PacificCPE

COURSE
11602A

Building Evidence-Based Fraud Examinations

Solid evidence is the backbone of any successful fraud examination. This chapter walks you through the principles of gathering, documenting, and evaluating evidence in a fraud context. You will learn how to structure an examination that holds up to scrutiny, understand the standards that govern evidence collection, and apply methodical approaches to tracing financial irregularities. Ideal for CPAs and financial professionals who want to conduct or support fraud investigations with confidence and credibility.

CREDIT HOURS 2 | FIELD OF STUDY AUDITING | EXAM QUESTIONS 10

Start Course ↓ | Final Exam Copy ↓

LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize the key characteristics of various types of evidence.

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Chapter 1: EVIDENCE-BASED FRAUD EXAMINATIONS

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the key characteristics of various types of evidence.

The Best Job!

Michael P Hanley, CFE (Bureau of Alcohol, Tobacco, Firearms & Explosives—Financial Investigative Services Division)

How do you end up with the best job there is for someone with an accounting degree? I graduated with an accounting degree in 1989, and like most graduates, was guided toward a career as a Certified Public Accountant. After four job interviews, I knew in my heart that a CPA life was not for me. Having a less than desirable GPA might have had something to do with it!

I went searching for a career and ended up as a GS-05 staff auditor at the United States Department of Transportation's (USDOT) Office of Inspector General (OIG). I moved away from family, friends and started a new chapter in a large city. It turned out to be the second-best decision of my life (In case you are wondering, marrying my girlfriend was the best decision). My work at the OIG set me on my path—I learned to be inquisitive, complete meaningful analyses and how to present (audit) analysis findings and results to people who might not have had the background to understand traditional accounting jargon.

I then took a position as a staff auditor with the National Aeronautics and Space Administration's (NASA) Office of Inspector General (OIG). What a great decision—working for NASA did not make me a rocket scientist, but it provided some of the best experiences for a young professional. I traveled the United States, all the way to Alaska! I went to NASA centers and audited the programs that produced satellites and space craft that I believe are still orbiting the Earth to this day. I rose quickly through the ranks to become a go-to Auditor. Then I caught a break—a vacancy announcement for a "Forensic Auditor" in my hometown of Pittsburgh, PA. I completed the paperwork, received an interview, completed a second interview, and I was offered the position! At that time in 1996, forensic auditing was in its infancy and going into this job, no one was sure what to expect. I found out very quickly.

My 1996 assignment: The U.S. Bureau of Alcohol, Tobacco, Firearms & Explosives (ATF) as a staff Forensic Auditor with ATF's Audit Services Division (a name later changed to Financial

Investigative Services Division—FISD). I was greeted at the door by a firearm carrying, BDU wearing, very self-confident ATF Special Agent. Welcome to law enforcement, Mike.

From that day forward, I was a criminal investigator with an accounting degree, using my knowledge and skills of financial and non-financial numbers to follow the money. In that role, I've worked:

- Investigations of violent criminals, both domestically and internationally—arson, firearms trafficking, drug trafficking, street gangs, organized crime, and tobacco smugglers.
- Fraud investigations—embezzlement, money laundering, mail fraud, and wire fraud.
- Fire scenes—digging out burned out offices to recover financial records, interviewed owners.
- Search warrants, interviewed victims, witnesses, and criminals.
- Testified in state and federal court.

When terrorists struck on September 11, 2001, sadly, I responded to Shanksville, PA, with the Special Agents in my office. But the greatest part: I've had the pleasure of working with some of the best people I have ever met. For a career with great people, adventure and reward, consider the Federal government.

THE FRAUD TRIANGLE AND THE COURTS

The September/October 2017 issue of *Fraud Magazine*, contained an article by John Gill titled, "The Fraud Triangle on Trial." In his commentary and analysis, Gill presented a perspective of the fraud triangle that has the potential to rock the foundations of the antifraud profession—at least when it comes to forensic accountants and antifraud professionals testifying in court. Gill found that three U.S. court opinions related to the fraud triangle denied the admissibility of expert testimony based on the fraud triangle because it was deemed to be "unreliable" theory.

Going back as far as 2006, Steve Albrecht (see a 2012 summary in Albrecht, Albrecht and Albrecht, "Fraud Examination"), who in 1991 crafted Cressey's concepts into the fraud triangle, offered a solution in the form of "the elements of fraud" or "the triangle of fraud action:" the act, the concealment, and the conversion.

As described by Dorminey, Fleming, Kranacher, and Riley in 2012 (see "The Evolution of Fraud Theory" in Issues in Accounting Education):

> *While the Fraud Triangle identifies the conditions under which fraud may occur, the triangle of fraud action describes the activities an individual must perform to perpetrate the fraud. The act represents the execution and methodology of the fraud, such as asset misappropriation, corruption, or financial statement fraud. Concealment represents deliberate effort to hide the fraud act; examples of*

> *concealment include creating fake invoices, false journal entries, falsifying reconciliations, or destroying records. Conversion is the process of transferring the benefits of asset ownership and control from the victim to the perpetrator; examples include laundered money, cash deposited in perpetrator bank accounts, purchased personal cars or homes.*

As Gill noted, the antifraud professional needs to "stick to the facts when you testify," which are provided by the triangle of fraud action. From this structure the professional can identify evidence that supports hypotheses (a.k.a. fraud theories) and answer the important questions of "who, what, when, where, and how" (who had access, how was it committed and concealed, where did the money go, etc.). This approach does not require that the professional answer the question of "why" that are associated with pressure and rationalization.

The primary lesson: Ensure that your work is grounded in the evidence. This means that reported findings are supported by facts, data, or information that you independently verify to the extent possible. This approach ensures relevant, reliable conclusions that can be presented with a reasonable degree of scientific certainty. Without the proper credentials and experience (e.g., psychologist), professionals should avoid commenting on motives associated with the perpetrators pressure or rationalization.

In essence, even though many antifraud and forensic accounting professionals have years of experience in dealing with fraudulent behavior and understand the profile of the fraudster, the antifraud professional should avoid commenting on the "why" behind the fraudster's alleged crime.

As an expert witness, ground your examination in objective, reliable, relevant, and valid evidence, and as John Gill contends, "your time on the witness stand will be much more comfortable."

In the following modules of this chapter, the authors examine various tools and techniques for fraud detection and risk assessment. Those modules, along with the learning objectives include the following:

- Module 1 briefly introduces the essence of forensic accounting and fraud examination: who, what, when, where, and how, grounded in the act, concealment, and conversion. The objective of this module is for the reader to be able to describe the elements of fraud and its role in antifraud and forensic accounting investigations.
- Module 2 reviews the framework for evidence. Law schools have entire courses devoted to the definition and assessment of evidence; while the material here is much less comprehensive, it outlines the critical elements of evidence that guide antifraud and forensic accounting examinations. The goal in this module is for readers to be able to identify what may serve as evidence, evaluate the quality of that evidence, and recognize the importance of organizing and documenting the evidence collected.
- Module 3 takes a closer examination of evidence that often contributes to all elements of the triangle of fraud action: the act, concealment, and conversion. The objective is for

readers to be able to apply knowledge of specific types of evidence in the context of case specifics.

- Module 4 explores types of evidence often associated with concealment of the fraud act. The goal here is for the reader to be able to search for and identify evidence of concealment.
- Module 5 offers an overview of the tools and techniques for developing evidence of conversion—the benefits derived from the act. These tools include four indirect methods to identify cash from unknown sources: net worth; lifestyle probe, bank records, and Cash-T. The goal is for readers to develop an understanding of available tools and techniques to estimate cash balances and financial activity, and apply those tools to case scenarios.

MODULE 1—FRAUD EXAMINATIONS: WHO, WHAT, WHERE, WHEN, HOW, AND WHY

Evidence-Based Examinations

To complete an examination, the fraud examiner or forensic accountant needs to answer the essential questions of who, what, where, when, how, and why—with evidence. Even in litigation support situations, the answers to these questions are required to convince a jury that you can explain each aspect of a case. In addition, the answers need to be woven into a coherent story. Critical thinking and analytical reasoning suggest that the fraud examiner or forensic accountant will have to make some intellectual connections to pull the various pieces of evidence and the answers to those questions into a compelling case. However, evidence-based decision making suggests that examiners need to ground their storyline in the evidence. A storyline grounded in the evidence is much more convincing to prosecutors, attorneys, judges, and juries.

The Hypothesis-Evidence Matrix

Incomplete evidence is a fact of life and an on-going challenge to examiners. Another fact is that fraud examiners typically prefer more evidentiary material. How does the fraud examiner deal with situations where the evidence is less than perfect? The answer is that fraud and forensic professionals always face the prospect of less-than-perfect evidence, and they address potential evidentiary shortcomings or holes in the storyline through their consideration of the alternative hypotheses (alternative fraud theories). This approach is referred to as the analysis of competing hypotheses and the specific tool is the Hypothesis-Evidence Matrix. Using a commitment to critical thinking and analytical reasoning, professionals attempt to identify all other hypotheses or theories that might fit at least some of the key pieces of evidence. Then the fraud or forensic professional identifies flaws in each alternative hypothesis by examining and focusing on the evidence. When the examiner identifies evidence that suggests that the alternative hypothesis does not withstand the scrutiny of the evidence, that hypothesis is disqualified as a possible explanation. The last remaining hypothesis that has not been disqualified is the most likely explanation of the case under

examination. As long as more than one hypotheses are not disqualified, the identification and examination of evidence continue until only one hypothesis remains—the hypothesis most consistent with the evidence.

Professionals in this field need to understand that no one is better at generating alternative theories of the case than opposing attorneys. The question isn't *whether* opposing attorneys will develop alternative theories of the case; rather, it's what theories they are likely to propose. Often, if a forensic accountant is deposed as part of the civil litigation process, the opposing attorney will develop new and novel theories for trial, especially if the fraud or forensic professional has cast significant doubt on some of this attorney's alternative theories during the deposition.

What tools are available to analyze evidence and develop a compelling storyline? First, the hypothesis– evidence matrix (analysis of competing hypotheses) should be used for considering alternative fraud theories in light of the evidence. By aligning alternative theories across the top of the matrix and by listing and considering each piece of evidence down the left-hand side of the matrix, the fraud examiner or forensic professional can highlight flaws in the various alternative theories.

With regard to suspected fraud, corruption or financial malfeasance, fraud examiners and forensic accountants need to develop evidence, to the extent possible, around the elements of fraud: the act, concealment, and conversion; the fraud triangle (particularly, opportunity). With regard to the fraud triangle, professionals know that, other than opportunity, they may never have compelling evidence of the other two aspects—perceived pressure and rationalization.

The following is an example Hypothesis Matrix. Assume that the matrix has evidence underlying the evaluation. Readers should note the following:

1. The H-E Matrix evaluates five hypotheses.
2. A key is provided to help readers understand the evaluation of evidence.
3. The evidence is presented in the left column of the matrix.
4. There are additional columns for the source of the evidence as well as an evaluation of its quality: reliability and validity, topics covered later in the chapter.

Hypothesis Matrix :				Key	o	Evidence has no diagnostic value		
Financial Statement Fraud					+	Consistent with the hypothesis		
					–	Disqualifies the hypothesis		
H1: Books are Not Materially Misstated				H4: Bad A/R Clerk with poor collection skills				
H2: Fictitious Revenues (Fake Customer Invoices)				H5: Customer Complaint/Pay Problem: (Quality, Service, Shipping, etc.)				
H3: Channel Stuffing								
Evidence:	**H1:**	**H2:**	**H3:**	**H4:**	**H5:**	**Source**	**Reliability**	**Validity**
Review of F/S (Act):								
EPS steady despite M&A and other business activities	+	+	+	+	+	Audited F/S	A	1
Sales increasing, marketing, adv. Flat to decreasing	+	+	+	+	+	Audited F/S	A	1
Organization Chart (Opportunity):								
Internal audit reporting to the CEO	o	o	o	o	o	Internal	A	1
Family members (related parties) in leadership positions	o	o	o	o	o	Internal (Audit W/Ps)	A	1
Ratio Analysis (Act):								
A/R growth significantly > Sales % growth	o	+	+	+	+	Audited F/S	D	1
Cash drain, operating cash flows:								
Flat, despite revenue and income growth	o	o	+	+	+	Audited F/S	D	1
Operating Cash Flows < Net Income	o	o	+	+	+	Audited F/S	D	1

Evidence:	H1:	H2:	H3:	H4:	H5:	Source	Reliability	Validity
Industry/Financial Press (Possible Pressure): Industry declining Analysts expectations increasing Financial Press – Expectation of company success	o	o	+	o	+	Independent	B	2
Financial Press – Noted company failures								
Compensation Contract (Conversion): Salary and bonus only	o	+	+	o	o	Internal (Audit W/Ps)	A	1
Sales Journal: Trends are not across all quarters	o	+	+	+	o	Internal	B	2
A/R: Journal (Act): Collection problems only for a few, large customers	–	o	+	–	–	Internal	B	1
Examination of large customer documents: Sales contract—collection terms require 30 days or less	–	–	+	–	–	Customers	B	1
Invoices details require payments in 30 days or less	–	–	+	–	–	Customers	B	1
Email (Concealment/Indirect Admission)	–	–	+	–	–	Data Analytics	A	1
Financial Statement Disclosure: Item #1 – Sales (Concealment)	–	–	+	–	–	Audited F/S	A	2

Predication

Prior to starting a fraud or forensic accounting examination, the professional needs predication. *Predication* is defined as the totality of circumstances that would lead a reasonable, professionally trained, and prudent individual to believe that a fraud has occurred, is occurring, or is about to occur. Essentially, predication is the starting point for a formal fraud examination. Suspicion in the absence of any corroborating circumstantial evidence is not a sufficient basis for conducting a fraud examination. Something as innocuous as an anonymous tip or complaint, with some supporting evidence to substantiate it, may be enough to meet the predication threshold. In other cases, discovery of missing cash or other assets is usually sufficient grounds for launching an examination.