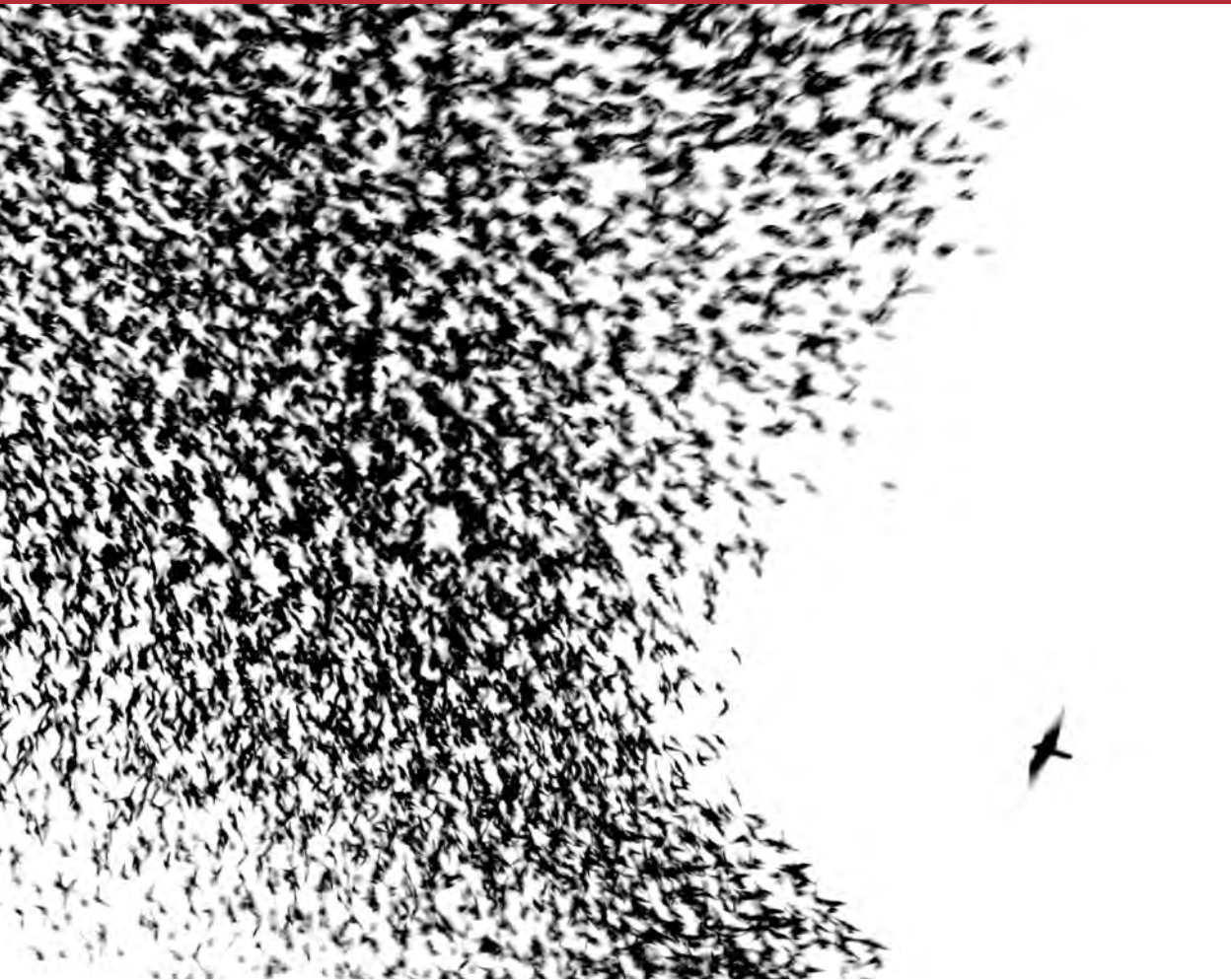


Serious Economic Crime

A boardroom guide to prevention and compliance



With contributions from leading advisers and featuring introductions from:



THE WORLD BANK

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Forensic accounting and serious economic crime – ‘follow the money’

Toby Duthie, Partner, and Frances McLeod, Partner **Forensic Risk Alliance**

Bob Woodward: The story is dry. All we've got are pieces. We can't seem to figure out what the puzzle is supposed to look like ...

Deep Throat: No, heh, but it's touching. Forget the myths the media's created ... The truth is, these are not very bright guys, and things got out of hand.

Bob Woodward: Supposedly he's got a lawyer with \$25,000 in a brown paper bag.

Deep Throat: Follow the money.

Bob Woodward: What do you mean? Where?

Deep Throat: Oh, I can't tell you that.

Bob Woodward: But you could tell me that.

Deep Throat: No, I have to do this my way. You tell me what you know, and I'll confirm. I'll keep you in the right direction if I can, but that's all. Just ... follow the money.

All The President's Men (1976, Warner Brothers Pictures)

Forensic accounting is central to investigating economic crime. It falls into two broad categories: establishing, assessing and analysing the fact patterns and data of an economic crime; and quantifying the financial and economic consequences of the event. It can be utilised reactively (in response to a regulatory inquiry) or as a preventive measure (in other words, compliance or internal audit functions). Typically, the task involves identifying and establishing the credibility of evidence and, in this context, ‘following the money’ is often pivotal – dividing real events from conspiracy and innuendo.

In this chapter we look at how forensic accounting is used, what it can do, what it cannot do, and what developments are in the pipeline.

Investigation: the proof is in the financial data

Allegations can be sweeping and amorphous in character at the outset of a financial accounting investigation, but the factual proof of an economic crime is typically found in the financial data and the surrounding documentation. Therefore, a key task is to identify, collect, verify and analyse the financial facts.

The places to look include accounting databases, annual reports, management accounts, bank records, market data, contractual documentation, correspondence and testimony. The nature of serious economic crimes varies – bribery and corruption, investor and market fraud, money laundering, anti-trust violations, procurement fraud – but in all cases the forensic accountant

looks to collate the financial facts and pull together an empirically based story on what actually happened, or did not happen, from the perspective of the financial transactions.

Furthermore, while the law may change significantly from jurisdiction to jurisdiction, the fundamental financial, accounting, business and economic principles remain constant in most cases, subject to local nuance. The way accounting records are compiled and details recorded for individual transactions is typically based on common practices.¹ Bank transfers are cleared in similar ways whether in Switzerland, the UK or Russia. Financial instruments (even complex ones) tend to follow international commercial standards – and, if they do not, red flags are raised.

The forensic accounting process can therefore help to provide a comprehensive factual overview of financial events overall and across borders – for example, how much was paid to whom, over what period and in respect of what, and how was it authorised and accounted for?

Investigation: coping with expanding data and increasingly complex cross-border transactions

Amid the globalisation of the economy and increasingly sophisticated financial structures, the skills and experiences of the forensic accountant have had to broaden beyond pure accounting work to include, for example, IT, banking and capital markets, as well as specific industry sectors.

Cross-border aspects complicate matters in terms of the legal obligations and restrictions, cultural differences and logistics. The forensic accounting team may need to operate in conflicting legal environments, in multiple languages and cultures, and to reconcile and analyse data captured from disparate accounting systems, in different formats and according to varying processes.

These challenges can be exacerbated in cases involving companies that are acquisitive and/or multinational. Accounting systems, in particular, are rarely – indeed, almost never – fully integrated or operated consistently, especially if the

investigation stretches back over a number of years. Furthermore, depending on the scope and type of investigation, it may be necessary to mine data from various ‘non-accounting’ databases, such as the supply chain/procurement, asset management, logistics and payments. Data and personnel mapping is extremely important to ensure evidence is being properly identified, collected and preserved. A clean audit trail is essential, and is greatly enhanced through the proper use of technology to mine today’s vast sets of financial data. The upside of increased data volumes is that they should improve the scope and reliability of the analysis.

Often there are legal considerations around the gathering of evidence. Whether it is via electronic data or interviews, local laws relating to blocking statutes, data privacy, employment, bank secrecy etc need to be understood and adhered to. It is also essential to recognise potential legal conflicts as early as possible so that one country’s law is not breached to comply with that of another.

Investigation: establishing the reliability of data

Financial data often lies at the heart of an effective response strategy as it can empirically counter or support the credibility of the innuendo and implications contained in documentation and testimony. It is important, depending on the context, to drill down to, and distinguish between, the types and credibility of evidence; just because an accounting system records that a payment was made does not mean that it actually was – bank payments can be returned, journal entries reversed, credit notes issued, off-book transactions made, and so on. The faster the net benefit and associated cash movements can be established, the better. Equally, the more empirical and comprehensive the data (and the audit trail), the more reliable the analysis and findings will be.

These activities assist with the creation of a factually accurate narrative, on which key legal responses can be founded. It is also worth noting that databases can be especially interesting sources of information, as often the users themselves have

limited (or no) ability to delete current or historic information.

It is also important to test, benchmark and ‘sanity check’ the data universe – to understand and rank the scope, scale and reliability of the data. This can, in part, be done by reconciling data with third-party sources – for example, shipping documentation, bank statements and audited financial records – where available. It may also be sensible to run some statistical analysis on the data by sector, date ranges, geography etc to test the credibility and completeness of the information.

Compliance analysis, pre-emption and remediation

Forensic accounting can also pre-empt crime. Specifically, it can assist in the assessment, testing and enhancement of a company’s compliance policies and controls.²

The quality, effectiveness and suitability of financial controls – as well as the quality of staff charged with maintaining the controls and actual practice on the ground – is an important assessment run in tandem with the analysis of the financial data.

The nuts-and-bolts review of high-risk transactions identified by a combination of algorithmic queries and best judgement provides a good test as to the extent to which a company’s written compliance policies and controls are (a) sufficient and (b) adhered to. These algorithms can also be used to identify transactional samples of high-risk areas. This kind of controls testing can help provide an insight into which departments, offices and individuals were involved in the underlying transactions (from initiation to approval and payment).

Forensic accountants have long assisted companies in overhauling their controls and compliance infrastructures to pre-empt economic crimes, but that role is particularly important now in the context of the UK Bribery Act 2010. The risks are significant under the new legislation and may be based on payments that are unlikely to be material in the context of a company’s operation. These will not necessarily be picked up by an internal audit, or the external auditors in their assessments of financial statements.

An adequacy review of a company’s policies and internal controls should involve a top-down (industry, country, sector etc) analysis, along with a bottom-up analysis of the financial data, as outlined above. There should also be a review of key account codes, cash usage, procurement policies etc.

Higher-risk areas are typically subject to tighter controls, which can mean that areas where risks are perceived to be lower may be more prone to abuse. It is essential to develop a system of risk mapping that works across the board and for the controls to be adjusted to facilitate easy and efficient testing as part of a company’s various audit functions. This can be especially relevant in matters that involve so-called ‘books and records’ charges – where the key to the prosecution’s case is a breakdown in controls rather than an actual transgression – and in matters where the defendant needs to prove a negative, such as “I didn’t bribe that person” or “I didn’t launder money”.

Understanding the operational context is essential in compliance reviews, and will often require and benefit from local- and/or industry-specific knowledge – say, customs practices in Nigeria or capital markets pricing in Austria – and specialist advice either from within the forensic accounting team or from outside experts. Invariably, it will also require that the forensic team establishes a rapport with the company’s financial and accounting staff, who often, knowingly or unknowingly, point the way.

Penalties and confiscation

Forensic accountants should always be part of the discussions and calculations relating to penalties and confiscation – the forced surrender by wrong-doers of their illicit gains. Confiscation is also intended as a deterrent to future violations and, implicitly or explicitly, it lies at the heart of most regulatory action.

The forensic accountant’s job is to calculate the scale of such gains, taking into account the related economic and financial arguments that may increase or decrease this sum. What a company or individual may or may not have gained from an

economic crime is usually not a straightforward arithmetic calculation; consideration will also need to be given to factors such as the nature of the crime, the period over which the gain was realised, how it was realised, whether costs or related losses could be deducted (and then what type of costs), and the ability to pay. This will become more involved the more complicated the crime and the larger and more complex the corporate defendant.

In certain jurisdictions, such as the United States, disgorgement calculation is a well-trodden, but still somewhat arcane path. For example, sentencing guidelines exist in the US and are seemingly adhered to, but precise calculation methodologies are not published (unlike with judgments, settlement agreements and deferred prosecution agreements) and a great deal of prosecutorial leeway is allowed. The US courts tend not to object to the majority of settlements reached by the Securities and Exchange Commission and the Department of Justice.

Fines and asset recovery in criminal and civil proceedings: recent trends in the UK

In the UK, this area is currently in flux. Forensic accountants are retained typically to play a central role in the calculations that form the basis of:

- **civil recovery orders (CROs)**³ under Part 5 of the Proceeds of Crime Act 2002 (POCA). These allow a court to order the return of property that is established to be the proceeds of ‘unlawful conduct’. Although CROs were first introduced in 2002, they have only been available to the Serious Fraud Office (SFO) since April 2008,⁴ opening a door to defence solicitors seeking alternative ways to conclude SFO investigations into companies
- **confiscation orders** under Part 2 of POCA. These are obligatory once a criminal conviction has been made by a judge sitting in a crown court. They are designed to prevent offenders from benefiting from the proceeds of their crime, and achieve this by confiscating an

amount equivalent to the ‘benefit’. It is normal SFO policy to apply for a confiscation order once a conviction has been secured, unless there are compelling reasons not to do so. The confiscation regime is recognised to be both complex and severe, limiting any judicial discretion that might soften its effects. A confiscation order is limited to the assets still available for confiscation,⁵ and here the need for qualified forensic accountants is apparent.

In tension with this new trend towards American-style negotiated settlements was the decision in the 2010 case of *R v Innospec Ltd*, where the UK-headquartered and US-listed chemicals company was accused of bribing officials in Indonesia to prolong the use of lead-based fuel in cars, as well as of paying kickbacks to the Iraqi government in respect of the United Nations oil-for-food programme. This was the first example of a global settlement in respect of criminal proceedings in both the UK and US. In *Innospec*, the court held that under current procedural rules, the SFO had no authority to enter into agreements with offenders as to the penalty for an offence. The judgment emphasised that sentencing rested with the court and not with the SFO through global settlement agreements or plea bargains.⁶

Similarly, in Southwark Crown Court’s December 2010 review of the BAE Systems settlement in a case involving a military radar deal with Tanzania, the plea bargain between BAE and the SFO, concluding a six-year corruption investigation, was attacked as “loosely and perhaps hastily drafted”. Handing down a £500,000 fine and £225,000 in costs, Mr Justice Bean said he was “surprised” the prosecutor had given BAE indemnity for all past offences, disclosed or otherwise, as part of the deal.⁷

Given the above, there is, as yet, no legal certainty (or even a balance of probabilities) or economic incentive that might encourage a company to co-operate or self-report with the authorities. In most cases, the corporate body and its shareholders, should they become involved in

economic crime, are not criminal enterprises per se in the same way that a drug dealer is, for example.

From a financial perspective, it makes sense that the benefit derived from any illegal act should be measured in terms of profit (or even incremental profit) rather than total revenue. It would also make sense to allow the prosecutors leeway to broker deals and arrange for discounts to take into account various legal, procedural and economic factors (affordability, debarment, level of co-operation).

As is frequently the case in the US, though more rarely if recently in the UK, the concept of a profit-based confiscation should be the preferred path. In this context, the forensic accountant adds a great deal of value in terms of setting out the various profit scenarios over time and the relevant deductions that should, or should not, be considered. Technical issues dictated by legal argument, such as statute of limitations and jurisdiction, may also feature in the profit calculation.

Conclusion

The key benefit of forensic accounting in the context of economic crime is the capacity to identify, analyse, test and present financial evidence. The more empirical and impartial the analysis, the more reliable the evidence. Globalisation and growing data volumes have introduced a clear need for strong IT skills, as well as an understanding of how to operate across jurisdictions and in various cultures. These tools are valuable in terms of reaction (regulatory responses and litigation), prevention and confiscation, and need to be part of the core forensic service.

We foresee greater cross-border co-operation and information-sharing between the enforcement agencies and a greater desire in many jurisdictions to use an American-style model based on plea agreements, prosecutorial leeway, confiscation of profits, individual prosecutions and whistleblowers. But equally, the disparities between the different penalty regimes make global settlements very challenging from an economic perspective, as well as a legal one. We assume this will have to be addressed in some way or other so

that corporate double (triple and more) jeopardy in the context of follow-on investigation and litigation does not become common and result in companies paying out repeatedly to various authorities for the same offence.

We also foresee a growing awareness among companies of their exposure to such risks through their supply chain, joint ventures, and mergers and acquisitions activity. In many sectors, this has already led to the merging of ethical and commercial interests as companies vet themselves and their business partners.

Some companies are starting to adopt a more integrated approach to compliance reviews: rather than periodic reviews and sampling, they are trying to look at all of the data all of the time. They use their IT systems and databases to highlight irregular, high-risk transactions as they are processed, to enable intervention before the transactions can be completed. This has some significant positives:

- **greater coverage of transactions.** For example, it is easier to collect, review and analyse data in large volumes of individual transactions
- **the ability to stop high-risk transactions,** pending further authorisation
- **100 per cent transactional testing.** The ability to review and analyse individual transactions is a core requirement, increasing the scope and scale of the testing and therefore the reliability of the analysis
- **lower review costs** resulting from a standardised and automated process
- **illicit activity** tending to diminish as employees and business partners come to understand that the likelihood of their being able to hide something is diminished.

However, experienced forensic advisers look set to remain highly valuable. Even large companies are unlikely to have sufficient experience of economic crime, and regulatory enforcement actions, to equip them with the comprehensive knowledge gained by a forensic adviser through repeated exposure to such situations.

Notes and references

Chapter 28. Forensic accounting and serious economic crime — ‘follow the money’

(1) We recognise that accounting principles and standards deal with how individual transactions are aggregated, and how transactions that are not yet completed are valued. While there are seemingly irreconcilable differences between the differing standards in different jurisdictions, at their heart individual transactions are all accounted for in similar ways. Moreover, many countries use or are converging on the International Financial Reporting Standards (IFRS), established and maintained by the International Accounting Standards Board. In some countries, local accounting principles are applied for regular companies, but listed or large companies must conform to IFRS. As a result, statutory reporting is increasingly comparable across jurisdictions.

(2) In the context of serious economic crime, the forensic accountant’s work will involve pre-emptive, as well as reactive applications – good housekeeping, as well as pre- and post-acquisition due diligence work. Prevention or early identification can prove especially valuable if the potential for successor or vicarious liability exists.

(3) A CRO is a civil remedy and is therefore subject to the civil standard of proof. It can therefore be used in situations where the subject cannot be brought to trial, or has been acquitted, or there is insufficient evidence to obtain a criminal conviction. As such, the CRO can be used as a means of settling bribery charges without the need for a criminal trial. For a civil recovery order to be made, the claimant agency (in this case the SFO) needs only to establish (a) that criminal activity has taken place; and (b) that the funds which it seeks to recover represent the proceeds of such crime.

(4) The SFO first used its new asset-seizing powers on October 6, 2008, when construction group Balfour Beatty agreed to pay £2.25 million under a

CRO agreed with the SFO over ‘payment irregularities’ in a joint venture in Egypt.

(5) The problem is that the starting point for confiscation is benefit, which is not profit but revenue. At least that is the case law to date. In the UK Court of Appeal case *R v Del Basso* in 2010, Luigi Del Basso and a colleague ran a lucrative long-term car park service at London’s Stansted airport on land owned by Bishop’s Stortford Football Club. Unfortunately, they operated without planning consent for several years, and failed to comply with a series of enforcement notices. The parking scheme was eventually closed down; the defendants pleaded guilty and were fined.

Confiscation proceedings under POCA began, and the main issue became how the business’s operating costs should be treated for the purpose of calculating ‘benefit’. The revenue received from the illegal parking was £1.88 million. The defendants, however, spent significant money operating the scheme, including paying rent and taxes. Deducting these costs brought the net profit to just £180,000.

The Court of Appeal rejected arguments that confiscation should be based on what the defendants actually made net of all expenses. Rather, it relied on the wording of the statute that deals with the total value of the property or advantage obtained, and made a confiscation order for the full £1.88 million.

(6) Lord Justice Thomas at Southwark Crown Court also indicated that criminal cases involving corporate defendants should be resolved by criminal proceedings, not civil recovery proceedings, and that the level of fines should be much higher than those currently handed out.

(7) The fine concluded an inquiry into payments of £8 million to businessman Shailesh Vithlani in the run-up to a £28 million military radar contract for Tanzania. It was to be paid out of the £30 million compensation fund for the Tanzanian people, agreed as part of a US-style plea bargain between BAE Systems and the SFO.

Forensic Risk Alliance

Third Floor, Audrey House, 16-20 Ely Place,
London EC1N 6SN
Tel +44 20 7831 9110
Web www.forensicrisk.com

Toby Duthie

Partner

Email tduthie@forensicrisk.com

Toby Duthie is one of co-founders of FRA and heads its London office. With experience in cases involving government enforcement in both the UK and the US, his expertise lies in internal and regulatory investigations, data protection and complex financial modelling, with particular experience in global, multi-jurisdictional cases.

Mr Duthie was instrumental in the development of FRA's service in the anti-corruption and white-collar defence arena across Europe. He spent more than five years in the US gaining extensive experience advising on damages amounts in a number of complex civil and criminal litigations and in connection with a number of high-profile FCPA enforcement actions (relating to, for example, Panalpina, Bonny Island LNG and oil-for-food). He has also worked on matters involving the UK, Swiss and French regulators.

His experience spans a number of areas. He has worked on pre- and post-acquisition due diligence for a number of multinational corporations. He has provided damages modelling and prepared expert reports relating to a dispute involving the acquisition of a major financial institution. He has advised on trust fund and restitution work for the International Criminal Court, involving all aspects of document and evidence management, reparation processes, asset identification and seizure.

After graduating from University College London, Mr Duthie worked for two years as a steel trader in Hong Kong and China. He then moved to the investment banking division of Deutsche Bank/Morgan Grenfell, where he focused on infrastructure finance and structured trade finance.

Forensic Risk Alliance

170 Westminster St, Suite 200, Providence, Rhode Island 02903
Tel: +1 401 289 0866
Web www.forensicrisk.com

Frances McLeod

Partner

Email fmcleod@forensicrisk.com

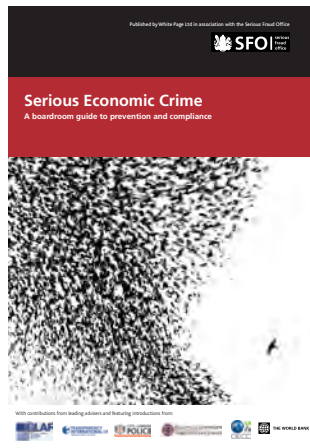
Frances McLeod is one of the co-founders of FRA and the Managing Partner. She advises diverse clients on anti-corruption (FCPA/OECD/ Bribery Act) issues in terms of response to internal and external investigations, in a compliance context, and in related civil and criminal litigation in a variety of jurisdictions. Having lived and worked in the developing world, the US and Europe, she has first-hand experience in balancing regulatory demands with the working practices of G7/G20 and emerging markets.

In addition, she advises a number of European clients on data protection, privacy and related matters in the context of US-driven discovery requests, with an emphasis on providing practical solutions that balance potential conflicts of law.

Ms McLeod was responsible for the design and implementation of the claim-evaluation and administration systems of the US\$1.3 billion Swiss Bank and US\$2.5 billion German Slave Labor Holocaust settlements advised on by FRA. In order to develop appropriate systems for such complex and challenging claims, she drew on her experience in banking, evaluating long tail liabilities, corporate and banking/insurance archaeology, forensic accounting and asset tracing.

She has been involved in advising all of FRA's clients responding to the oil-for-food investigations in respect of their investigative and forensic accounting needs – from contributing to the formulation of strategy, presenting complex financial analysis and data, electronic and other discovery, to conducting an evaluation of the database system that underpinned the whole oil-for-food programme, and preparing witnesses for interview. Drawing on experience gained in the Swiss Bank investigations, Ms McLeod was instrumental in finding solutions for a number of clients to allow for the presentation of analysis in a manner that was not in breach of Swiss banking secrecy and/or the Swiss Criminal Code.

After graduating from Oxford University with a Masters degree, she spent six years in investment banking working in the M&A divisions of Lazards and Schroders in London and of HSBC in Indonesia.



Published by White Page Ltd in association with the Serious Fraud Office, Serious Economic Crime's primary purpose is to give board-level readers in the UK and international businesses informed commentary on the impact of UK anti-fraud and anti-corruption legislation. As the scope of this legislation continues to expand and interact more with the legislation in other jurisdictions, so the landscape for best-practice compliance and fraud prevention has become increasingly complex. The wealth of expert insights from lawyers, accountants and specialist anti-fraud consultants in this publication's 36 chapters is therefore an invaluable resource.

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