

**Alba Advisors, LLC**

# **Fraud and the Forensic Matrix**

**2016 Conference on Insurance Fraud and Auto Theft**

**Louisiana DOI / Louisiana ATIFPA**

**Baton Rouge, LA**

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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. (*2016 Report to the Nations*)**
- **Fraud hits >75% of businesses each year. (*2015 Kroll Global Fraud 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.
- The “*System*” is more complicated than it has to be.



# 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 82% of companies) is external audit.

Association of Certified Fraud Examiners  
*2016 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

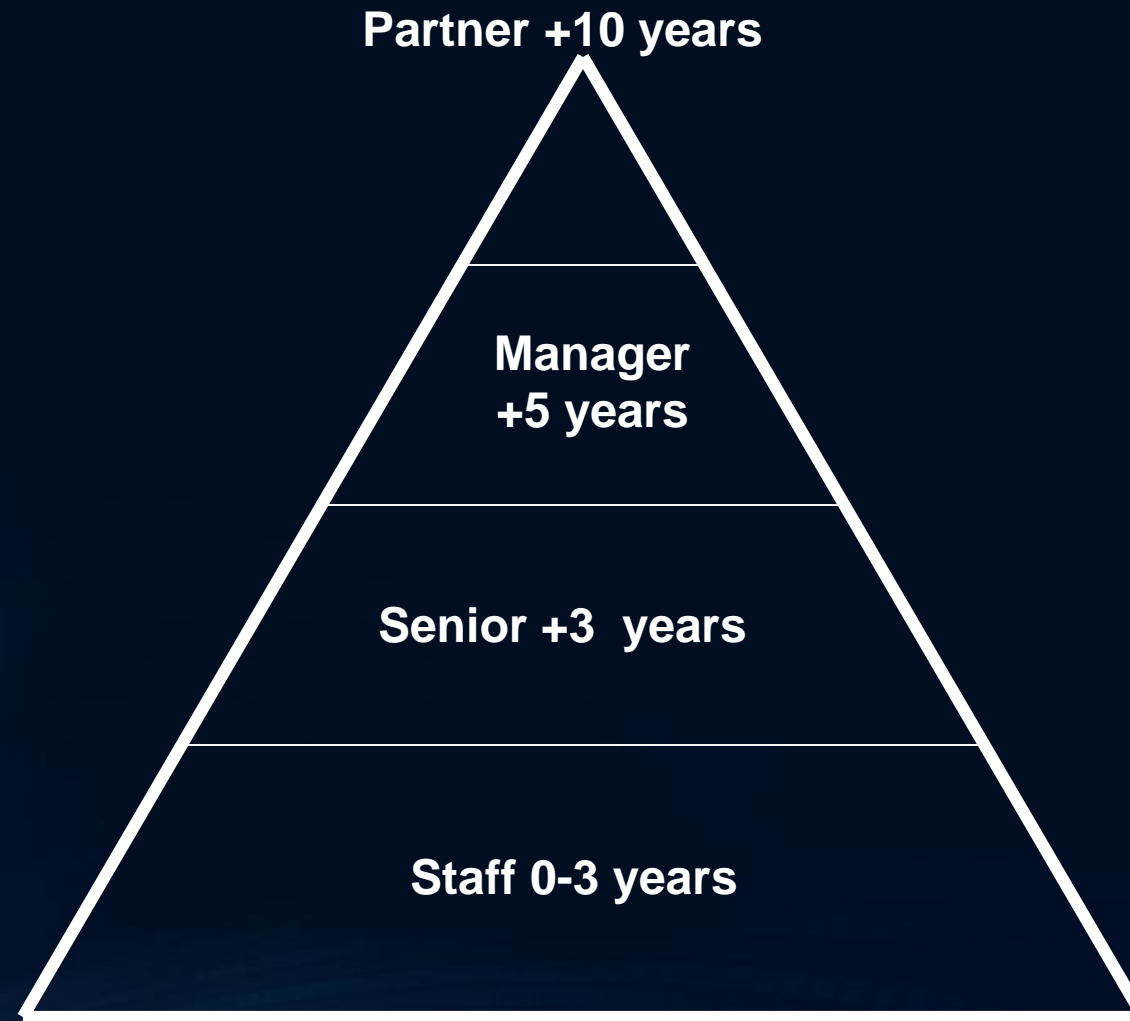
- Overwhelming % legitimate transactions.
- Judgment call.
- Not material.



# 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

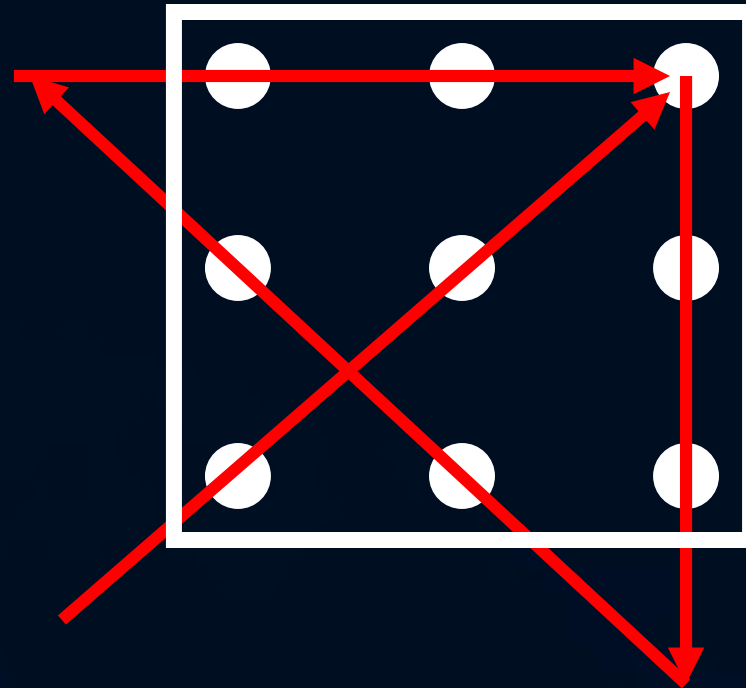
- Finding Fraud is easier if it's always there.
- Don't be too smart.



# Price Waterhouse?



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





## A different perspective...

- Reading between the lines.
- Gut instinct.
- Exercising mental agility.
- No preconceived notions.



# 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

**A = B**  
**?**  
**B = C**



**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.**

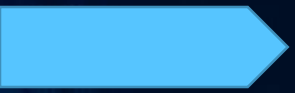


**Until you know the secret.**



# Addressing the challenges of finding Fraud

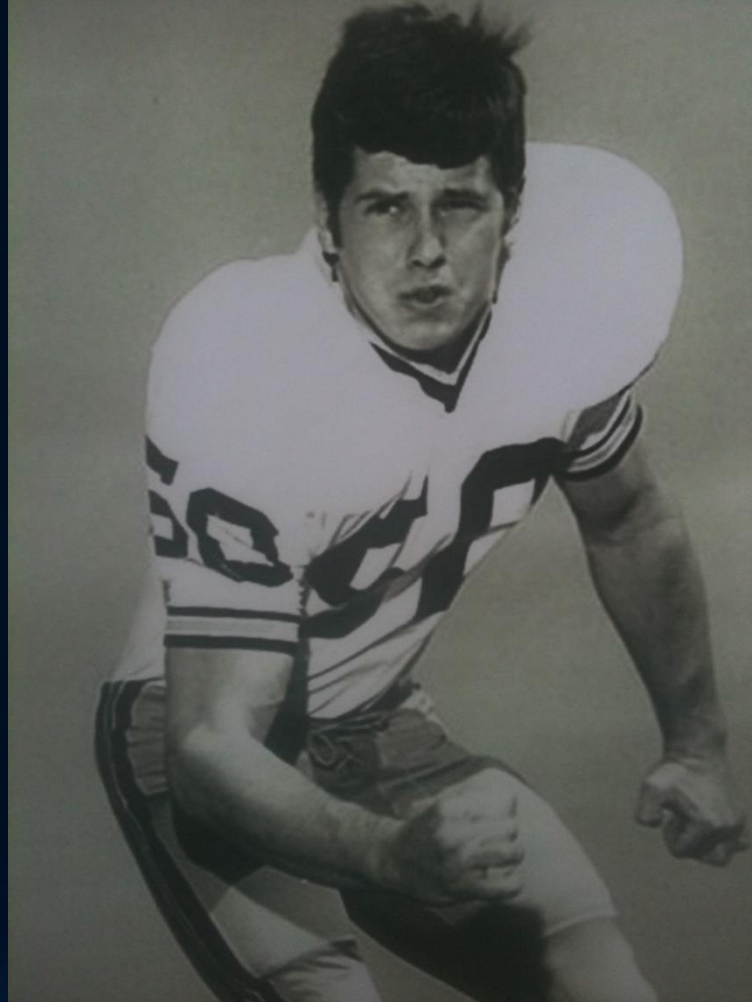
- Finding Fraud is easier if it's always there.
- Don't be too smart.
- Finding the story behind the numbers.

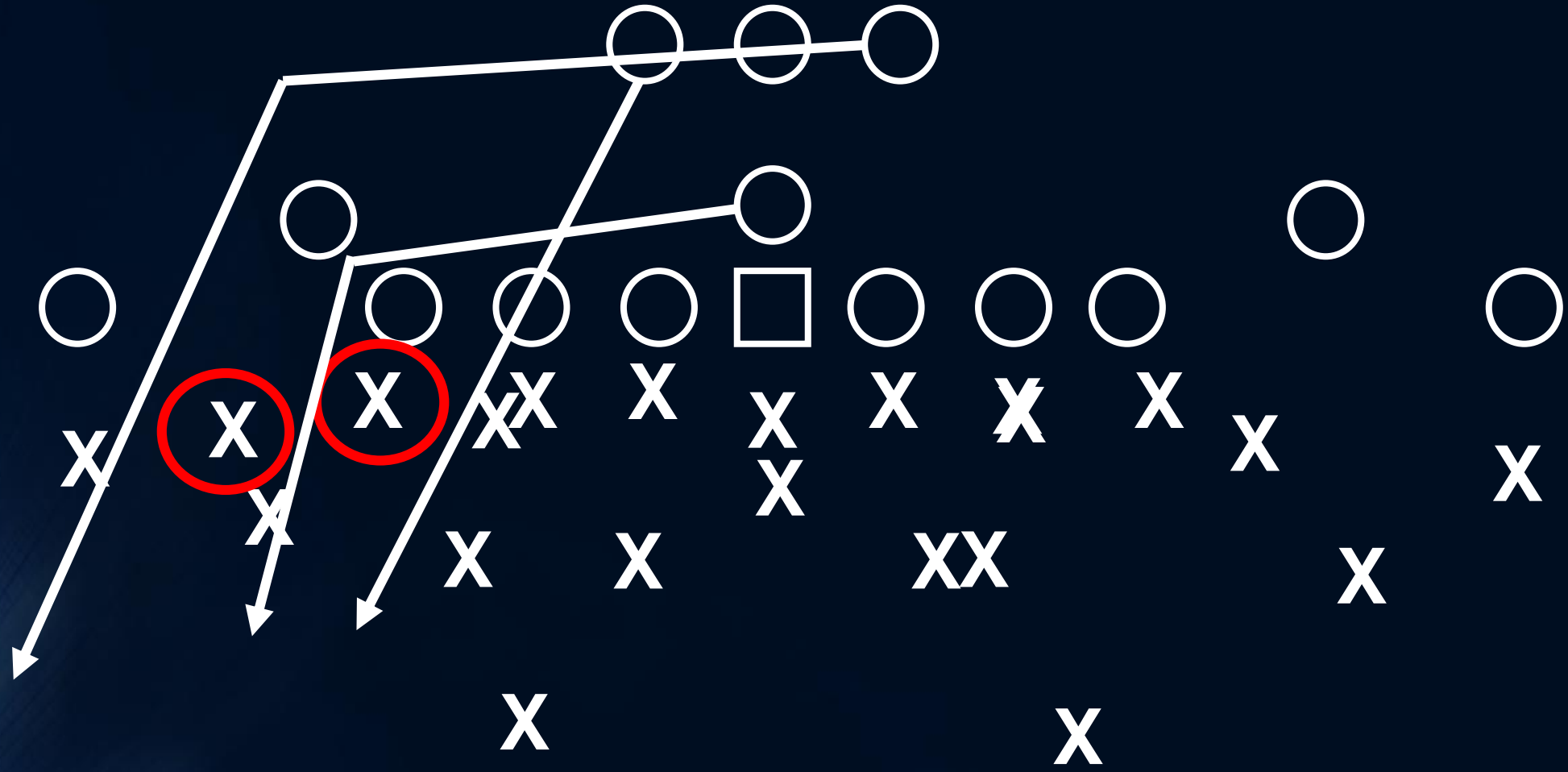


# Numbers

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?

**\$1,000,000**

Compared to what?

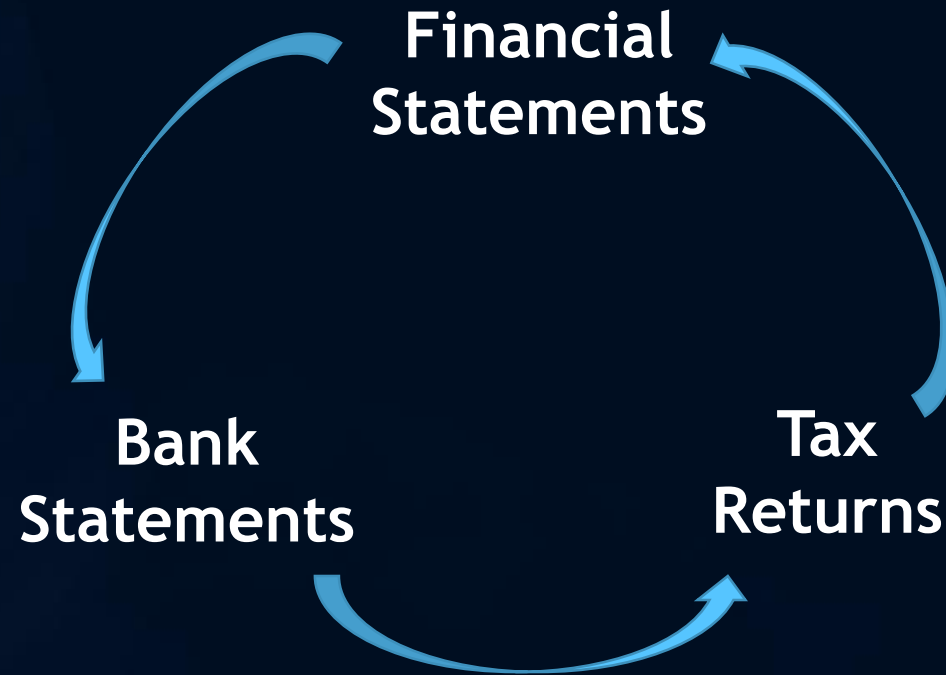




# Relate

- 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)**

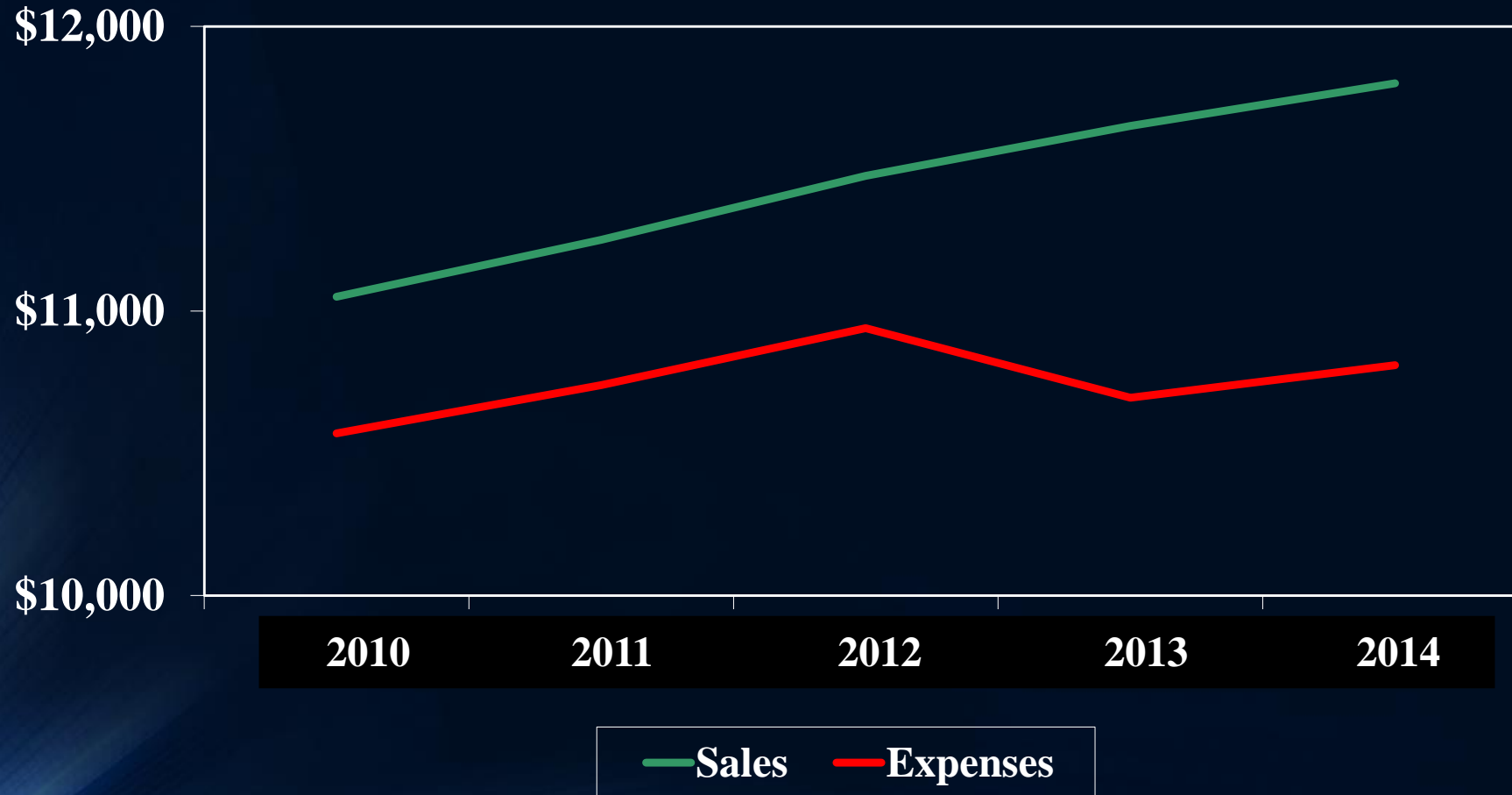
for the period ending December 31	2010	2011	2012	2013	2014
Net Sales	\$ 11,050	\$ 11,250	\$ 11,475	\$ 11,650	\$ 11,800
Cost of Sales/Operating Expenses:					
Cost of Goods Sold	\$ 9,005	\$ 9,175	\$ 9,350	\$ 9,105	\$ 9,220
Depreciation	275	270	280	280	275
Selling Expenses	700	695	705	695	710
Administrative 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



# FUN COMPANY, INC.

## *Comparative Income Statement*

### *2010-2014*







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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

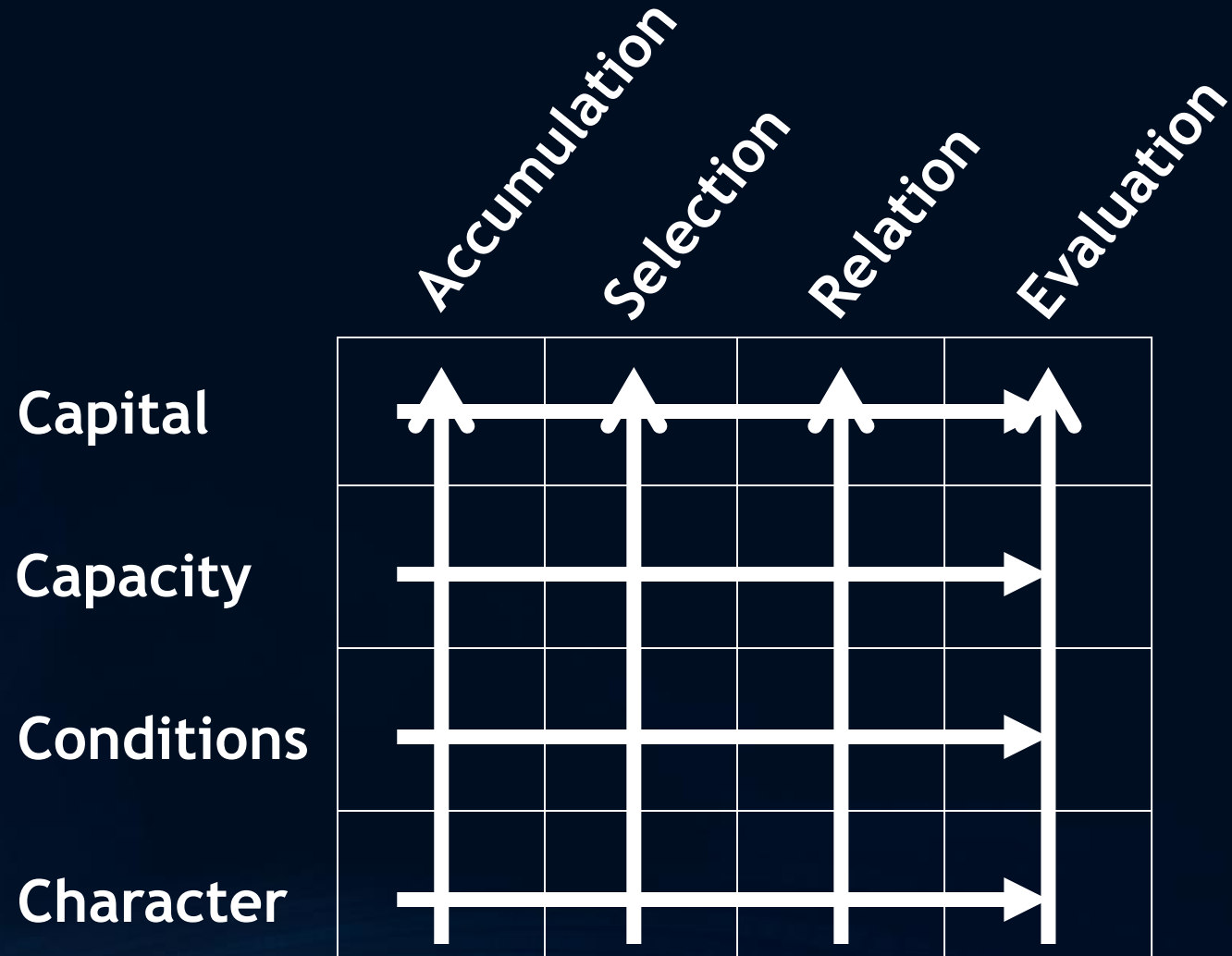
- Internal or external factors with extreme influence.
- Circumstances that cause people to act the way they do.
- Incentives. Who wins? Who loses?
- Out of the ordinary occurrences.



# Character - Integrity

- Reputation.
- Do you like them? Do they like you?
- Subtle clues.

# 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**

## **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**

**CEO who gouged EpiPen Price is  
daughter of Democratic Senator**

**Associated Press  
Aug 24, 2016**



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