

# PREVENTING BUSINESS FRAUD

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## Why It's Important to Investigate Tips— and How To Do So

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**B**ecause most fraud schemes are revealed not by normal auditing procedures but through tips and complaints, it pays to know what you can do to increase your ability to elicit such information—and what to do with it when it is received.

I recently attended the Association of Certified Fraud Examiners' Annual Auditors Fraud Conference in San Francisco. As one of the conference speakers, I had a captive audience of more than 200 attendees. So I asked them: "In your audit procedures, do you include interviews with the purchasing agent and the customer service representative?" Not one person did. My response: This should *always* be the case.

Why my emphatic insistence on these interviews? If a customer or vendor has a problem, who will most likely hear about it? The ZZZZ Best Carpet scam began to unravel when a customer complained. And, as the following story illustrates, one school board found that vendor complaints were only one of many red flags that a fraud scheme was going on in one of its departments.

**Bring in the sleuths.** We were engaged to perform a fraud examination for a large county school system which has more 2,000 employees and encompasses 37 elementary and secondary schools. Members of the school board had received tips concerning thefts, kickbacks, and other misconduct involving employees.

Although the school system's internal audit department and even the city's police department had investigated a number of these tips over the years, nothing had come of the investigations. But members of the school board believed that since questions of fraud remained, investigative help was needed.

**Following up on tips.** As is the case in just

about any fraud examination, one of my first steps was to interview the purchasing agent, Lisa Wren, who told me that a few months earlier she had received a disturbing phone call from Miguel Carlos, president of Carlos' Air Conditioning Sales and Services (as always, names and locations have been changed to protect the innocent and the guilty).

Miguel complained that even though his company was the low bidder to supply air conditioning and heating equipment to the school system, it continued to purchase a substantial amount of equipment from another supplier, Coldstuff, Inc. Miguel demanded (and he had every right to see) information about the school system's purchases from Coldstuff.

Lisa reviewed the purchase records with Miguel and saw that while there had been a number of purchases from Coldstuff, they had been classified as "emergencies" and, therefore, were exempt from state bid laws. These purchases had been approved by appropriate supervisory personnel in the school system's physical plant division and, as Lisa explained to Miguel, were legal.

But the situation continued to bother Lisa. She realized that 90% of the "emergency purchases" were not emergencies, but departmental efforts to go around the purchasing system and the state bid law. (I would concur that at most companies, the majority of such purchases aren't really emergencies.) Furthermore, Lisa showed me evidence that two purchases were apparently split into two orders to avoid the state bid law.

We shared these findings with Clark Lang, the school system's director of internal audit, who had investigated earlier suspicions of misconduct in the physical plant division, including kickbacks and conflicts of interest. But nothing had been proven and Clark had been criticized for his investigations—the physical plant division managers claimed he had a vendetta against them.

Still, questions remained. For example, relationships between vendors and key school system employees were cushy. Coldstuff's president was a neighbor of the physical plant division's supervi-

sor and the two men enjoyed fishing, hunting, and going to parties together.

Although Clark knew most fraud and corruption scams are uncovered by tips, he did not know how to elicit or investigate them. The internal audit department was known as "the nitpickers"; none of the other departments in the school system would volunteer information. And his audits were limited to reviewing the numbers to look for anomalies.

As a result, the information from the purchasing agent was the critical link that led to the exposure of this scheme.

Although Coldstuff had lost the contract, an analysis of the school system's records showed no decrease in purchases from the company. Investigations of these purchases, however, revealed invoices for which goods were never supplied—a scheme that had lasted more than five years and generated approximately \$50,000 in annual profits for Coldstuff.

Neither the physical plant supervisor nor Coldstuff would cooperate in our investigation. The supervisor was placed on administrative leave pending investigation by the district attorney. We concluded our exam upon the criminal referral.

**Lessons learned.** In any audit—internal or external—it is important to interview appropriate personnel, such as purchasing agents, to determine whether they have heard any complaints from vendors. When a tip is obtained, it is important to try to interview the tipster.

In such an interview, you want to obtain: more information about the parties committing the fraud; details concerning fraudulent transactions (dates, amounts, documentation); the names of others who know about the fraud; and information about whether the fraud is ongoing.

If the tipster remains anonymous, you must test the fraud allegations to determine if they are believable. Another technique many companies use is to send questionnaires to current or potential contractors and vendors indirectly

requesting information that could reveal any irregularities.

Ethics hotlines are an excellent means for eliciting tips and complaints (not to mention complying with the Corporate Sentencing Guidelines). Even though only about five percent of hotline calls result in serious fraud allegations, studies also show that hotlines can return as much as sixty times their cost. They also enhance employee morale—honest employees don't want to work with thieves.

Along with evaluating tips and complaints, there are several red flags that may indicate kickbacks or conflicts of interest. These include unexplained or poorly explained favorable treatment of vendors, vendor price hikes, increases in purchases from the suspect vendor, and gifts to or displays of wealth by the contracting employee.

For example, the annual income of the physical plant department supervisor at the school system described above could not support his travels and fishing boats. An analysis of emergency purchases would have revealed unwarranted and unexplained exceptions to purchasing procedures—all red flags indicating a possible kickback scheme.

Also beware of employees who are keenly interested in particular vendors (maybe even to the point of bending or breaking rules, such as those concerning emergency purchases), who engage in close socialization with particular vendors, who decline promotions to non-procuring positions, or who fail to file conflict of interest forms (disclosure of outside business). □

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