



“Detecting Fraud Within Companies: An Insider’s View”

By: Jim Wanserski,
October, 2009
To: ACFE--Atlanta

(These opinions, observations and direct case examples are offered by Jim Wanserski, based upon his: fraud-uncovering experiences, consulting work, research, preparation, development and delivery of direct testimony, evidence and exhibits.)

Outline:

- Background, Education and Experience
- Experience-Based Data -- ACFE
- Lessons-Learned
- Case Experience Summaries (7)
- Analyze one particular case in detail:
 - MCI Culture 1995-1997
 - MCI Carrier fraud: Anatomy & Timeline
 - Detection: Behavior precedes transactions
- Quotable Insights
- Contact Information

Background:

Education: Rockhurst University (Kansas City) - BSBA/MBA

Work Experience: Sprint, Telecom*USA, MCI, Arthur Andersen, Business Consulting, Turnaround Projects, DoJ assignments.

Fraud-Busting Experiences, at different companies:

- Capitalized maintenance costs.
- “Welching” on a deal.
- Pension trust-fund irregularities (or, “good money after bad”).
- A classic case of revenue acceleration.
- Fictitious invoices, diverted refunds, credits and other incidents.
- Billing & Receivables—MCI “carrier” fraud.
- Proactive investigations: Pre-acquisition reviews; “Deep-dive” when results appeared too good; “Root cause” analysis efforts.
- Client investigations:
 - Healthcare: Due diligence uncovers financial statement fraud & litigation.
 - Telecom: Hard facts dispel negotiated claims in a purchase agreement.
 - Agriculture: Ill-gotten gains in a bankruptcy.

“Post-Mortem” Data:

How frauds are initially discovered, according to ACFE:

	<u>2008</u>	<u>2006</u>	<u>2004</u>	<u>2002</u>
1. Tip	46.2%	34.2%	39.6%	43.0%
2. “By Accident”	20.0	25.4	21.3	18.8
3. Internal Audit	19.4	20.2	23.8	18.6
4. Internal Controls	23.3	19.2	18.4	15.4
5. External Audit <small>(All...vs. SEC clients)</small>	9.1	12.0	10.9	11.5
6. Notified by Law	4.1	4.5	6.1	N/A
Enforcement	3.2	3.8	0.9	1.7

ACFE: Association of Certified Fraud Examiners “*Reports to the Nation on Occupational Fraud and Abuse.*”
Note: some participants cited more than one method for initial discovery.

2008 Study: Average fraud goes undetected for 24 months.

Lessons-Learned: (Individual)

1. Personal commitment: where do you stand?
2. Build relationships ACROSS the organization.
3. Note, understand, act on--changes in behavior.
4. “The devil is in the details.”
5. Act...or be acted upon.
6. You gain “street-smarts” from experience. So, once developed—trust your instincts:
 - If you cannot get crisp answers, probe further.
 - Sometimes it’s a judgment call; so do what you need to do.
 - Be skeptical, corroborate, validate, verify...but...ACT.

Lessons-Learned: (Organization):

1. Face the facts — fraud is occurring
2. Develop a fraud framework—who, what, when, where, how, why--as part of Risk Management/Assessment.
3. Management must proactively establish, and regularly communicate expectations...at several levels.
4. Develop robust, sophisticated reporting, to analyze:
 - The “usual suspects,”
 - Special areas of attention,
 - “Sacred Cows,”
 - but most importantly, ACT on the data.
5. Decision-Point: documenting vs. preparing evidence.
6. “Whistleblower” is a four letter word.

Due Diligence on a bad deal

Background: *Due diligence effort on a targeted, high-tech company acquisition*

- Agreement in Principle anticipated a multi-million \$ price tag
- Analyzed revenue stream, customer base, and data from financial systems—could not make the numbers “work”
- Received data inconsistently, in variety of formats, at various times
- Target company accounting staff “too close to the vest”
- All subsequent communication on deal went through owner
- Lack of crisp answers; no “forthcoming” approach
- EBITDA targets and rational multiple simply not achievable
- Killed the deal—“close call”

Lessons-Learned: *“The devil is in the details”;* need for crisp information, if not received, probe; corroborate the information to the data; always stay tuned-in for further data—especially that which is received informally, “connect-the-dots”

Escrow Analysis Uncovers Financial Statement Misrepresentation

Background: Acquisition(s) by out-of-state parent; due diligence firm noted no material issues

- At last minute, acquiring company held back \$ value of A/R due to purchase price “concerns,” along with odd behavior by one owner
- Consulting firm hired to analyze collections against purchased receivables to determine if payment from escrow was merited
- Collections % on purchased receivables—performance far too low
- Led to revenue recognition issues, inadequate or no reserves indicated non-GAAP processes...financial statement misrepresentation
- Documents then uncovered indicated misdirection of cash receipts
- Suit filed by acquiring company—litigation

Lessons-Learned: Stay skeptical; seek to understand the business; validate and “relate” the numbers

“Welching” on a Deal

Background: Parent company sold CAD/CAM subsidiary to globally-known conglomerate. Terms: up-front payment, plus 11% of sales for subsequent 5 years--paid quarterly

- 5 quarters into the subsequent period, acquiring firm restated prior reported quarters (downward), current quarterly sales at zero
- Internal audit sent to California HQ, to audit sales
- Dow Jones database search uncovered multiple press releases announcing Joint Venture formed with C. Itoh, a Japanese trading company “...to distribute CAD/CAM systems”
- Uncovered title transfer (to JV) information in COGS data and records
- Communicated (with examples) to parent company Controller, CFO, General Counsel, President; led to meeting w/CEO “Neutron Jack”
- \$80 million settlement

Lessons-Learned: “The devil is in the details”; know the business processes; seek information and confirm with data

“Good Money After Bad”

Background: Asked to design and execute first-ever audit of the pension trust (investment) assets

- Tested asset performance and allocations against pension trust committee investment parameters, among other things
- Noted several \$ multi-million investments made with a privately-held (oil exploration) drilling firm; contacted company “...all dry holes”
- Following year, more funding to the same entity...more “dry holes.” Total funding exceeded investment guidelines over the period
- Fraud not proven, but pension trust officer known personally to drilling company personnel
- Full audit of pension trust assets, including revised reporting to BoD.
- Early retirement of pension trust officer

Lessons-Learned: “The devil is in the details”; proactive information-gathering; “connect-the-dots”

The Classic: Revenue Acceleration

Background: “My guys tell me I can trust you; we need to talk”

- Subsidiary company controller called me for a “confidential” meeting
- Year-end revenue acceleration being directed by subsidiary president (to controller), ahead of contract terms
- President in line to be named boss of new venture with major partner
- Designed special review audit around contract terms, revenue recognition, invoicing processes
- Audit staff “discovered” timing disparities during review of sales cut-offs
- Audit results ultimately reported to the Audit Committee
- “What do you think we did? We fired the guy, OK? Can we move on?”

Lessons-Learned: *Build and maintain relationships across the organization; Construct parameters, test, prove; Act*

Fictitious Invoices to A/P

Background: HQ accounting staff came to me discretely, with selective concerns...

- Alleging fictitious invoices were being submitted and then approved by the “boss”, the Corporate Director of Accounting
- Gathered documents, investigated invoices vs. “services” and remittance instructions—sole-sourced, unconfirmed
- “Tag team” of Finance/Accounting and Legal confronted “perp”
- Admitted doing it, under guise of “testing” internal controls
- Terminated; heard done again at another company, unfortunately with an even sadder ending

Lessons-Learned:

Develop relationships across the organization; be skeptical

Receivables & Billing Fraud

Background: Assigned additional business segment —after prior management team took the two largest disconnections of service in the company’s history.

- Inherited incompetent performers: poor track record, lack of crisp information, sloppiness, bad business judgment, odd behavior
- Over 8 month period became more and more suspicious; actively looked for the “smoking gun”; ultimately found “proof positive” of kickbacks, “cooking the books”, collusion with two outside firms...confronted the “perps”
- Hired White Collar Crime resources; involved law enforcement early. FBI told us that we handed this case to them on a silver platter” – 40 hours testifying, mountains of evidence, exhibits, “e-mail-trail”, etc.
- Terminated 10 people, testimony/evidence led to successful prosecution of 2 MCI managers and two outsiders.

Lessons-Learned: Behavior precedes transactions; trust your gut; monitor metrics; follow leads relentlessly; transition from investigating to preparing evidence; Act.

MCI (Carrier) case, in more depth:

Timeframe: Preceded “Bernie Ebbers/WorldCom”

- Planned by “perps”, late 1995/early 1996; executed mid-to-late 1996
- “Proof-Positive” uncovered in January/February 1997
- Within weeks, MCI took case(s) to law enforcement:
 - Discovery, subpoenas, criminal grand jury convened, FBI, et.al.
 - Ten people terminated; civil and criminal litigation
 - Charges filed against the perpetrators:
 - Two 2nd level MCI managers (“internal perps”) pleaded guilty – JAIL
 - One outside “perp” pleaded guilty – JAIL
 - Last outside “perp” case to jury trial – guilty verdict on all counts -- JAIL
- Media shenanigans: Storytelling vs. Testimony
- Proof: US Attorney/Law Enforcement: 4-0 in successful prosecutions
- “Perp Marketing”: speeches, articles, TV interviews, a SWAG book
- Personal costs: security (financial, family, physical); personal attacks

MCI Culture: 1995-1997

Strategy and Targets: Sole Focus was AT&T

- Competition: External & internal.
- Market share, power, marketplace visibility.
- A high energy, fast-moving place to work.

Structure: Decentralized organization, but transitioning.

Processes: A Marketing & Sales “Machine.”

- Unparalleled legal & regulatory expertise.
- Functional and structural control environment.

People: Aggressiveness was rewarded, top management drove fast growth, some inexperienced people in big jobs.

In Retrospect: Separation of duties operative, SEC and GAAP financial statements; oversight and integration effective.

Anatomy: Fraud Schemes

With the factoring company or loan broker:

- Influenced by these outsiders, “perps” developed, executed, and signed phony (unauthorized), 3-way-deals involving a very small set of MCI customers.
- Each “deal” required customer to pay factoring firm or loan broker...who would then (supposedly) “pay” customers’ MCI invoices for contracted telecommunications costs.
- “Perp” then convinced by outsiders to concoct, develop and incorporate an “MCI guarantee.”
- Internal “perps” then “cooked the books” to cover the fraud--via phony credits, payments and transfers.
- Series of payments to software developer.
- Trapped two different ways, by MCI boss.

Timeline:

1995: Fraud schemes hatched.

1996: “Perps” do the fraud: behavior precedes suspicion

- March: “Perps” execute documents & deals with outsiders.
- April: Wanserski takes over the Carrier business segment.
- MCI records \$50 million of A/R write-offs.
- August: Carrier MCI finance review in Atlanta.
- September-December: odd behavior...search intensifies for “smoking gun” proof.
- MCI records \$30+ million to bad debt reserve.
- December: MCI records \$70 million of A/R write-offs.

1997: Jan/Feb: Final positioning, “proof positive” of fraud

- 10 employees terminated & Pavlo resigns (twice).

1997-2004: Investigations, Court cases, “Perps” jailed.

Timeline: A Very Active Fraud:

Jan-Feb, 1997: “Proof-Positive” fraud uncovered, terminations completed.

October 17, 2000: Feds presented (Guilty) Plea Agreement, indicated the specified charges, and that...

- “The Government will recommend that defendant committed obstruction of justice...”

January, 2001: Feds Executed Guilty Plea with one perp, specified a \$6 Million Judgment; perp pleaded guilty to:

- Two counts of wire fraud.
- One count of engaging in monetary transactions in property derived from wire fraud (from the schemes to defraud MCI, and to defraud WorldCom Technologies, Inc., AT&T Corporation, and Business Telecom, Inc).
- Obstruction of justice.

“Tall Tales”:

Published claims—however, not while under oath:

- “His actions benefited MCI.”
- My supervisors told me, “hold losses to a minimum, even if doing so required deceptive means.”
- MCI taught me the tricks to hide bad debt ...“ he cooked the books, under pressure from higher-ups...”
- “Pavlo sent his superiors a memo on Jan. 4, 1996, warning of \$88 million, and possibly more, in reseller receivables that MCI was unlikely to collect...”
- “...at the direction of his supervisors, Pavlo helped manipulate the telecom company's accounting records to hide bad-debt expenses totaling US \$180 million.”
- “I worked on my own. It was me.”

Conflict with offered testimony, facts, and:

...Multiple other differences vs. testimony, evidence, exhibits since completing his sentence, and joining the “lecture” circuit

Quotable Insights

- Warren Buffett:
 - ***“In looking for people to hire, you look for three qualities: integrity, intelligence, and energy. And if they don’t have the first, the other two will kill you.”***
 - on fraud: ***“...just avoid it”***
- ***“Life is choices.”*** Matthew Kelly
- ***“Everyone is entitled to their opinion, but not their own facts.”*** Daniel Patrick Moynihan
- ***“...But it was just my imagination, once again, running away with me...I’m tellin’ you it was...”*** The Temptations
- ***“My basic principle is that you don’t make decisions because they are easy, you don’t make them because they are cheap, you don’t make them because they are popular, you make them because they’re right.”*** Theodore Hesburgh
- ***“It is unwise to argue with a fool, because others may not know the difference.”*** Rush Limbaugh

Contact Information:

*Jim Wanserski
The Intersect Group
10 Glenlake Parkway
Suite 300—South Tower
Atlanta, GA 30328*

Email: jwanserski@theintersectgroup.com

Office Telephone: 770/500-3615