has committed the crime or has knowledge of the illegal act.
 - Even if you have sufficient evidence to prove it, it is always useful to get an admission. It can make a trial unnecessary.
 - **Some strategies:**
 - * Logical approach
 - * Do-the-right-thing approach
 - * Silent approach
 - * Rationalisation approach
 - * Asking questions to which you have the answers
 - * *(never works, and might be considered coercion or duress)*

18.3 The Interview Process

- Bonding (putting the witness at ease)
- Baseline (Getting a feeling for the subject's body language) so that in questioning, changes in the subject's body language can be detected
- Admissions and defenses (develop the line of questioning to facilitate the remaining steps)
- Confrontation (First lay the groundwork and then bring the accusation)
- Admission

19 Building a Case: Gathering & Documenting Evidence

Always assume that the case is going to end up in a criminal court. Preservation and admissibility of evidence is paramount.

- Is the information privileged?
- Who is responsible for preserving the evidence?
- How long should the evidence be preserved?
- Confidentiality of evidence collected pursuant to grand jury proceedings is to be maintained. It is a crime to disclose such materials to unauthorized persons
- Plan the gathering of information
 - Client document retention policies and compliance
 - Storage locations
 - Imaging technologies used
 - Existence and storage of employee files
 - Files in employee homes
 - File retention policies at various locations
 - Organisation chart and reporting hierarchy
 - On and off site storage media
 - Backup procedures
 - Retention of records on former employees
 - System changes

- Records on outsourced corporate functions
- Chain of custody: Documentation of where, when, and how it was found; documentation of its changing hands
- Preservation of privacy of personal data (DPA of EU, HIPAA,...)

20 Supporting a Criminal Prosecution

- Deterrent effect of appropriate response
- Federal Sentencing Guidelines II
 - Tone at the top
 - Conduct and Internal Control
 - Leadership accountability
 - Resources and authority
 - History of violations
 - Conduct training
 - Evaluate programs
 - Whistle-blower system
 - Encourage employees
 - Risk assessment
- Majority of employees who defrauded are terminated and not prosecuted, and they move on to find their next job where they may indulge in fraudulent activities again. Not prosecuting them also does not provide a deterrent for other employees.
- Whether to refer a case for prosecution depends on whether
 - investigation is sufficiently advanced to make a determination about the nature of the suspected crime
 - Laws require it
 - Level of the individual nature of the offense
 - clauses in the company's insurance policy affects the timing of referral
- Determination of which prosecutors (state, local, or federal) to refer to.
- Sometimes it will be advantageous to pursue a civil suit, especially when financial recovery is possible