# Forensic Accounting CLE: Protect Your Law Practice

Presented by:

Amber Jasmin, CPA

# Fraud, What is it?

Definition:

Wrongful or criminal deception intended to result in financial or personal gain.

To prove fraud in court, the actions of a person committing fraud would need to involve the following elements:

- A false statement of a material fact;
- Knowledge that the statement was untrue;
- Intent by the individual to deceive the victim;
- Reliance by the victim on the statement; and
- Injury sustained by the victim as a result of the preceding actions.

# Fraud, What is it?

Common types of fraud:

Consumer Fraud

Occupational Fraud

Government and other Agency Fraud

Non-cash Fraud

# Fraud, What is it?

Categories of Occupational Fraud

- Asset misappropriation
  - Employees stealing or misusing the employing organization’s resources,
  - Most common occurrence of occupational fraud; however, these schemes also tend to cause the lowest median loss at USD 100,000 per case.
- Corruption
  - Offenses such as bribery, conflicts of interest, and extortion
  - Middle in terms of both frequency and financial damage.
- Financial statement fraud
  - Intentional act that results in a material misstatement or omission in the organization’s financial statements
  - Least common but costliest occupational fraud.



Source: ACFE’s 2020 *Report to the Nations*

# Fraud, How?

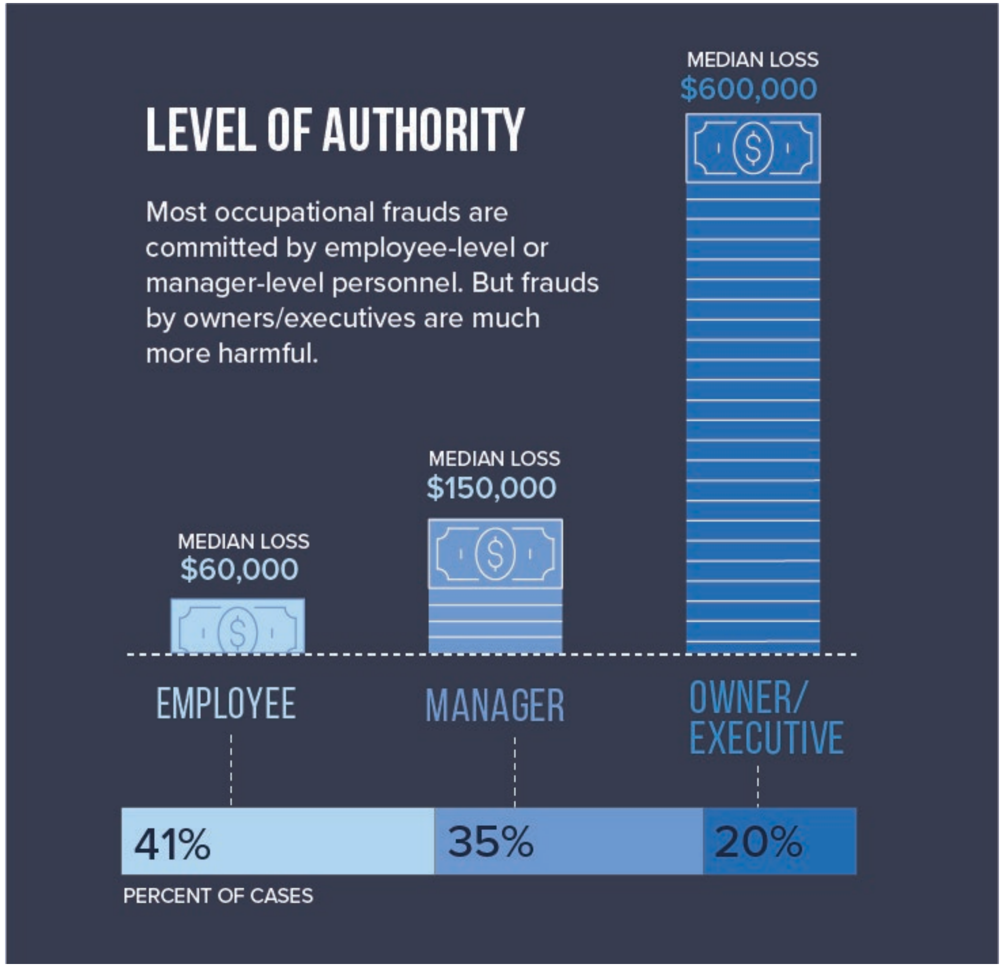
Methods of Financial Statement Fraud:

- Fictitious Revenue & Sales
- Phantom Revenue Posting
- Asset Manipulation
- Altered Accounting Records
- Inflated Company Valuation

Asset Misappropriation

- Cash larceny
- Check and payment tampering
- Payroll Fraud
- Invoicing Fraud
- Non-Cash Misappropriation
- Expense Reimbursement
- Skimming

# Fraud, Who?




Source: ACFE's 2020 *Report to the Nations*

# Fraud: Why?


The Fraud Triangle
Opportunity
Internal Controls:
• None in Place
• Not Enforced
• Not Monitored
• Not Effective
No Segregation of Duties
Too Much Trust
Poor "Tone at the Top"
Rationalization
"I don't get paid what I'm worth!"
"Everyone else is doing it!"
"If they don't know I'm doing it, they deserve to lose the money"
"I intended to pay it back"
"Nobody will miss the money"
Pressure / Motivation
External Pressure/Motivation:
• Debt, Greed
• Lifestyle Needs
• Life Pressures
• Illicit Activities: Vices, Gambling, Drugs
Internal Pressure/Motivation:
• Pressure to Perform
• Too Much Work

# Red Flags for Fraud

Seven most common employee behavioral red flags:

- Living beyond one's means
- Financial difficulties
  - History of Debts, excessive gambling, etc.
- Unusually close association with a vendor or customer
- Excessive control issues or unwillingness to share duties
- Recent divorce or family problems
- A general “wheeler-dealer” attitude involving shrewd or unscrupulous behavior
- Disgruntled employees

# Red Flags for Fraud

Operational Fraud red flags:

Inventory shrinkage

Missing documents

Multiple payments

Spikes in invoice volume

Frequent complaints

Excessive number of adjusting entries

# Red Flags for Fraud

Financial Statement Fraud Red Flags

- Accounting anomalies
  - i.e. growing revenues without a corresponding growth in cash flows.
- Consistent sales growth while competitors are struggling.
- A significant surge in a company's performance within the final reporting period of a fiscal year.
- Depreciation methods and estimates of assets' useful life that don't correspond to those of the overall industry.
- Weak internal corporate governance,
  - Increases the likelihood of financial statement fraud occurring unchecked.
- Increase of complex third-party transactions,
  - Especially those that do not add tangible value, and can be used to conceal balance sheet debt.
- The sudden replacement of an auditor resulting in missing paperwork.
- A disproportionate amount of management compensation derived from bonuses based on short-term targets,
  - Incentivizes fraud

# Just for fun

Which of the following would be a red flag of potential financial statement fraud for a nonpublic company that would require further investigation?

a) The company issued the financial statements on Feb. 28 even though the books were closed by Jan. 15.

b) The financial statements have been reviewed by a CPA, but the company has never undergone a financial statement audit.

c) The company has changed auditors annually for the last four years because of disagreements regarding accounting principles.

d) The financial statements present only the current year's statements instead of comparative statements for previous years.

# Checks and Balances

- Just like the branches of the United States Government are designed to mitigate any one person/branch from having too much power, so do checks and balances in accounting.
- Fraud can occur when any one person has too much control (power) over a business’s financial transactions.
- A system of checks and balances are necessary in order to prevent and detect fraud.
- Having a system of checks and balances ensures no one person has control over all parts of a financial transaction.

# Checks and Balances aka Segregation of Duties

Obtain checks and balances through segregation of duties.

Segregation (or separation) of Duties is an internal control mechanism designed to prevent error and fraud by ensuring at least two individuals are responsible for separate parts of any high-risk or sensitive task.

# Segregation of Duties

Whenever possible, one individual should never have access to more than one of the following for the same asset:

- The ability to **record** a transaction
- The ability to **authorize** a transaction
- Having **custody** of the asset
- Having **verification** authority (Reconciliation/Control authority)

# Segregation of Duties

Examples of good Segregation of Duties:

- Requiring 2 signatures on each check.
- Not allowing the person who writes checks to reconcile the bank accounts.
- Having a secretary or receptionist open, stamp and catalog the mail before giving to the bookkeeper to pay bills or record receipts.
- Have bank statements sent to a different address instead of directly to the bookkeeper.
- Require all purchases over a certain dollar amount (including payroll) to be approved by management before paid.

# Segregation of Duties: Where to Start

- Audit your existing security
- Understand your business processes
- Understand and prioritize the risks
- Create a remediation plan
- Define your Risk Model/Matrix
- Find the right tools to help
- Implement both Detective and Pro-active Segregation of Duties controls
- Conduct regular Periodic Reviews (or User Certification)
- You need good visibility and reporting
- Adopt a policy of Least Privilege

# Segregation of Duties in a small business

**Two-Person Office**

| Bookkeeper | CEO or Owner/Manager |
| --- | --- |
| •Record accounts receivable entries | •Approve and sign checks |
| •Mail checks/authorize electronic payments | •Sign employee contracts |
| •Write checks | •Complete deposit slips |
| •Record general ledger entries | •Perform interbank transfers |
| •Reconcile bank statements | •Distribute payroll |
| •Record credits/debits in accounting records | •Reconcile petty cash |
| •Approve payroll | •Approve employee time sheets |
| •Receive cash | •Process and approve vendor invoices |
| •Disburse petty cash | •Review bank reconciliations |
| •Authorize purchase orders | •Prepare/approve annual budget |
| •Authorize check requests | •Review monthly financial statements |
| •Authorize invoices for payment | |

# Segregation of Duties in a small business

**Three-Person Office**

Bookkeeper

- Record accounts receivable entries
- Reconcile petty cash
- Write checks
- Record general ledger entries
- Reconcile bank statements
- Record credits/debits in accounting records

Office Manager

- Process vendor invoices
- Receive cash
- Mail checks/authorize electronic payments
- Approve invoices for payment
- Distribute payroll
- Authorize purchase orders
- Authorize employee timesheets
- Approve payroll
- Disburse petty cash
- Prepare annual budget

CEO or Owner/Manager

- Sign checks
- Sign employee contracts
- Complete deposit slips
- Perform interbank transfers
- Review bank reconciliations and contents of bank statements
- Approve annual budget
- Review monthly financial statements

# Accounts Receivable and Receipts

Cash handling duties can be divided into four stages: receiving, depositing, recording, and reconciling. Ideally, all four stages would be performed by different individuals.

Cash handling best practices:

- Do not allow the use of cash receipts for operating purposes including the payment of invoices, salaries or wages, or to make advances or loans to staff.
- Require receipts/documentation for all cash receipts.
- Safeguard cash receipts through the use of lockable cash boxes and secure the boxes in a locked cabinets drawer or safe when not in use or being deposited.

# Accounts Payable and Payments

One of the largest forms of employee theft or fraud is creating fictitious vendors and/or fictitious vendor invoices for payment. The employee then pays these fake invoices and pockets the money themselves.

Best practices:

- Regularly and routinely review recently used vendor lists.
- Analyze and compare amounts spent to certain vendors to past years or industry norms.
- Call or meet up with vendors that appear new or unfamiliar.
- Maintain vendor contracts or agreements
- Regularly review spending habits

# Just for fun

Many of the companies involved in scandals wind up under investigation by the SEC. What does SEC stand for?

a) Secure Economy Commission
b) Securities and Exchange Commission
c) Solomon Eventuality Center
d) Stock Exaggerations are Certain

# Just for fun

What international retailer, which had filed for bankruptcy protection, suffered allegations by former employees in May 2003 that its accounting practices misled investors about its financial health?

a) Wal-Mart
b) Kmart
c) Target
d) Marks and Spencer

# Essential Reports

To begin to understand or catch fraud, it is essential to understand your financial statements.

Basic Accounting reports:

Balance Sheet

Income Statement

Cash Flow Statement

# Essential Reports

Just knowing your accounting reports will not catch fraud.

Take it a step further. Comparative statements are your friend.

Types of useful comparisons:

- Year-to-date numbers to the same time period in the previous year
- Current month to previous month
- 3, 5 or even 10 year trends reports

# Essential Reports

**Comparative Balance Sheet**
**December 31, 2008 and 2007**

| | 2008 ($) | 2007 ($) | Increase or (Decrease) Amount | Percent |
|---|---|---|---|---|
| Assets | | | | |
| Current assets | 550,000 | 533,000 | 17,000* | 3.2% |
| Long-term investments | 95,000 | 177,500 | (82,500) | (46.5)% |
| Plant assets (net) | 444,500 | 470,000 | (25,500) | (5.4)% |
| Intangible assets | 50,000 | 50,000 | -- | |
| Total assets | 1,139,500 | 1,230,500 | (91,000) | (7.4)% |
| Liabilities | | | | |
| Current liabilities | 210,000 | 243,000 | (33,000) | (13.6)% |
| Long-term liabilities | 100,000 | 200,000 | (100,000) | (50.0)% |
| Total liabilities | 310,000 | 443,000 | (133,000) | (30.0)% |
| Stockholders' Equity: | | | | |
| Preferred 6% stock, $100 par | 150,000 | 150,000 | -- | -- |
| Common stock, $10 par | 500,000 | 500,000 | -- | -- |
| Retained earnings | 179,500 | 137,500 | 42,000 | 30.5% |
| Total stockholders' equity | 829,500 | 787,500 | 42,000 | 5.3% |
| Total liabilities and stockholders' equity | 1,139,500 | 1,230,500 | (91,000) | (7.4)% |

* 550,000 - 533,000 = 17,000
(17,000 / 533,000) × 100 = 3.2%

# Essential Reports

**Comparative Income Statement**
**For Years Ended 31, 2008 and 2007**

| | 2008 ($) | 2007 ($) | Increase or Decrease | |
|---|---|---|---|---|
| | | | Amount | Percent |
| Sales | 1,498,000 | 1,200,000 | 298,000 | 24.8% |
| Cost of goods sold | 1,043,000 | 820,000 | 223,000 | 27.2% |
| Gross profit | 455,000 | 380,000 | 75000 | 19.7% |
| Selling expenses | 191,000 | 147,000 | 44,000 | 29.9% |
| General expenses | 104,000 | 97,400 | 6,600 | 6.8% |
| Total operating expenses | 295,000 | 244,400 | 50,600 | 20.7% |
| Operating income | 160,000 | 135,600 | 24,400 | 18.0% |
| Other income | 8,500 | 11,000 | (2500) | (22.7)% |
| | 168,500 | 146,600 | 21,900 | 14.9% |
| Other expenses | 6,000 | 12,000 | (6,000) | (50.0)% |
| Income before income tax | 162,500 | 134,600 | 27,900 | 20.7% |
| Income tax | 71,500 | 58,100 | 13,400 | 23.1% |
| Net income | 91,000 | 76,500 | 14,500 | 19.0% |

# Essential Reports

Consolidated Statement of Cash Flows

| *In millions* | *Years ended December 31,* ***2016*** | *2015* | *2014* |
|---|---|---|---|
| **Operating activities** | | | |
| Net income | **$ 4,686.5** | $ 4,529.3 | $ 4,757.8 |
| Adjustments to reconcile to cash provided by operations | | | |
| Charges and credits: | | | |
| Depreciation and amortization | **1,516.5** | 1,555.7 | 1,644.5 |
| Deferred income taxes | **(538.6)** | (1.4) | (90.7) |
| Share-based compensation | **131.3** | 110.0 | 112.8 |
| Other | **96.9** | 177.6 | 369.5 |
| Changes in working capital items: | | | |
| Accounts receivable | **(159.0)** | (180.6) | 27.0 |
| Inventories, prepaid expenses and other current assets | **28.1** | 44.9 | (4.9) |
| Accounts payable | **89.8** | (15.0) | (74.7) |
| Income taxes | **169.7** | (64.4) | 3.3 |
| Other accrued liabilities | **38.4** | 383.0 | (14.3) |
| **Cash provided by operations** | **6,059.6** | 6,539.1 | 6,730.3 |
| **Investing activities** | | | |
| Capital expenditures | **(1,821.1)** | (1,813.9) | (2,583.4) |
| Purchases of restaurant businesses | **(109.5)** | (140.6) | (170.5) |
| Sales of restaurant businesses | **975.6** | 341.1 | 403.1 |
| Sales of property | **82.9** | 213.1 | 86.8 |
| Other | **(109.5)** | (19.7) | (40.9) |
| **Cash used for investing activities** | **(981.6)** | (1,420.0) | (2,304.9) |
| **Financing activities** | | | |
| Net short-term borrowings | **(286.2)** | 589.7 | 510.4 |
| Long-term financing issuances | **3,779.5** | 10,220.0 | 1,540.6 |
| Long-term financing repayments | **(822.9)** | (1,054.5) | (548.1) |
| Treasury stock purchases | **(11,171.0)** | (6,099.2) | (3,198.6) |
| Common stock dividends | **(3,058.2)** | (3,230.3) | (3,216.1) |
| Proceeds from stock option exercises | **299.4** | 317.2 | 235.4 |
| Excess tax benefit on share-based compensation | **—** | 51.1 | 70.9 |
| Other | **(3.0)** | (58.7) | (12.8) |
| **Cash provided by (used for) financing activities** | **(11,262.4)** | 735.3 | (4,618.3) |
| **Effect of exchange rates on cash and equivalents** | **(103.7)** | (246.8) | (527.9) |
| **Cash and equivalents increase (decrease)** | **(6,288.1)** | 5,607.6 | (720.8) |
| Cash balance of businesses held for sale at end of year | **(174.0)** | — | — |
| Cash and equivalents at beginning of year | **7,685.5** | 2,077.9 | 2,798.7 |
| **Cash and equivalents at end of year** | **$ 1,223.4** | $ 7,685.5 | $ 2,077.9 |
| **Supplemental cash flow disclosures** | | | |
| Interest paid | **$ 873.5** | $ 640.8 | $ 573.2 |
| Income taxes paid | **2,387.5** | 1,985.4 | 2,388.3 |

# Building a baseline

Accounting Ratios (equations):

- Accounts Receivable Turnover
- Accounts Payable Turnover
- Quick Ratio
- Working Capital Ratio
- Debt-Equity Ratio
- Return on Equity

# Just for fun

Financial statement ratio analysis can be helpful in identifying the warning signs of financial statement fraud. Which of the following results of a ratio analysis of your client's income statement would raise a red flag and merit further investigation?

a) a. Industry average gross margin is 55%, and the client's gross margin is 58%.

b) b. Lease expense has accounted for 10% of general administrative expenses in previous years, but it is at 12% this year.

c) c. Payroll expense increased by 6% last year, while previous years' increases in the same expense averaged 10%.

d) d. Since last year, sales revenue has increased 25% and cost of goods sold has increased 5%.

# Building a Baseline with Forensic Accounting Tools

- Analytical Procedures
- Risk analysis
- Comparative Techniques
- Account reconciling
- Sample Testing

# Forensic Accounting

An outside CPA auditor is NOT required to detect fraud in the normal course of an audit.

> *While the risk of fraud is considered in an audit, an auditor's job is to give relative assurance that the financial statements are complete, accurate and free of accounting errors.*

Other attest services that may be useful in detecting fraud or pointing out potential weaknesses that could result in fraud are:

- Assessing the risk of fraud and illegal acts
- Evaluating the adequacy of internal control systems
- Substantive testing of transactions during an attest or a general consulting engagement
- Designing and implementing internal control procedures
- Proactive monitoring and performing analysis and tests when fraud is not suspected
- Preparing company codes of business ethics and conduct
- Developing corporate compliance programs

A forensic accounting or forensic auditing services are typically performed AFTER a fraud is already detected or during the process of potential dispute resolution proceedings. The job of a forensic accountant is to assess the overall damage to the company or trace transactions for dispute resolution.

# Forensic Accountant Tools

Comparative Techniques

- Comparison of current period information with similar information from prior periods.
- Comparison of current period information with budgets or forecasts.
- Study of relationships among elements of information.
- Study of relationships of financial information with the appropriate non-financial information.
- Comparison of information with similar information from the industry in which the organization operates.
- Comparison of information with similar information from other organizational units.

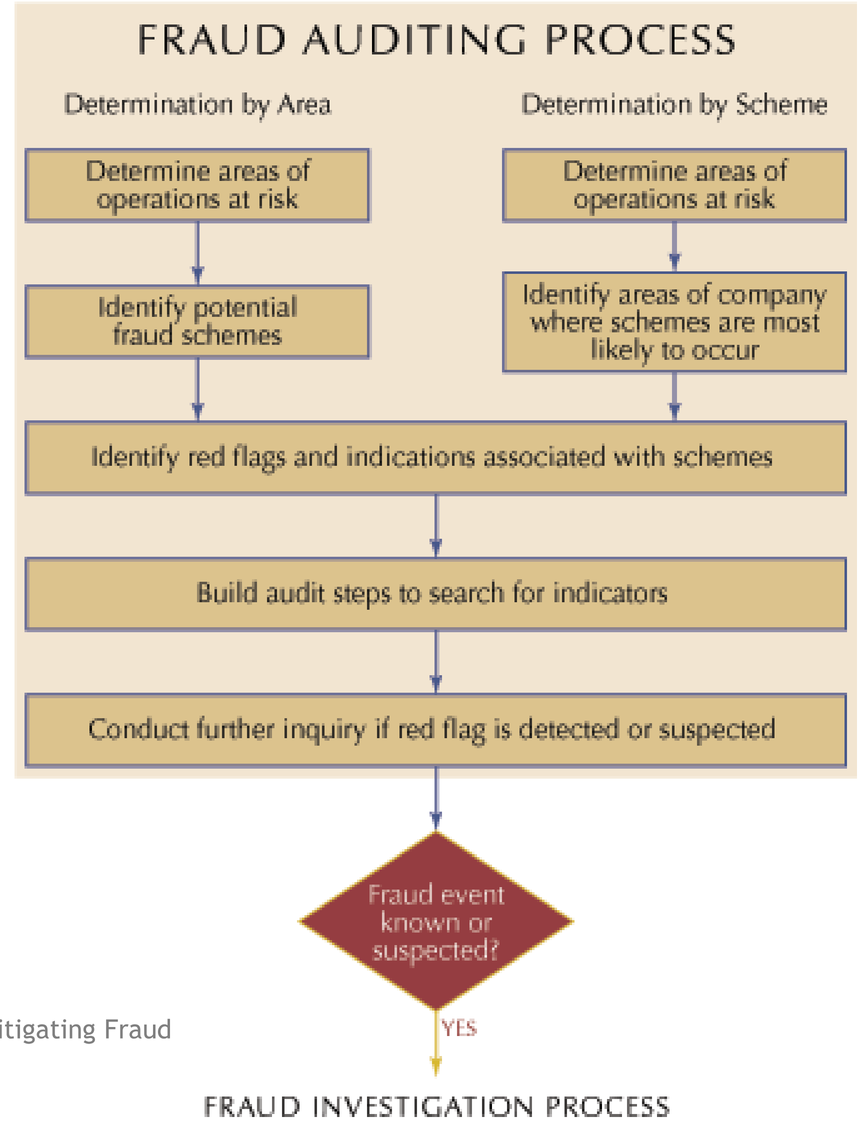
(Source: Practice Advisory 2320-1 “Analysis and Evaluation,” The Institute of Internal Auditors. January 5, 2001.)

# Forensic Accountant Tools

At a forensic level, the following situations should raise concern as possible indicators of fraud:

- Missing/altered documents
- Discrepancies and unexplained items on accounting reconciliations
- Increasing revenue without a corresponding growth in cash flow
- A significant uptick in the company's performance during the final reporting period of the fiscal year
- Significant or unusual changes in assets or liabilities
- High revenue figures during a time in which competitors are in a downturn
- Disclosures that appear to have no logical business purpose
- Loans or bonuses with no proper explanation

# Forensic Accountant Tools




(Source: "The Emerging Role of Internal Audit in Mitigating Fraud and Reputation Risks," Internal Audit Services,

PriceWaterhouseCoopers, 2004)

# Just for fun

During the audit of XYZ, Inc., a public company, the auditors uncover evidence that indicates several midlevel managers are conspiring in a nonmaterial asset misappropriation scheme. Which of the following best describes the auditors' required reporting of this evidence under Auditing Standard (AS) No. 2401, Consideration of Fraud in a Financial Statement Audit?

a) a. Because the scheme is nonmaterial, the audit team has no obligation to report the evidence of this fraud to the audit committee.

b) b. The audit team should report the evidence of the fraud directly to the SEC.

c) c. The audit team should report the evidence of the fraud directly to the appropriate level of management.

d) d. Because the fraud is an asset misappropriation scheme and does not involve senior management, the auditors do not have any obligation to report it to any party.

# Fraud Prevention

- Hiring policies
  - Do background checks on all new hires, from top executives to the part-time mailroom worker. These can include criminal background screens, verification of previous employment and education, and contacting references.
- Financial controls
  - Implement checks and balances in your finance department, including an internal audit and/or management review function.
- Ongoing anti-fraud training
  - Educate your workforce about what fraud looks like and make clear that you have a zero-tolerance policy. Make clear what "zero-tolerance" means – termination and criminal charges when warranted.
- Effective fraud reporting tools
  - Create a fraud hotline, which can be a phone number, an email address or a web-based tool. The study showed that fraud hotlines were very effective in catching fraud earlier and minimizing financial damage.

# IOLTA & Trust Accounting

It is imperative that you reconcile your IOLTA bank accounts to your Client Trust Liability account(s) on a regular basis.

This is an added step to just reconciling the bank account.

Not only could it be easier for employees to steal from an unreconciled IOLTA account, but you could have clients attempting to misappropriate funds through an IOLTA account.

- For example, in a civil asset forfeiture case opened in July 2016, the U.S. Department of Justice (DOJ) alleged that major law firms were used to launder approximately $1 billion stolen from the Malaysian government into the United States.

# IOLTA & Trust Accounting

Most Common Frauds and Scams that Target IOLTA accounts:

Counterfeit Check Scam

Forged Trust Account Checks

Compromised Wire Instructions

Client Money Laundering

# IOLTA & Trust Accounting

Best practices:

- Be sure the money going into the IOLTA account is cleared and available before sending money out.
- Document every transactions in and out of the IOLTA account. Especially if it's used to pay for your own legal fees.
- Reconcile to the Trust liability at the same time as the reconciling to the bank statement each month.
- Do periodic self audits of IOLTA transactions for compliance with all state and federal laws.

# Questions?

# Presenter contact info

Amber Jasmin, CPA
Grandinetti & Barton, PS
amber@gbspokane.com
509-703-7279

# Just for fun

The year 2002 was a big year for scandals. In March 2002 a company reported that US$3.85 billion in cash flow had been due to cooked books. In August, it reported another US$3.3 billion in improperly booked funds. Which communications giant was it?

a) Telemundo
b) Global Crossing
c) Sprint
d) WorldCom

# Just for fun

Which American politician was formerly the CEO of Halliburton, a construction company alleged to have improperly booked US$100 million in cost overruns before customers agreed to pay them?

a) Dick Cheney
b) Bill Clinton
c) Bob Dole
d) George W. Bush

# Just for fun

Where is the headquarters of the bankrupt energy corporation, Enron?

a) New Orleans
b) Los Angeles
c) Houston
d) Chicago