

FraudTrack 4: Criminal v Civil Investigation



Dear Reader

I am delighted to enclose the fourth edition of FraudTrack. This report is based upon the extensive research conducted throughout 2006 by BDO Stoy Hayward along with observations from our team's investigative experiences. You may be familiar with some of the findings following recent national and international press coverage of FraudTrack. With the escalation of fraud, the public interest and genuine corporate concerns are of little surprise to us.

I would also like to take this opportunity to introduce myself and our Fraud team at BDO Stoy Hayward.

I head up the UK fraud practice and I'm based in Leeds which is our centre of excellence in this field of work. I've been investigating fraud for over 23 years and in this time I have been involved with in excess of 100 financial investigations in over 20 countries.

Our team are adept at managing large scale national and international investigations and offer specialist guidance on fraud prevention strategy, particularly to leading corporates, banks (high street and private) and the public sector. Our team comprises experienced forensic accountants, forensic analysts and specialist computer forensic investigators. Our highly skilled digital data investigators ensure that the integrity of the data that

we capture electronically is intact for investigation and presentation at tribunal or court. We use the latest specialist software to standards set by the Association of Chief Police Officers (ACPO) and all our investigators are trained to law enforcement standards.

If you have any questions about BDO Stoy Hayward's Fraud services, or have any concerns that you would like to discuss confidentially, please contact me on 0113 204 1286 or email me at simon.p.bevan@bdo.co.uk

Yours sincerely

Simon P Bevan

Partner, Head of Fraud Service Unit



FraudTrack 4: Criminal v Civil Investigation



Fraud hits organisations for £1.37bn

Welcome to FraudTrack 4 BDO Stoy Hayward's fourth report into fraud in the UK.

In this edition I have endeavoured to compare and contrast our analysis of fraud in the criminal arena in 2006 with our experience of conducting civil investigations for clients.

In 2006 the value of reported business fraud shot up by almost 40 per cent to £1.37bn, yet another record year for fraud in the UK.

I hope you enjoy this edition of FraudTrack and that you have a fraud free year!

S Bevan

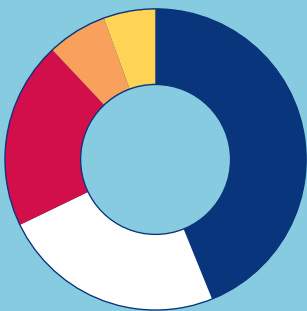
*Simon P Bevan
Partner, Head of Fraud Services Unit*



BDO Stoy Hayward

Criminal

Fraud value by industry sector



■ Public Administration
 ■ Non-corporate (individuals)
 ■ Transportation and Warehousing
 ■ Finance and Insurance
 ■ Others

We regard clients who have suffered such losses as victims, just as the person mugged in the street is a victim.

Why does a bank robber rob banks? The answer, so the joke goes, is: 'Because that's where the money is.' It's therefore not surprising that the financial sector is one of the sectors most at risk from fraud.

What is surprising is the amount of fraud in the transport and logistics sector: But then this sector tends to invest heavily in fixed assets such as freight planes, articulated vehicles and IT. In our experience, industrial sectors with a high fixed asset expenditure suffer more procurement fraud. Just look at the oil and gas industry and the advent of information brokers – people who sell inside knowledge to allow suppliers to win multi-million pound contracts.

Public perception of fraud

Business fraud attracts little public sympathy. Recently one of our clients lost £1.4m to fraud. The Company Secretary had been systematically siphoning the money from the company's bank account over a period of five years.

The fraudster is now serving a four-year jail sentence and her husband was given three years for laundering the money through his bank account.

Although this story made the headlines in the national press, it focused on the spending habits of the fraudster rather than on the potential threat to the company and to the jobs of fellow workers.

Time and motive

According to BDO Stoy Hayward's research the fraudster and her husband received lower than average jail sentences and the crime was also unusual as the majority of fraudsters are males.

The motive does however fit with our research. Greed and a lavish lifestyle were the main reasons for this fraud and these are by far the main drivers of frauds recorded during 2006.

We regard clients who have suffered such losses as victims, just as the person mugged in the street is a victim. Honest employees, directors and shareholders should be protected from fraudsters whether it is the police or BDO Stoy Hayward that investigates the crime.

Civil

In 2006 BDO Stoy Hayward's Forensic Accounting team investigated frauds in the following areas: housing associations, manufacturing, private banking, asset finance and commodity trading.

These areas mirror our own thoughts on what are currently the major risk areas in the commercial sector. It is worth noting that several areas are property related: historically we have noticed that property-related fraud tends to be committed when interest rates are low and the economy is booming, and that these frauds come to light as interest rates increase. A good analogy is that when the tide goes out you can tell who is swimming without their trunks on!

The major fraud risk areas appear to be:

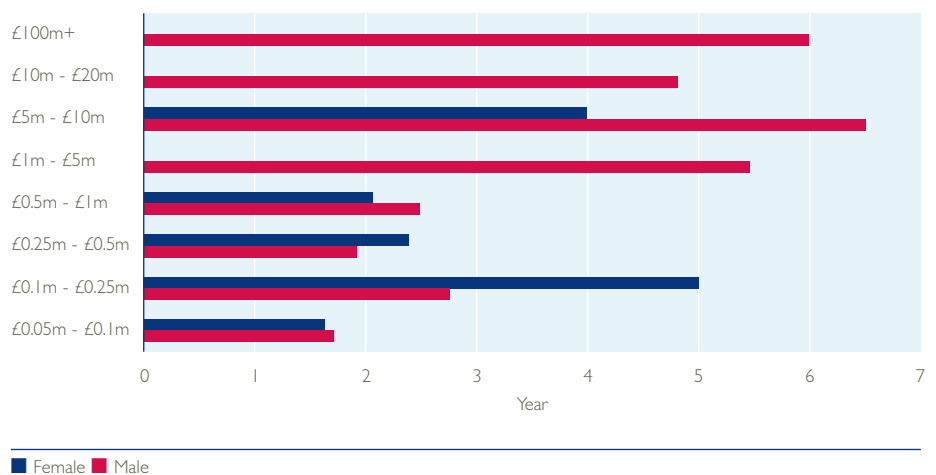
- development frauds in housing associations
- procurement fraud suffered by all industry sectors
- commercial lending fraud suffered by banks.

...maintenance and procurement frauds are all too common within housing associations.

Development frauds in housing associations

Housing associations are a very interesting sector. A number of housing associations would get into the FTSE 250 in terms of assets under their control. Some associations have more than 50,000 houses and spend hundreds of millions on maintaining them. It is no shock that over the past 15 years we have seen a steady stream of maintenance-related procurement frauds at housing associations.

Average custodial sentence by fraud value and gender



Criminal

It is important to remain detached during investigations and BDO Stoy Hayward is careful to avoid any personal interaction with the fraudsters apart from conducting interviews.

We have assisted many clients and helped them to recover assets that might otherwise have been lost to fraudsters. By taking quick and decisive action, a recovery may actually help to save a threatened business and the jobs it provides.

Companies that have lost out due to fraud must question whether it is worth reporting the crime to the police.

Police attitudes to fraud

Detectives investigating the case of the Company Secretary and her husband, described earlier, rather unexpectedly said that the couple were actually 'nice people' and that BDO Stoy Hayward were a little harsh in securing their assets!

This is not the general attitude, fortunately, although the capacity of fraud squads varies around the country. The police have a duty to investigate crimes that are reported to them but it is up to the discretion of individual forces how investigations are undertaken and the officers and time allocated to them.



Civil

Worryingly, recent investigations have shown that fraudsters have sought to place people in housing associations with the sole purpose of defrauding the organisation.

As associations have merged and become larger, they have started to become involved in activities with a higher risk profile: for example, land for a land bank before planning permission has been granted. This has exposed the associations to the same property-related fraud issues as those experienced by the commercial lenders.

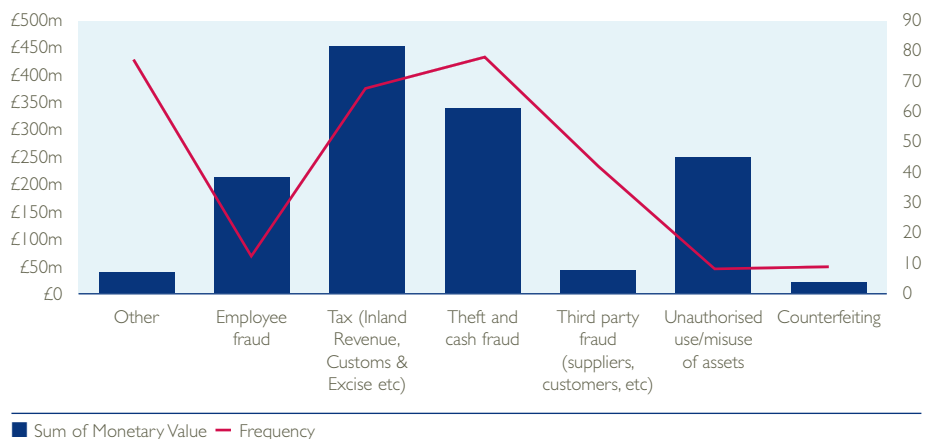
Considering the sums of money involved this is a major concern: the 2006 – 2008 National Affordable Housing Programme is worth £3.9bn. In our experience, approximately 20 per cent of an association's land/property purchases are overvalued. This represents a loss to the tax-payer in the region of £800m – enough to build ten hospitals.

We regularly see this sector being targeted by criminals: maintenance and procurement frauds are all too common within housing associations.

Worryingly, recent investigations have shown that fraudsters have sought to place people in housing associations with the sole purpose of defrauding the organisation. One assignment revealed that an employee – with a history of moving from association to association – was able to submit false invoices within the procurement systems and then intercept the payments.

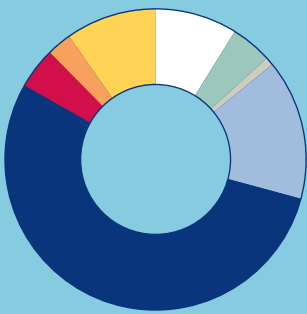
The same person then appeared to act as an 'honest broker' by bringing a parcel of land to the attention of the association. But, it transpired that the employee was attempting a back-to-back transaction, and in the process trying to pocket £200,000. Along with the procurement fraud above, this would have netted the fraudster over a quarter of a million pounds in the space of 12 months.

Total value + frequency of different types of fraud



Criminal

Motives



■ Debt
 ■ Divorce/Marital Problems
 ■ Drugs/Alcohol
■ Gambling
 ■ Greed/Lavish lifestyle
 ■ Health/Depression
■ Need/Unforeseen Circumstances
 ■ Other

Police forces say publicly that they will investigate cases but, in reality, fraud squads (or economic crime squads) simply do not have the resources to deal with a complicated fraud.

The police, like many public sector organisations, have targets set by the Government. Usually these are biased towards the safety and property of individuals and certain crimes in these categories may be decreasing. But this is generally the result of officers being redeployed from other areas, such as traffic policing and fraud investigation. With fraud there are regional variations: over the past year we have seen some police forces treat fraud with indifference whilst neighbouring forces investigate rigorously.

Companies that have lost out due to fraud must question whether it is worth reporting the crime to the police. Large frauds will attract media attention and vital business time could be lost during police investigations.

The importance of forensic accounting

Half of the evidence we obtain in our investigations is in electronic format. Keeping electronic evidence secure is now so important that the Tech 03/06 Insolvency Guidance Paper, highlights the need for an insolvency practitioner to consider how to deal with information held in electronic form.

In 1994 the average size of a computer hard drive was two gigabytes (GB). Today it is 120GB. What does that mean to the average business? A 1994 hard drive could store data that, if printed onto both sides of A4 paper, would have reached two thirds of the way up the Eiffel Tower. Nowadays the printouts would reach forty times the height of the Eiffel Tower. Equate that to a Storage Area Network that can easily store 50 Terabytes of data or 50,000GB and your printouts would be 16,666 times the height of the Eiffel Tower or the length of the Great Wall of China.

This is why forensic accounting experts are essential. Their forensic skills and the forensic software they use are crucial for capturing and investigating the vast amounts of digital data generated by companies. In other words; finding the electronic needle in the electronic haystack. Without the assistance of a forensic computer expert, the evidence needed to prosecute fraud cases may not be secured.

Civil

More surprising is the high incidence of fraud related to the purchase of IT hardware, software and consultancy services.

Procurement fraud

This type of fraud affects all industry sectors. But those sectors with the greatest spend on fixed assets are obviously most at risk. The oil and gas sector has been hit by large procurement frauds over the last three decades.

More surprising is the high incidence of fraud related to the purchase of IT hardware, software and consultancy services. The public sector and the banks have been particularly hard hit in this area for the simple reason that they spend hundreds of millions of pounds on IT services, and fraudsters target those areas where the corporate spend is the greatest.

A common method used by employee fraudsters involves awarding contracts to businesses secretly owned by family or friends. The services will be overpriced or may never even materialise. At the very minimum, companies should expect a full disclosure of any connection a manager has with a supplier. Either way, close family connections to a supplier, whether secret or not, will almost inevitably create conflicts of interest for even the most honest manager:

The spectrum of bribes and inducements offered by would-be suppliers to businesses may range from a 'free' lunch to holidays or high-value assets such as cars or use of yachts and holiday homes for no cost. We have also seen more basic human instincts catered for, with the provision of prostitutes for those making purchasing decisions.



Criminal

...the forensic computer team at BDO Stoy Hayward is trained to law enforcement standards set by the British Association of Chief Police Officers.

Although the burden of proof is less for civil offences than for criminal ones, capturing the digital evidence must always be at a criminal standard. If a civil investigation turns into a criminal one, and the capture of the digital evidence only met the civil standard, there is a grave possibility that the evidence would be inadmissible in court. This is one of the reasons why the forensic computer team at BDO Stoy Hayward is trained to law enforcement standards set by the British Association of Chief Police Officers.

Employee theft

One of the frauds tracked in 2006 involved a disgruntled employee who used his computer knowledge to steal the details of 12,000 credit cards from his former employer. The card details were then used to buy £750,000 of electrical equipment. Regular checks and a better incident response policy could have prevented this. Advice from our Forensic Computer team could have helped reduce the chances of this happening.

Ghost employees

Forensic examination of payroll data can reveal ghost employees, non-existent employees created by a member of staff for fraudulent purposes. In a case that came to light in 2006, a fraudster created 12 ghosts and stole £184,000 from the company in just under two years. Our forensic computer team have experience of checking these occurrences.

Civil

Commercial lending/asset finance

Interest rates have risen three times since the last quarter of 2006. Research by BDO Stoy Hayward has also shown that there are strong indications of further rate rises to come.

Such rises can lead to commercial lenders experiencing increased losses from fraud, due to factors such as:

- lending on overvalued assets
- corruption of lending staff
- internal personnel problems
- third party advisers being 'seduced'.

There are a number of warning signs that may assist lenders in spotting the early signs of fraud and other problems.

An unusually fast-growing loan portfolio could indicate that the bank is being targeted or that the calibre of lending officers is in question. While the increasing loans may be seen as a positive and profitable development, there may also be ticking time bombs ahead in the form of overvalued assets and lack of security.

Dominant individuals on the credit committee may also influence certain lending decisions to the detriment of the bank.

Other possible indicators of problems could include:

- incomplete security documentation
- employees who have left under a cloud
- use of the same solicitors and valuers
- overseas property not visited by bank staff.

Awareness of these issues seem like simple 'common sense' but we have seen a number of frauds where that common sense has been lacking.

Investigations into frauds on commercial lenders can generate substantial recoveries for the victims. It is worth resisting the attraction of immediate litigation in favour of a preliminary investigation. Without that the fraud uncovered may only be the tip of the iceberg.

There will always be lessons to learn from losses due to fraud. Awareness of those previous losses and understanding gained from previous frauds should inform future lending decisions.

Investigations into frauds on commercial lenders can generate substantial recoveries for the victims.

Sample

FraudTrack 4 is prepared by BDO Stoy Hayward and is based on all reported fraud cases of over £50,000 during 2006. The sources for the database are publicly available and include the UK's national, regional and local press. The data represents 295 cases of fraud with a total value of £1.37bn.

Additional research was conducted for BDO Stoy Hayward by leading opinion polling firm YouGov in October 2006. 265 Financial Directors were surveyed in order to discover their attitude to fraud.

To view more of our fraud analysis in 2006 please visit:
www.bdo.co.uk/fraudtrack

Defining fraud

Breach of regulations: wilful violations of laws or government regulations that are integrity-related.

Employee: employees by themselves or in collusion with customers or suppliers, perpetrate fraud against the company, resulting in financial loss.

Financial misstatement: management and/or employees issue misleading financial statements with intent to deceive stakeholders and the external auditor.

Non-corporate: individuals or entities who commit a fraudulent act against another individual, resulting in financial loss.

Tax: individuals or entities who commit fraud against HM Revenue & Customs or other tax related government departments.

Third party: individuals, suppliers or customers acting by themselves who commit fraud against an organisation, resulting in financial loss.

Unauthorised use: use of the organisation's physical, financial, information and other assets for unauthorised or unofficial purposes by employees or others resulting in a loss of competitive advantage.

Defining employee fraud

Procurement frauds typically involve an employee rigging the tender for a contract in return for a bribe or placing orders with businesses in which they have a secret financial or family connection.

Payment frauds involve payments, whether for real or false bills, being diverted to the fraudster.

Revenue diversion frauds typically involve payments to the business being intercepted by the fraudster, who then destroys evidence that the money is owed (eg by erasing the original invoice or even running a business within a business).

Cheque fraud is usually where a cheque or other negotiable instrument contains a forged signature or where the amount payable or payee has been altered.

Payroll fraud typically involves an employee creating ghost workers on the company's payroll and diverting their salaries to their own or an acquaintance's account.

Expense fraud involves claiming for fictitious expenditure, exaggerating genuine expenses to the company or claiming personal expenditure.



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