

# EXPERT FRAUD INVESTIGATION

**A STEP-BY-STEP GUIDE**



TRACY L. COENEN



## **Additional Praises for *Expert Fraud Investigation: A Step-by-Step Guide***

“Crime is inherently dramatic. And since fraud is a crime, writing about the subject of fraud should not be mundane nor monotonous but rather riveting, exciting and informative. Tracy Coenen, in her new book *Expert Fraud Investigation: A Step by Step Guide*, may be the first to actually capture why the topic of fraud is not only exciting but also informative, thought provoking and most importantly a subject that no one can afford to not thoroughly understand. In an environment of fraud on Wall Street and on Main Street, this book literally levels the playing field by equipping everyone who wants to avoid becoming a future fraud victim. In times like these, this is a must read.”

—Barry Minkow, Co-Founder Fraud Discovery Institute

“This book should be required reading for anyone who is thinking about or is about to start on their fraud examiners career. She doesn’t talk down to the reader but lays out in clear concise points that must be considered before starting ones own firm as well as a fraud investigation. This is where Tracy’s experience and knowledge about fraud shine through.

She continuously establishes credibility with the season fraud examiner by being subtle yet informative with her own opinion which is based on years of practical experience. It is evident this book is not written by a college professor looking for tenure at a University. Instead it appears to be written by a seasoned professional with years of experience. I would strongly recommend it to the experienced fraud professional as well as it contains information needed throughout ones career.”

—David Bleser, President, Bleser & Associates, LLC

“Ms. Coenen’s book should be on every accounting and financial manager’s bookshelf. When you suspect fraud, call an expert. But this book explains the who, what, where, and why of financial frauds and the techniques professionals like Ms. Coenen use to help you investigate and prosecute it.”

—Francine McKenna, President,  
McKenna Partners LLC and Author of the blog,  
*re: The Auditors*

“Through an examination of common types of frauds and discussion of ‘best practice’ methods to identify fraud, this book provides excellent practical guidance on how to conduct a fraud examination. Such guidance is a valuable resource to auditors and security professionals involved in fraud examinations. I highly recommend this book to auditors, security professionals, management and board of directors who desire a practical, not theoretical, understanding of fraud examinations.”

—Michael D. Akers, PhD, CFE, CPA, Professor and Chair,  
Department of Accounting-Marquette University,  
Charles T. Horngren Professor of Accounting



# Expert Fraud Investigation



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## *A Step-by-Step Guide*

**TRACY L. COENEN**



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For Grandma & Grandpa



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# Preface

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Fraud investigation is a field that has gotten plenty of publicity since the big public company frauds uncovered in the early 2000s. Despite the media coverage and overall greater awareness of the issue, there are few books to date that have led readers through the process of conducting a fraud investigation. *Expert Fraud Investigation: A Step-by-Step Guide* changes all of that. It is the first book to really make the leap from theoretical discussion of fraud investigations to the actual nuts and bolts of performing an investigation.

This book is no substitute for real-world experience under the direction of a highly qualified forensic accountant or fraud investigator, but it is a tool to help professionals learn about fraud investigations. This guide takes the professional through the process of opening an investigation, selecting a team, gathering data, and the entire investigation.

It discusses the most common types of fraud cases, and points out some of the best methods for analyzing the books and records to search for proof of fraud. Business executives, auditors, and security professionals will benefit from this book, and companies should find this a useful tool for fighting fraud within their own organizations.

The basis for this book is more than a decade of fraud investigation experience, with cases ranging from those at small family-owned companies to large publicly traded corporations. Formal and informal training have helped refine my fraud investigation skills and add to my repertoire of techniques to ferret out fraud.



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**T**hank you again to everyone at Wiley who has helped make writing this book easier than I ever imagined. You allow me the creative freedom to write according to my vision, and for that, I can't thank you enough. It is an honor to be associated with such professionals.

I again thank my family, friends, and business associates, who support and encourage me each day. Special thanks goes out to Max, who makes each day worth living. You are the best!



## Finding Fraud

There are two different ways that a reactive fraud investigation starts. One type of investigation begins when an actual fraud has been identified, and maybe one or more perpetrators are identified, too. The other type of investigation starts with a strong suspicion of fraud, but no real proof of theft.

Both types of investigations are important to any organization that takes fraud prevention and control seriously. Companies with good fraud prevention controls actively monitor their systems and follow up on questionable data and unusual relationships between numbers. The investigation that starts this way should not be viewed as any less important than the one that begins with a definitive instance of fraud.

### Signs of Fraud

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Numerous signs can point to the possibility of fraud. Literally hundreds of different types of fraud schemes exist, so the number of possible red flags of fraud is huge. It would be impossible to cover them all in their entirety here, but some general signs of fraud can apply across all types of businesses and fraud schemes.

It is important to educate management and employees on these warning signs of fraud. Study after study indicates that tips from employees are one of the most common ways that corporate fraud is

detected. Therefore, it makes sense to educate employees about symptoms of fraud so they can report red flags when they see them.

### Accounting Irregularities

Irregularities that point to the possibility of fraud can range from simple things like unreconciled accounts and unusual account balances to more complex problems like “on-top entries,” which are made after the books are closed in order to manipulate the numbers ultimately reported on the financial statements.

An auto dealership had a controller who had not reconciled the bank accounts for nearly a year, despite management’s insistence that it be done. Management did not insist enough, and the problem persisted; the accounts remained unreconciled month after month. Unreconciled bank accounts usually signal one of two problems: The accounting staff is incompetent or understaffed, or there is a fraud-in-progress that will likely be exposed through a bank reconciliation. Both of these problems need to be corrected quickly.

In this case, it turned out that the controller simply couldn’t handle all of the responsibilities of her job. She was out of her league and was not doing the reconciliations because she did not have time and was likely afraid that the reconciliations would expose her incompetence. The reconciliations would have shown that she didn’t have a good handle on the company’s finances.

The auto dealership was lucky in this case. They simply dismissed the controller and hired someone more experienced and more competent. But there was a period of time during which management was afraid a fraud had occurred. They should have recognized early on that the unreconciled accounts were a sign of a big problem.

Cynthia Cooper, head of internal audit at WorldCom, recounts the on-top entries problem that she and her team discovered was part of a massive fraud scheme at the company. Executives were directing employees to make journal entries *on top* of the regular general ledger activity to make the financial statements conform to a predetermined template. Lower-level employees did not see these entries, because they

occurred outside the regular system of recording accounting details, so the practice went on for a long time before it was discovered.

To further confuse anyone who might look at the on-top entries, executives directed a web of confusing entries to be made. They were not a handful of simple debits and credits. There were hundreds of entries, with figures divided and bounced between many different accounts, apparently in an attempt to confuse and discourage anyone who might try to dig into these entries. The existence of these entries was discovered because of some irregular numbers and account names by the internal audit team. This demonstrates the importance of being on the lookout for unusual accounts, numbers, and descriptions within the accounting system.

It's not always easy to spot accounting irregularities. After all, an employee or executive who engages in fraud is often aware of what others are expecting their work or their numbers to look like. In many companies, management knows that revenue and expenses are expected to fall within certain parameters. Numbers outside of those expectations might raise suspicions. So a good fraudster will ensure that the numbers do not appear unusual in that regard. It's only when someone digs deeper that the irregularities start to surface. An examination of a public company's Securities and Exchange Commission (SEC) filings might reveal some notes or disclosures that do not make sense in light of the numbers reported. Small clues like these will be necessary to point to irregularities.

For example, suppose a company reports in the notes to the year-end financial statements that the raw materials used to make its products have become significantly more expensive. An examination of the company's gross profit margin, however, shows that the percentage is stable. The only legitimate way for the gross profit percentage to remain unchanged during a period in which raw material prices increase significantly is for the sales price of the goods to rise proportionately. The sales prices at this company did not change, however, so that immediately raises a red flag about that unchanged gross profit margin. The numbers reported don't make sense in light of the information provided in the notes. This should definitely be examined further.

It is clear that the accounting irregularities giving rise to a fraud investigation may not be easily identifiable. Those committing financial statement fraud are often adept at covering their tracks, so the red flags are not always obvious. The investigator often relies on intuition when examining the numbers and explanations for possible irregularities.

### Apparent Control Weaknesses

When readily apparent major deficiencies in a company's control procedures are identified, they should be considered warning signs that fraud could be occurring. All companies have some things that are not as secure as they should be. However, when the controls over a company's assets and data are severely deficient, that is cause for alarm.

Some of the most common characteristics that might be considered severe deficiencies include:

- *Complete lack of segregation of critical duties*, giving one or more persons almost complete control over a financial area of a company and offering many opportunities to commit fraud and easily conceal it. For example, if the same person receives customer payments, records the payments to the customer's accounts, makes the bank deposits, and reconciles the bank statement, there are many opportunities to commit and conceal fraud. The employee could steal a customer payment, record the payment on the customer's account so the customer doesn't know the funds have been stolen, and later adjust the accounting records while doing the bank reconciliation in order to cover the theft. If these duties are segregated among two or three employees, the risk of theft of a customer payment and subsequent acts to cover the theft are much less likely.
- *Ability to override controls and limits of authority easily*, either with no oversight of the process or with lax enforcement of it. For example, an area supervisor regularly exceeds his authority for vendor payments. His approval limit is capped at \$20,000. He commonly requests that vendors issue multiple invoices for work, so that no individual invoice exceeds the \$20,000 threshold. Upper management is aware of this situation, but does not enforce the policy or regularly monitor this