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# Your City's AUDIT



## INVESTIGATION

# Fraud Investigation: How to Survive It

By Gregory A. Gadawski, Heidi Bowen and Mark P. Amberg

It is difficult to read the news nowadays without seeing a story about some type of white collar crime or fraud that was uncovered. Unfortunately, cities are not immune to these crimes, which include anything from bribery and corruption to embezzlement and everything in between. For city leaders, it is imperative that they are cognizant of such potential crimes and know what to do when they occur.

Municipal employees are stewards of public funds and assets. Therefore, all known or suspected fraud should be investigated to the fullest extent. But what does this mean? Who should conduct the investigation? What will the investigation entail? And what happens after the investigation is completed? This article will examine all of these issues and provide some general guidance on how to approach a fraud investigation should one be warranted.

### The Discovery

Once a potential fraud is discovered, it is important for the city to move quickly with a series of critical decisions. The success of the investigation may hinge on prompt attention to and prudent deliberation of these decisions. To facilitate this process, the city should appoint one or two high-level individuals to oversee the investigation. It is also imperative that the city involve and consult with qualified legal counsel and a qualified fraud investigator right away since investigations of this nature will involve numerous legal and investigation strategy issues that can only be addressed appropriately in consultation with qualified experts. The individual or individuals selected by the city to oversee the investigation should serve as the primary point of contact for legal counsel and the fraud investigator.

The city will face two primary concerns upon the discovery of potential fraud: stopping further losses or damages, and securing the relevant evidence. These two tasks should be addressed simultaneously.

### Stopping Further Losses

Considering the potential for further losses or destruction of evidence, the city will have to decide what to do with the suspect. The decision should be carefully deliberated with the city's legal counsel, fraud investigator and insurer. Legal counsel will insure that the city acts within its rights and does not expose itself to potential legal action. The fraud investigator should provide advice regarding the probability of further damage and the ability to obtain additional evidence from the suspect.

### Audits vs. Fraud Investigations

**Financial Statement Audit** - Conducted annually, pursuant to ORS Chapter 297 (see article on page 12), auditors are primarily concerned as to whether the financial statements present fairly, in all material respects, the financial position of the entity and the results of its operations. Consideration is given to fraud but detecting fraud is not the primary objective.

**Compliance Audit** - Conducted often as a requirement in a grant agreement or other directive. For example, cities that receive significant federal assistance may be required to have a Single Audit or OMB A-133 audit.

**Fraud Investigation or Forensic Investigation** - Investigation of alleged illicit acts with the purpose of obtaining evidence to prove or disprove that fraud has occurred.

A decision must be made whether to suspend the suspect or to try to conduct the investigation quietly behind the scenes while the suspect remains in place. There may be good reasons for either option. However, if the suspect is kept in their position, it creates a greater urgency to move quickly and confidentially to minimize further harm. The suspect's actions must be closely (and discreetly) monitored. If the suspect believes they have been caught, they may begin to destroy evidence or alter records.

If the decision is made to terminate or suspend the suspect, all city property must be immediately seized from the suspect. This includes all portable devices—laptops, tablets and cell phones. The suspect should be escorted from time of termination until exiting the building to ensure that no city property is taken or destroyed. Immediate changes should be made to access rights, passwords, key codes, remote access, signing authority, etc. to protect the city's assets from further loss.

Finally, it is important to notify other employee personnel. Rumor and gossip will overtake the workplace unless the city addresses the noticeable absence. Legal counsel should be consulted regarding the appropriateness and timing of said disclosures.

## Securing Evidence

After securing documentary evidence from the suspect, the city should work with legal counsel and the fraud investigator to establish an appropriate chain of custody for the evidence obtained throughout the investigation. A sufficient chain of custody is imperative for any criminal prosecution.

Electronic records also need to be maintained and secured. Depending on the nature of the fraud, this may require the assistance of a computer forensic analyst. A backup image should be made of the suspect's hard drive and other electronic devices. If the city uses a rotating backup of its server, then a current copy of the backup should be removed from the rotation and kept in a safe place. If possible, critical electronic evidence should not be accessed until a validated backup has been completed.

## Investigation Goals

It is imperative that the city, the fraud investigator and the city's legal counsel confer regarding the ultimate goals of the investigation. Is the city primarily concerned with recovering its losses? Is the city determined, evidence permitting, to prosecute the suspect to the fullest degree of the law? Is the city concerned with conducting a full investigation in the interest of public disclosure? How much is the city willing to spend to accomplish these objectives? These are all questions that should be answered before the investigation begins.

## Civil vs. Criminal

It is important that the city understands the difference between civil and criminal investigations. If the city merely retains a fraud investigator, they are conducting a civil investigation. If the city notifies law enforcement of the suspect activity, law enforcement may conduct a criminal investigation. It is not uncommon for a civil investigation to be completed and then those findings are turned over to law enforcement for a criminal investigation. Sometimes civil and criminal investigations are undertaken concurrently. In either case, the city needs to proceed cautiously and consult closely with its legal counsel and fraud investigator to ensure that its actions don't compromise any criminal investigation.

In a civil investigation, the main goal is usually the recovery of losses. The recovery can come from a variety of sources including, but not limited to, the suspect, insurance policies, and other third parties who may have liability but did not commit the suspect activity. The investigation is primarily concerned with quantifying the loss and determining how it occurred.

The goal of a criminal investigation is to obtain a conviction of the suspect. A conviction may result in jail time, probation or some other form of punishment for the suspect. The convicted suspect may also be required to pay restitution to the victim.

In addition to the possibility of jail time or other punishment, there are other key differences between a civil and criminal investigation. The two primary differences pertain to the standard of proof required and the potential statute of limitations.

First and foremost, the standard of proof is significantly different between criminal and civil actions. In a criminal action, the allegations must be proven beyond a reasonable doubt. Whereas in a civil action, the allegations must be proven by the preponderance of evidence. Therefore, it is possible the city could prevail in a civil action but there might not be sufficient evidence to obtain a guilty verdict in a criminal action.

Criminal actions are often subject to a more stringent statute of limitations. In general, the statute of limitations for fraud matters in Oregon is three years. Conversely, civil actions are usually not subject to such stringent statutes of limitations. This may be an important factor to consider for older frauds or those of longer duration.

## Investigation Costs

Most victims are concerned with the costs of undertaking a fraud investigation. It is extremely difficult to estimate the expected investigation costs up front as every fraud is different. Cost is a function of the fraud's complexity, the fraud's duration, and the availability and condition of evidence. Report writing and testimony in a civil or criminal matter can also significantly increase the costs.

In an effort to control costs, the city and fraud investigator should clearly define the investigation scope and goals. The scope of the investigation is often influenced by predication.<sup>1</sup> For example, if it is suspected that the court clerk is skimming receipts, then it would not be necessary to include the building department in the investigation. Conversely, artificially limiting the scope to save costs can significantly hamper the investigation. The scope and goals should make sense given the facts and circumstances. Frequent communications with the fraud investigator regarding their progress and findings can result in a natural narrowing of the scope over time that will likely result in a managed cost budget.

## The Investigators

The most important decision a city may be faced with is who will undertake the fraud investigation. The decision should not be taken lightly and, unlike many other municipality decisions, should not be based solely on costs. It is important that the city retain a qualified investigator along with competent legal counsel. Furthermore, it is critical that the investigators be disinterested parties and conduct an independent investigation.

*(continued on page 22)*

<sup>1</sup> Predication is the totality of circumstances that would lead a reasonable, professionally trained, and prudent individual to believe that a fraud has occurred, is occurring, and/or will occur. — *ACFE Fraud Examiners Manual*

### The City's Current Auditors or CPA Firm

Oregon Revised Statutes (297.425) requires virtually all municipal corporations to obtain an annual audit. As such, most Oregon cities already have an external auditor or certified public accountant (CPA) firm that they currently work with. On the surface, the current CPA firm may seem like a logical choice to complete the fraud investigation. However there are two key reasons why the city should not retain their current or past CPA firm.

First, while auditors must give consideration to fraud during their audit, uncovering fraud is not their primary objective. In financial statement audits, auditors are primarily concerned as to whether the financial statements present fairly, in all material respects, the financial position of the entity and the results of its operations.

More importantly, the city's CPA firm is probably not independent from the fraud investigation. This is especially true if the suspected fraud occurred during the years in which the CPA firm prepared audited financial statements for the city. In essence, the city may be asking the CPA firm to review their own work and the question will undoubtedly be asked "Why didn't our CPAs uncover the fraud?" Since the city's CPA firm will have a self-interest in defending the work they have done, it is essential to use a fraud investigator who is independent and who has the expertise to properly conduct the investigation.

### City Employees

Unless the city has an internal audit department or something similar, the city should not be conducting the fraud investigation in-house. The lack of appropriate skills set and independence withstanding, it would also be a distraction to the employees from their everyday duties. Furthermore, it is difficult to determine at the outset who may be complicit in the suspect activity. The fraud investigator may use city employees to assist in gathering information, but their direct involvement should be minimal.

### The City Attorney

While the city attorney is often a trusted advisor, in certain circumstances it may not be appropriate for him or her to head up the investigation. Depending on the nature of the fraud, it is possible that the city attorney may not be independent from the subject matter of the investigation. Additionally, the investigation likely will entail human resource litigation and other legal issues that may be outside the scope of the city attorney's expertise.

### The Fraud Investigator

Not all investigators are created equally. There may be investigators who are adept interviewers but struggle to read and interpret financial information and vice versa. The fundamental challenge of forensic accounting and fraud investigation is the sheer breadth and depth of technical disciplines involved. Depending on the nature of the matter, the

fraud investigator should be competent in the following disciplines: accounting, computer forensics, financial analysis, corporate governance, interview and interrogation, stylometry, adult-learning theory, testimony skills and others.

If the fraudulent activity involves financial matters, the fraud investigator should have a good understanding of general governmental accounting practices and preferably be a certified public accountant. Additionally, the fraud investigator should maintain at least one or more additional credential such as certified fraud examiner (CFE)<sup>2</sup>, master analyst in financial forensics (MAFF)<sup>3</sup>, or certified in financial forensics (CFF)<sup>4</sup>. These credentials not only indicate that the fraud investigator has obtained additional training pertinent to investigations, but also increase the credibility of the fraud investigator should they have to testify regarding their findings in a civil or criminal trial.

### Investigations and Public Records Law

Any reports and other documents generated as part of an investigation will be public records that potentially are subject to disclosure under Oregon's Public Records Law (ORS 192.410 through 192.505). "Public record" is broadly defined under the law:

"Public record" includes any writing that contains information relating to the conduct of the public's business . . . prepared, owned, used or retained by a public body regardless of physical form or characteristics." (ORS 192.410(4)(a)).

The term "writing" also is defined broadly to include:

"[H]andwriting, typewriting, printing, photographing and every means of recording, including letters, words, pictures, sounds, or symbols, or combination thereof, and all papers, maps, files, facsimiles or electronic recordings." (ORS 192.410(6)).

As discussed in the Attorney General's Public Records and Meetings Manual (2011): "[r]ecords need not have been prepared originally by the public body to qualify as public records. If records prepared outside government contain "information relating to the conduct of the public's business," and are "owned, used or retained" by the public body, the records are within the scope of the Public Records Law."<sup>5</sup> Therefore, any reports or investigation materials, even if prepared by an outside investigator, will qualify as public records. As such, they are subject to public disclosure unless a specific exemption applies.

This can, and usually does, present a number of dilemmas and potential conflicts for city decision-makers involved with overseeing an investigation and addressing any fraud or wrongdoing that is discovered. The city will almost certainly be faced with political and legal pressures to disclose information while an investigation is being conducted and after it is concluded. After all, it is public money that is being spent and it is public money that allegedly has been

2 Issued by the Association of Certified Fraud Examiners

3 Issued by the National Association of Certified Valuators and Analysts

4 Issued by the American Institute of CPAs

5 Attorney General's Public Records and Meetings Manual, 2011, p. 7

diverted. The public generally has a right to know how government is being conducted and how public money is being spent. These pressures must be weighed against the privacy rights of the individuals involved, potential legal issues and the need to conduct a fair and impartial investigation that is not improperly interfered with or subject to public disclosure before facts are gathered and conclusions are reached.

The Oregon Legislature has recognized some of these conflicting rights and dilemmas by creating a number of exemptions from disclosure under the state's public records laws. Many of these exemptions are contained directly in ORS 192.501 and 192.502. A number of other exemptions are found in other federal or Oregon statutes and are incorporated into public records law exemptions through either ORS 192.502(8), which exempts from disclosure "Any public records or information the disclosure of which is prohibited by federal law or regulations," or ORS 192.502(9), which exempts from disclosure "Public records or information the disclosure of which is prohibited or restricted or otherwise made confidential or privileged under Oregon law."

In the context of personnel-related investigations, such as an investigation into potential fraud or embezzlement, one of the most important exemptions to keep in mind while the investigation is being conducted is the exemption provided by ORS 192.502(1) for:

"Communications within a public body or between public bodies of an advisory nature to the extent that they cover other than purely factual materials and are preliminary to any final agency determination of policy or action."

This exemption will almost certainly cover the investigation while it is being conducted. It should be noted, though, that this exemption, like many exemptions under Oregon's public records laws, contains an "exception" if it can be shown that the "public interest" in disclosure outweighs the exemption. In most cases, it is unlikely that a reviewing body (the district attorney at the first level or a court at the second level) will require a public body to disclose information or records related to an investigation while the investigation is being conducted—to do otherwise could, and most likely would, seriously compromise the investigation.

A number of other potential exemptions under the public records law may apply. The city should consult with the city attorney—or legal counsel knowledgeable about the public records law and its exemptions—to determine which exemptions may apply, to ensure that an exemption is being claimed properly, and, if information is going to be released, that the release is not otherwise prohibited. Lawsuits—and even criminal prosecutions—have resulted from the improper disclosure of information.

One way to protect the investigation from public disclosure, at least until the city can determine what it is dealing with and can make a conscious decision regarding what, if anything, should be publicly disclosed, is to have the investigation conducted by or under the direction of legal counsel. Under ORS 192.502(9)(a) documents or communications that fall under the attorney-client privilege are protected

## 8 CRITICAL DECISIONS

1. Who will head up the investigation for the city?
2. What should the suspect's employment status be?
3. What are the goals of the investigation?
4. What is the scope of the investigation?
5. Should the city pursue a criminal investigation?
6. Does the city need to engage outside legal counsel?
7. Who should the city retain to investigate the fraud?
8. Should the city compel a statement from the suspect?

against disclosure. The client (generally, this means the city council as the governing body, not individual members of the council) can elect to waive the privilege and disclose otherwise protected records or communications but cannot be compelled to do so.

By doing this, the city can protect itself against the premature or untimely disclosure of information. The governing body of the city can always make a choice to waive the privilege and disclose the results of an investigation—which often makes sense from a political or public interest standpoint—but conducting the investigation under the direction of legal counsel gives the city control over whether the information will be released and, if so, how and when it is released.

### Conducting the Investigation

#### Information Gathering

An initial step in any investigation is to gather information. It is vital that the city is open and transparent with the fraud investigator. The investigator will need information about city processes and employees, and may ask questions or seek data that seems irrelevant or inappropriate. It is important to remember that the investigator is not being meddlesome but rather needs as much background information as possible to form an accurate assessment of the situation and people involved.

Part of gathering information includes identifying key documents, their location and who has access to those documents. Once the fraud investigator has identified the key documents, securing them is imperative. If possible, original key documents should be removed and stored in a secure location. If removing the documents is not possible given their nature, photocopies should be made and secured in case the key document is later "missing." If photocopies are made for the investigation, the investigator should document who made the copies and when.

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## Audits – Fraud Investigations

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As deception is an element of fraud, it is possible that the city's accounting records and supporting documents have been manipulated in attempt to conceal the suspect activity. Therefore, a keen investigator will likely seek control data to validate the city's internal and external data. Internal data includes those records prepared by the city such as the general ledger. External data includes records prepared from the internal data such as tax returns or financial statements. Control data comes from sources outside the city and is used to validate the internal and external data such as bank statements. The concept of correlating the internal, external and control data is known as ICE.



While certain control data may be readily available at the city, the fraud investigator will be concerned that said data has been subject to alteration. It is not uncommon for suspects to alter or fabricate control data in order to conceal their activity. Given the technology available today, the altered documents often appear to be originals to the naked eye. To combat this, the fraud investigator may ask the city to obtain original control data directly from the source.

### Interviews

The investigator will identify and conduct interviews with key individuals. These individuals will know information about city processes, may be possible witnesses to the fraud, or may even be possible accomplices. If the suspect is available, the investigator will want to interview or interrogate them as well. The timing and order of the interviews is crucial to the process, so it is important to try to accommodate the investigator while minimizing disruption to the city's day-to-day operations.

### Compelling Employee Statements – Garrity Rights

If potential criminal charges are involved in an investigation, an employee who is a subject of the investigation has a Fifth Amendment privilege against self-incrimination. This creates a potential problem for a public entity conducting an administrative investigation into allegations of wrongdoing since the accused employee can invoke his or her Fifth Amendment rights and refuse to provide information.

This issue was resolved by the United States Supreme Court in 1967 in the case of *Garrity v. New Jersey*. In this case, a police officer who was under investigation for issues that involved potential criminal charges was required by his public employer to provide a statement under the threat of discharge if he refused to answer. The officer was then criminally prosecuted based on the statement he gave to his employer. The Supreme Court held that public employees have the right to be free from compelled self-incrimination.

By invoking a Garrity right, an employee is invoking his or her right against self-incrimination. The employer then has two choices. One is to proceed with the investigation and findings without having the employee's statement. The other is to require the employee to provide a statement about the matters in question under the threat of discipline or discharge if the employee refuses to answer. If this second approach is used, under Garrity the compelled statement may not be used against the employee in any criminal prosecution of the employee. More information regarding Garrity rights and their implications can be found at: [www.garrityrights.org](http://www.garrityrights.org).

Since most fraud matters result in criminal charges, the city should carefully consider its tactic on obtaining statements from the suspect. Compelling a statement from the suspect and triggering the suspect's Garrity rights may hinder the criminal investigation. Often times a successful investigation can be completed without obtaining a statement from the suspect.

### Analysis

The investigator will sift through all the information gathered, identify relevant and competent evidence and analyze pertinent information. The evidence must be related to the case and must be an accurate representation of what was found. Investigators understand the type of evidence needed to support their conclusions. The analytical tools and techniques used by the investigator are dependent on the unique facts and circumstances of the case. In the end, the investigator will utilize all available information gathered and analyzed and form conclusions that will be presented as reportable findings.

### Reporting Findings

Once all of the evidence is collected and analyzed, the results will be reported to the city based on the previously agreed upon format. Reporting can be done orally or in written form. Fraud reports deal only with the relevant facts discovered and underlying analysis performed. The city should not expect the fraud investigator to provide opinions regarding the guilt or innocence of the suspect. Fraud requires intent and the fraud investigator cannot opine on the suspect's state of mind. As such, the finding of guilt is left to the trier of fact, a judge or jury.

It is important to remember that even if there is a lack of findings, this does not mean there was "no fraud." Fraud is often committed with a great deal of care to conceal the

activities. Deception and secrecy are key to continuing the fraud without getting caught. It is possible that the deceptive tactics created enough obscurity to make it unfeasible to obtain sufficient evidence of fraud.

### Other Investigation Issues

During the investigation there may be other key issues to consider beyond civil and criminal litigation. If federal funds are involved in the fraud, then there may be additional financial exposure due to the rules of the federal grant. The fraud may also affect prior year financial reporting which may affect bond ratings. Shared tax assessments may create reporting requirements with other government agencies or municipalities. It is important to be cognizant of the impact the fraud may have on these and other aspects of the city's operations.

### The Aftermath

Once the investigation is complete, the city will have to determine how it wants to proceed based on the investigation findings. If the investigation yields no significant findings, then the city is likely done with the process. However, if the investigation leads the city to conclude that a fraud has occurred, then it is time to revisit the city's goals and objectives. The city should confer with legal counsel and the fraud investigator to determine the next steps.

If the city has insurance policies that covered the fraud, then legal counsel would have already notified the carrier of the potential claim. Once the investigation report is complete, legal counsel will deliver the report to the insurance carrier to evidence the suspect activity. This does not mean that the carrier will automatically pay the claim. The insurance carrier will likely have someone review the investigation findings, ask follow-up questions, and possibly undertake their own investigation.

If a fraud has occurred, the city will need to determine what personnel actions to take against the perpetrator and any other employees who are involved. A proven fraud or theft will almost certainly result in a decision to terminate the involved employee or employees, but legal counsel should be consulted to make sure the city is proceeding appropriately.

The city will also have to decide whether to file a civil action against the suspect. The city should first assess whether the suspect has or can obtain assets to satisfy recovery of damages. If not, then it is a fruitless exercise to file a civil matter because that city will end up with an uncollectible judgment.

Finally, if a criminal investigation has not already begun, the city will need to decide whether the evidence warrants a criminal investigation. If so, the city should contact law enforcement and discuss the appropriate steps to begin the

## FRAUD FACT

**Fraudsters will go to great lengths to conceal their activities. It is common for suspects to alter bank statements and try to pass them off as originals.**

**The availability of electronic bank statements has made this process much easier. Suspects merely need to change/delete the suspect activity from the PDF copy of the bank statement and then re-save or print the file.**

investigation. Unlike the fraud investigation, once this process begins it is usually out of the city's hands. In short, law enforcement or the district attorney will decide if, when and how the criminal investigation will proceed.

Many victims are reluctant to file criminal actions because they feel compassion for the suspect and do not want to be involved with sending them to jail. Oftentimes the suspect may have children or issues that compel this level of compassion. However, the city should take into consideration the effects of not taking criminal actions when the evidence warrants it. First and foremost, the best deterrent to fraud is the potential of getting caught and knowledge that wrongdoers will be prosecuted to the fullest extent of the law. Secondly, the city and its employees are stewards of taxpayer funds and should be held to a higher standard. The finding of fraud can harm the public's confidence in its elected leaders, but failing to prosecute to the fullest extent of the law can destroy the public's trust and confidence in its elected leaders.

### Summary

Fraud investigations are often exhausting, expensive and sometimes painful for the parties involved. Because each instance of fraud is unique, it is impossible to address all of the possible issues that may be encountered during an investigation. For cities faced with conducting a fraud investigation, the most important decision will be choosing legal counsel and a fraud investigator. It's likely that the city probably has little experience with fraud investigation, so choosing experienced advisors and relying upon their advice will be critical.

**Editor's Note:** Mr. Gadawski is a partner and Ms. Bowen is an associate with financialforensics, a forensic accounting firm in Portland. Mr. Amberg is the senior deputy city attorney for the city of Portland. ■