CLARK SCHAEFER HACKETT

CPAs & BUSINESS CONSULTANTS

Caught in the Act: Fraud Case Studies

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Objectives

- Discuss conditions for fraud and types of fraud
- Focus on fraud risks in today's environment
- Present actual cases / fraud schemes
- Reveal red flags and what auditors missed
- Auditor's role (and hints for plan sponsors)

Conditions for Fraud and Types of Fraud

Facts on Fraud (overall)

- June 2010 Journal of Accountancy Article ("Keeping Fraud in the Cross Hairs") stated that:
    - Accounting departments tend to be particularly vulnerable to fraud schemes
    - Accounting department is the financial nerve center of an organization (opportunity)
    - Ironically, the accounting department is the place where control is more strongly enforced
    - Accounting department employees are familiar with the controls and how to develop methods to circumvent them

How Does EBSA Find Out about Fraud?

- Participants and Beneficiaries Contact Employee Benefits Security Administration
- Review Form 5500
- Plan Officials
- News Media
- Referrals from Law Enforcement
  - ❖DOJ/FBI
  - ❖SEC
  - ❖FINRA
- Auditors are conspicuous by their absence

Fraud in the EBP World

No conceptual differences:

- Types of Fraud
  - Fraudulent Financial Reporting
  - Misappropriation of Assets

- Conditions for Fraud
  - Incentive/pressure
  - Opportunity
  - Attitude/Rationalization

Badges of Fraud

- Concealment
- Lies
- Misrepresentations
- False Statements

Today's Environment: *Increased* fraud risk

Current economic conditions provide the <u>incentive</u>:

- Aging population is unable to retire as planned
  - Depending largely on age and income, between 4-14 percent of Americans who otherwise would have had adequate income to cover basic expenses in retirement became "at risk" of running short because of the housing and financial crisis of 2008-2009, according to a new report by Employee Benefit Research Institute
- Layoffs at plan sponsors and Administrators= fewer people watching the store
- Financing and liquidity difficulties at the plan sponsor level mean less ability to fund employer contributions
- Continued sponsor losses and unknown recovery timeline

Technology Poses New Risks

- Social media is a new risk that fraudulent transactions may occur (hacking, etc.)
- Consider veracity of document you use:
  - Faked authorizations (should plan accept email from participant as an authorization?)
  - Faked documents (pdf and Photoshop)
  - Excel spreadsheet (hard-key appears as formula)
  - Did client intervene in obtaining it? (Alteration)

Warning Signs!

- Individual account statement is consistently late or comes at irregular intervals
- Participants complain that account balance does not appear to be accurate
- Notice that employer failed to transmit contribution to the plan on a timely basis
- A significant drop in account balance that cannot be explained by normal market ups and downs
- Individual account statement shows contribution from paycheck was not made

Warning Signs – (continued)

- Investments listed on statement are not what participant authorized
- Former employees are having trouble getting their benefits paid on time or in the correct amounts
- Unusual transactions, such as a loan to the employer, a corporate officer, or one of the plan trustees
- Frequent and unexplained changes in investment managers or consultants
- Employer has recently experienced severe financial difficulty

Fraud Schemes and Examples

Subject Study # 1
The Company Office Manager

- She was in her late 40s early 50s, married, with one child living in Hawaii
- She has some college; her husband worked as a blue collar worker
- She handled her family's finances
- She and her husband had significant credit card debt
- Along with her husband, they traveled to Florida and Las Vegas and also sent money to her son who lived in Hawaii
- She was employed as an office manager for a small company for about 15 years and handled insurance billing, invoices, A/R, A/P, ordering supplies, ingoing and outgoing mail, etc.
- She was also responsible for preparing monthly account and reconciliation reports (basic general ledger/accounting duties) for the business

The Scheme

- Subject wrote checks from the company's operating account to a fictitious company. The fictitious company had the appearance of being a vendor – the type of company they would do business with.
- The subject would then deposit the check in her personal bank account
- The amount of her thefts was approx. $50,000 per year
- In order to avoid detection, the subject had to explain why corporate accounts were being diminished.
- The company sponsored a Profit Sharing Plan and made contribution to the plan twice a year of approx. $25,000
- This gave her an idea

The Cover Up

- She would create false account statements showing that the contributions were made when, in fact, they were not
- This was a “cut and paste” job
- The next slides show her “art”

18752	Apr. 4	2626211349	37.20
18754*	Apr. 2	2421726527	24.81
18755	Apr. 23	2522664058	35.00
18756	Apr. 20	2522300497	166.00
18757	Apr. 4	2626203315	1,210.55
18759*	Apr. 16	8997399682	484.25
18760	Apr. 4	2128767424	9,629.43
18761	Apr. 6	2328752882	488.69
18763*	Apr. 6	2328757351	398.99

18752	Apr.	2	[illegible]	37.20
18754*	Apr.	4	2626211349	24.81
18755	Apr.	2	2421726527	35.00
18756	Apr.	23	2522664058	186.00
18757	Apr.	20	2522300497	1,210.55
18759*	Apr.	4	2626203315	484.25
18760	Apr.	16	8997399682	9,629.43
18761	Apr.	4	2128767424	488.69
18763*	Apr.	6	2328752882	398.99
[illegible]	Apr.	6	2328757351	[illegible]

Apr. 20
Apr. 3
Apr. 4
Apr. 16
Apr. 4
25,000.00
1,210.55

- So, the company's corporate accounts now showed the $25,000 contributions
- Our subject then needed to show that the contributions were invested in the plan
- Below is the doctored custodial statement showing the fictitious deposit and investment of $25,000

TRANSACTION DETAIL

[redacted]

[redacted]

- The subject would also prepare fraudulent reports-using QuickBooks or similar software-used by the CPA for reporting purposes

- The CPA prepared the 1120 and 5500 reports based on the monthly reconciliation reports provided by the company

Plea and Sentencing

- The subject pled to mail fraud, tax evasion and filing false documents required under ERISA

- The subject was sentenced to 38 months and is currently serving her sentence in FPC Alderson, a minimum security facility housing female offenders, located in the foothills of the Allegheny Mountains in West Virginia, on both sides of the Greenbrier River.

Subject Study # 2
The Plan Adviser

- The subject was an insurance agent who also provided retirement planning and administrative services to individuals and employer sponsored benefit plans (mostly defined contribution plans)
- He was born in 1949 and is married with no children
- He has no known drug or gambling addictions
- He has a fairly modest lifestyle
- Perhaps his only extravagant purchase was a 2010 Lancair Legacy Kit Airplane
- By the mid 2000s, he only had 4 clients – a dental association, a small manufacturing company, a doctor's plan, and a nursery
- These four clients were his only source of "income"

The Lancair Legacy FG kit plane on it maiden flight

The Scheme

- Client plans were established as defined contribution plans funded by employer contributions
- Employer contributions were maintained in pooled investment accounts
- Plan fiduciaries were to give investment directions except for limited participant elections
- The subject was not supposed to have discretion over plan investments
- Through his insurance business, client plans purchased annuities or life insurance for their investments portfolios
- As annuities matured, the subject would receive the proceeds, which clients thought were put in bank deposit type funds or used to purchase new annuities
- He prepared account statements showing funds with names such as short term fund, nearing retirement fund, QPI (Qualified Plan Investments)

The Scheme continued….

- The scheme began in the late 1990's when subject began taking plan money and investing it in Oil and Gas Limited Partnerships
- Investments were in his own name, not disclosed to plans and he did not share his initial profits with the plans
- Around 2000, he suffered large losses in oil and gas
- He began investing through a brokerage account in his own name using plan money –mostly invested in penny stocks and other thinly traded issues
- No luck there – investment losses exceeded $3 million by 2013
- Also diverted at least $1 million for personal use – made up for loss in income
- Cash flow from contributions was sufficient to make distributions
- Moved money between plans to cover any short fall

The Cover Up

- He controlled the information flow to the plans
- He created account statements showing investments
  - Statements had some legitimate investments
  - But statements showed fictitious investments in bogus annuities, CDs, or other investment funds called QPI (Qualified Plan Investments), Short term, etc.
- He prepared the Plan's annual reports, balance sheets and income statements
- Statements included fake returns on the made up investments
- Fraud was also buried in the liability side
  - Fake commissions and fees for products not purchased
  - Redemption charges reported for nonexistent annuities

Plan #1

[redacted] Association
Balance Sheet [redacted]
For All Accounts
As of May 30, 2013

ASSETS

Checking	
[redacted] State Bank Trust	$ 52,570.70
Total Checking	$ 52,570.70
Securities	
JHF: Global Fund B	$ 0.03
JHF: International Core A	1,435.75
JHF: International Core B	26,818.89
JHF: Large Cap Equity A	708.44
JHF: Large Cap Equity B	58.44
JHF: Small Cap Equity A	0.01
JHF: Small Cap Equity B	4,776.81
JHF: Small Cap Growth B	(0.01)
Total Securities	$ 33,798.36
Other investments	
Allianz Ins -- EIA Rh[redacted]	$ 26,947.71
Allianz Ins -- EIA S[redacted]	42,974.44
Total Other Investments	$ 69,922.15
Other assets	
Certif, renewed @2.05%	$ 25,826.26
Loan: [redacted]	3,145.92
Nearing Retirement Acct	272,304.57
OPI Fund I, shrt trm Ind	704,990.09
OPI Fund II, pend Distrib	35,000.00
Total Other assets	$ 1,041,266.84
TOTAL ASSETS	$ 1,197,558.05

Plan #1

Checking acct. in name of the TPA firm plus name of Plan – NOT trust account

FAKE ACCOUNTS

Plan #2

[redacted], Ltd.
Balance Sheet
For All Accounts
As of May 30, 2013

ASSETS

Checking	
[redacted] State Bank	$ 3,902.67
Total Checking	$ 3,902.67
Other investments	
S&P 500 Annuity: 0102-1	$ 78,881.35
S&P 500 Annuity: 0103-1	72,927.04
S&P 500 Annuity: 0105-1	67,050.70
S&P 500 Annuity: 0107-1	123,316.66
S&P 500 Annuity: 0108-1	27,353.24
S&P 500 Annuity: 0109-1	48,171.07
S&P 500 Annuity: 0110-1	84,357.69
S&P 500 Annuity: 0111-1	89,709.51
S&P 500 Annuity: 0112-1	79,399.29
S&P 500 Annuity: 0405-1	156,735.43
S&P 500 Annuity: 0406-1	169,646.23
S&P 500 Annuity: 0407-1	147,104.80
S&P 500 Annuity: 0407-2	112,642.16
S&P 500 Annuity: 0411-1	124,295.56
Total Other investments	$ 1,381,590.75
Other assets	
Fixed Interest/short term	$ 1,622,667.99
Loan to [redacted]	24,158.59
Loan to [redacted]	17,900.00
Total Other assets	$ 1,664,726.58
TOTAL ASSETS	$ 3,050,220.00

Plan #2

Business checking account in TPA's name

FAKE ANNUITIES

FAKE ACCOUNTS

Plan #3

[redacted], M.D.
Balance Sheet - [redacted]
For All Accounts
As of December 31, 2012

ASSETS

Checking		
[redacted] Bank [redacted]	$	0.00
[redacted] State Bank		2,311.74
[redacted] State Bank (2)		14,747.22
Total Checking	$	17,058.96
Other investments		
Americo Financial	$	0.00
CDs@ 1.15%apr - 12 mo.		50,575.00
Conseco EIA: 0N5[redacted]		0.00
Conseco EIA: 0N5[redacted]		29,395.12
Conseco EIA: A060[redacted]		145,566.11
Conseco EIA: RN50[redacted]		60,321.67
Conseco EIA: RN5[redacted]		71,590.12
Fidelity & Guaranty SPDA		0.00
NWL Group Dep. Admin.		0.00
Short Term Investments		212,277.46
USAA Mutual Funds		73,164.11
Total Other investments	$	642,889.59
Other assets		
Cash in Transit	$	0.00
Conseco Simple Index 9-02		0.00
Rec'ble: Co. Contribution		0.00
Texas Life: Ins Pol Value		48,478.28
Total Other assets	$	48,478.28
TOTAL ASSETS	$	708,426.83

Plan #3

Business checking account in TPA's name

FAKE ACCOUNTS

Plan #4

[redacted] Inc. PSP
Balance Sheet - Actual
For All Accounts
As of May 31, 2013

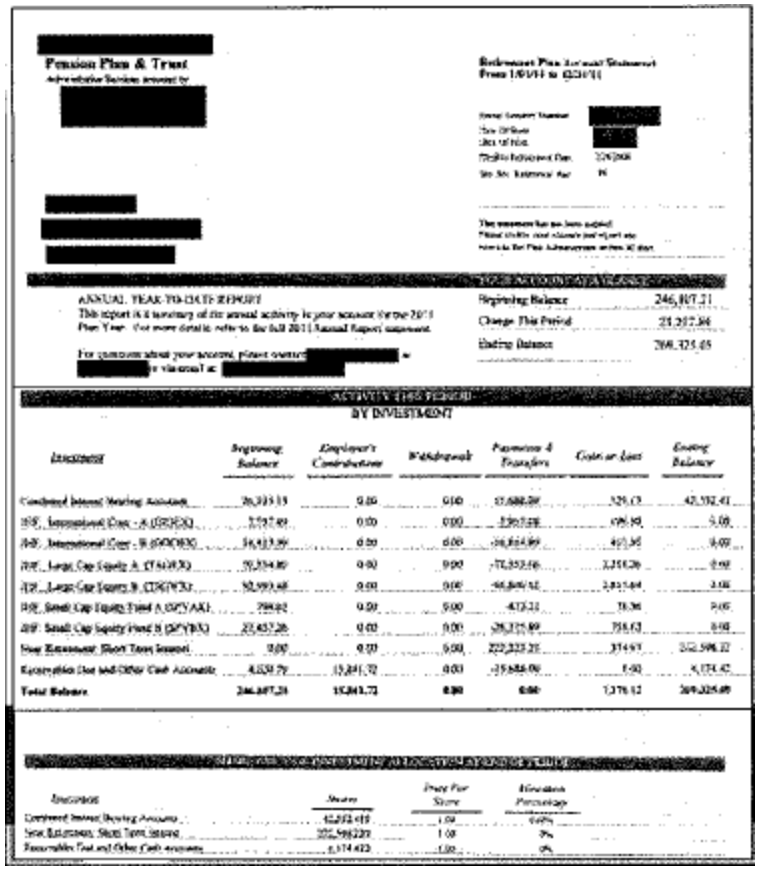
ASSETS		
Checking		
[redacted] Bank & Tr.	$	773.12
Other Investments		
EIA S&P500 issued 11/2005	$	51,226.63
Other assets		
Short & Intermediate Term	$	800,757.70
TOTAL ASSETS	$	852,757.45
LIABILITIES		
TOTAL LIABILITIES	$	0.00
EQUITY		
Participant Accounts		852,757.45
TOTAL EQUITIES	$	852,757.45
TOTAL LIABILITIES & EQUITY	$	852,757.45

Plan #4

Business checking account in TPA's name

FAKE ACCOUNTS

Participant Statement


Pension Plan & Trust

ANNUAL YEAR-TO-DATE REPORT

Beginning Balance 246,807.21

Change This Period 23,217.84

Ending Balance 269,325.05

BY INVESTMENT

Investment	Beginning Balance	Employer's Contribution	Withdrawals	Payments & Transfers	Gain or Loss	Ending Balance
Combined Interest Bearing Accounts	26,333.13	0.00	0.00	[illegible]	329.13	42,332.41
JHF International Core - A (JHIEX)	2,757.49	0.00	0.00	[illegible]	98.98	0.00
JHF International Core - B (JHIOB)	16,413.89	0.00	0.00	[illegible]	417.95	0.00
JHF Large Cap Equity A (JHLIX)	59,334.80	0.00	0.00	[illegible]	3,215.26	0.00
JHF Large Cap Equity B (JHLIOB)	92,993.68	0.00	0.00	[illegible]	2,815.64	0.00
JHF Small Cap Equity Fund A (JHVAA)	799.02	0.00	0.00	412.21	78.36	0.00
JHF Small Cap Equity Fund B (JHVBX)	23,457.28	0.00	0.00	[illegible]	756.63	0.00
New Economy Short Term Income	0.00	0.00	0.00	222,223.21	374.93	222,598.12
Receivables Due and Other Cash Accounts	4,559.79	15,841.72	0.00	[illegible]	0.00	4,174.42
Total Balance	246,807.21	15,841.72	0.00	0.00	7,376.12	269,325.05

Investment	Shares	Price Per Share	Allocation Percentage
Combined Interest Bearing Accounts	42,332.41	1.00	0.0%
New Economy Short Term Income	222,598.12	1.00	0%
Receivables Due and Other Cash Accounts	4,174.42	1.00	0%

- Trustee of Plan #1
- Money was safe in John Hancock funds
- Moved $ for safety
- Getting ready to retire
- Discussed with Subject
- He used $125K of her money to pay someone else

Inevitable Discovery

- In 2010 his largest client was sold to a new owner who wanted to terminate the plan and start a new one
- Our subject tried stalling tactics blaming the IRS and DOL for delay in termination
- Two of the other plan sponsors were no longer in business and should have been terminated
- Only one plan sponsor had been making contributions over the last few years
- Subject had been using that plan as the as cow for all the other plans
- No way to come up with more than $3 million in pending distributions
- Turned himself in, sent a letter to clients stating that he had lost their money investing

	Plan #1	Plan #2	Plan #3	Plan #4	Total
Plan Assets as Reported by Subject	$1,097,526.00	$2,508,161.00	$672,983.00	$741,056.00	$5,061,785.00
Actual Assets	$156,291.00	$3,903.00	$443,183.00	$53,536.00	$698,971.00
Loss	$941,235.00	$2,504,259.00	$229,800.00	$687,520.00	$4,362,814.00

Subject Study #3
The Investment Advisor

- The subject, 35, was a state-registered investment adviser
- Through his firm, the subject provided financial services including investment advice, portfolio management, insurance, real estate consulting and retirement planning
- He also acted as a third-party administrator for multiple 401(k) plans
- The subject offered three investment funds to prospective clients
- The Private Placement Memorandum represented to investors that he would invest assets in various entities including real estate ventures
- The PPM also provided that investors would receive secured notes and that the collateral would be the subjects personal assets
- The subject provided brokerage statements showing that he had $4.8 million in assets
- Investors leaned about the subject through word of mouth and through his TPA firm

The Scheme

- After the subject deposited investor funds into the subject's corporate bank account, he used a significant portion to pay interest or redemptions to other investors.

- The subject used the money for personal and business expenses, including payments on a new home, vehicles, office rent, payroll, country club dues and more than $300,000 to a sports team to market himself as their exclusive investment-service provider.

The Cover-up

- The subject represented that he had assets in brokerage accounts of $4.8 million. But the accounts belonged to advisory clients of the subject's company and another adviser with which the subject did business.
- The subject pasted his own name on some of the clients' statements.
- The subject acted as a Designated Representative (similar to a financial advisor) and Plan Administrator for his 401(k) plan clients.
- The subject initiated a total of twelve transfers from the plan's custodial account to his personal corporate account totaling $888,237.69.

Investment Activity

Investment Name	BEGINNING BALANCE	CONTRIBUTIONS	WITHDRAWAL	FUND TRANSFERS	FORFEITURE	LOAN INTEREST	GAIN/LOSS	CLOSING BALANCE
K3 BALANCED PORTFOLIO	$14,455.08	$5,250.02	$0.00	$0.00	$0.00	$0.00	$410.24	$20,115.32
OUTSIDE BROKERAGE ACCOUNT	$900,000.00	$0.00	$0.00	$0.00	$0.00	$0.00	$0.00	$900,000.00
Total:	$914,455.08	$5,250.02	$0.00	$0.00	$0.00	$0.00	$410.24	[illegible]

You must examine [illegible] statement carefully and promptly. You are in the best position to discover errors. If you fail to notify your Plan Sponsor in writing of suspected problems, more than 30 days after [illegible] statement are [illegible] the Plan Sponsor, their representatives and advisors will assume that the information presented is correct and are not liable for any claims resulting the information presented

Retirement Plan Change Form

1. Participant Information

Participant's Name (Last, First, Middle Initial) | Social Security Number | Date of Birth

Mailing Address | Company

2. Salary Reduction Election

Subject to the maintenance and installation of the Plan, I elect to defer the following amount of my current and future eligible compensation (i.e., wages, salary, etc.) into the Plan each pay period.

Self Directed Brokerage Account $ _____ Triple _____ % Future Contribution

4. Signatures

Participant Signature [redacted] Date 7/16/10

Plan Representative [redacted] Date 7/16/10

☑ Change existing portfolio allocation

Changes will apply only to your current balance. By using this form, you agree that your existing allocation will be transferred as appropriate to match this new allocation. For setting individual funds or shares, please call for assistance or log on to the Internet.

☐ Change future investment direction

Changes will affect only your new contributions going forward.

☐ Change both my existing portfolio allocation and my future investment direction

Self Directed Brokerage Account $ _____ Triple _____ % Future Contribution

4. Signatures

Participant Signature [redacted] Date 7/16/10

Plan Representative [redacted] Date 7/16/10

Plea and Sentencing

- The subject pled to mail and wire fraud as well as theft from an employee benefit plan
- He was sentenced to 10 years and is serving his sentence in the United States Penitentiary (USP), McCreary, Kentucky, a high security facility that houses male offenders, with an adjacent minimum security satellite camp also housing male offenders

Subject Study #4

The Employee of the Third Party Administrator

- In this case our subject was an employee of a third party administrator company that provided plan administration to numerous union sponsored benefit funds
- Employers contributing to the Fund, sent contributions to the TPA who deposited the contributions into a Fund bank account
- As part of the subject's duties, the subject was charged with administering the Fund, including making distributions to participants
- The subject would process benefits payments and issue a check with a rubber stamp of the trustees

The Scheme

- The subject copied 441 distribution checks payable to participants who had not actually requested their vacation benefits
- The subject then placed a label with the subject's name over real participants' names on the copied checks
- The subject then photocopied the falsified copied checks with cardstock check paper loaded into the photocopier
- This process made Fund checks payable to the subject while still showing on the Funds books as being paid to actual participants

The Cover Up

- The subject was able to avoid detection of the scheme by intercepting the vacation fund's account statements. She directed the receptionists to giver her the statements instead of the bookkeeper who was responsible for reconciling the account.
- When the subject had to turn over the accounts, several pages were missing as well as the cancelled checks paid to the subject.

The Plea and Sentencing

- The subject used the stolen funds for entertainment purposes including spending it on her husband's hobby, auto racing
- In the subject's plea, she stated:

  Started having major financial problems and marital problems[.] [T]his seemed to be a way to help. My husband left 3 days before Christmas for another women leaving me with our son. I had to go on 2 antidepressants & had 3 nervous breakdowns[,] been in therapy 2 times. This started 2008 and 2009. I took $ from the vacation fund and would deposit the checks into my acct[.] I worry every day about doing it to the point I don't eat or sleep anymore because feeling guilty and how to hide what I've done.
- The subject was sentenced to 6 months home detention. She was required to wear and electronic monitoring device
- The plan's fidelity bond paid over the losses

Subject Study # 5
Theft by Company Employee

- The Subject was a long term employee and senior manager of human resources for a large electronics firm as well as the plan administrator for the company sponsored health and welfare plan.
- The plan was self insured with stop-loss coverage.
- The stop-loss insurer would mail insurance payments to the Subject as plan administrator for reimbursement for covered claims.
- The Subject opened an unauthorized bank account in the name of the company's health and welfare plan but used his personal address on the account.

- The Subject failed to file a form 5500.
- The Subject deposited the insurance checks into that account over a number of years.
- The amount of theft was approximately $8 million
- The Subject used all of these funds to pay for personal expenses for himself and his family
  - For example, he used approximately $1 million to pay his personal credit cards and approximately $625,000 for a house in Vero Beach, FL.

Convictions and Sentencing

- The Subject pled guilty to health care fraud, embezzlement and money laundering.

- The Subject was sentenced to 57 months imprisonment and ordered to pay restitution of approximately $8 million.

Subject Study #6
Theft By Company Employee

- As the Vice President and Controller of a LLC Investment Advisory firm the Subject also acted as the Plan Administrator for the Company's 401(k) Plan (Plan).

- As Controller, the Subject was involved with the annual audit performed by the company's independent auditors, and Subject noted that those auditors never reviewed any of the retirement plan's records for activities which lead to Subject strategy for augmenting his income.

- As the Plan Administrator, Subject directed the custodians of the Plan's assets to make distributions totaling $386,711 to various fictitious entitles.

- At the same time, Subject employed the services of a nephew to establish bank accounts at different banks in the name of these fictitious entities and to deposit the distributions into those bank accounts.

- Thereafter, Subject withdrew funds from those accounts and used the money for Subject's own personal benefit.

Convictions and Sentencing

- Subject pled guilty to embezzlement from an employee pension fund.

- Subject was sentenced to 24 months imprisonment, 24 months of supervised release with conditions, $100 special assessment and $349,887 restitution.

Auditor’s Role

(and hints for plan sponsors)

Risk Analysis: Plan Environment

- Most controls lie outside the plan (at sponsor, TPA, or brokerage) – look at entire environment
- People involved in internal control at sponsor usually do it as a second job (low priority)
- SOC reports cover the provider entity, but don't mean the person handling your account is honest (you must test user interface controls)
- No one may review the overall plan operation regularly (failure to detect discrepancies between information from company, TPA, and broker)

Risk Analysis: Unique Risk Factors

- Terminated participants with undistributed balances are vulnerable to fraudulent payouts ("but you told us to clean up the plan…").
- Multi-employer plans pose problems due to unique set of internal controls in each participating employer's payroll system.
- Lack of segregation of duties at the sponsor level can defeat excellent TPA controls (creates ability for one person to create fictitious participant, or participant loan or withdrawal requests).

Procedures to address fraud risk

- Establish expectations and evaluate business reasons for unusual transactions
- Examine journal entries and other adjustments for evidence of fraud
- Insist on validating transactions, such as benefit payments
- Review accounting estimates for intentional bias
- Send participant confirmations
- Review personnel and payroll files

Procedures to address fraud risk

- Read the Plan document!
- Reviewing arrangements with third parties. Are the SOC 1 (SSAE 16) reports available?
- Ensure that benefit payments are made to plan participants; test eligibility for benefit payments
- Consider confirmation of benefit payments, especially if distributions appear large or unusual
- Review account activity for participants who have access to plan assets or for administering plan

Keep fraud on your radar….

Employee benefit plans are not immune!

- Who has knowledge of controls?
- Who has access to assets?
- Who has ability to override?

Questions?

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