

The Use of Fraud Examiners in the Battle Against Occupational Fraud and Abuse

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In 2003, it was estimated that occupational fraud and abuse cost organizations \$660 billion, or roughly 6% of their revenues.¹ While there are various ways a company can protect itself from becoming a victim of fraud, one solution toward which many companies are turning is the use of fraud examiners to help monitor and detect fraudulent activities within their organizations.

PREVALENCE OF FRAUD IN THE MARKETPLACE

The losses sustained by companies through occupational fraud are quite astounding. Findings of an industry study, *2004 Report to the Nation* (the "2004 Report") by the Association of Certified Fraud Examiners (the "ACFE"), note that small businesses are generally more vulnerable to occupational fraud and abuse: the average scheme in a small business (less than 100 employees) causes \$98,000 in losses while the average scheme at a large corporation causes \$87,500 in losses.² This statistic is not surprising as smaller organizations have fewer layers of oversight and do not always have the fraud prevention and enforcement mechanisms available to larger companies. Only mega corporations (over 10,000 employees) sustained losses greater than small businesses, with median losses at \$105,000.³

Occupational frauds generally fall into one of three categories: 1) asset misappropriations, 2) corruption, and 3) fraudulent state-

ments. *Asset misappropriation* refers to the act of embezzling funds or stealing goods from an employer.⁴ *Corruption* usually involves two or more entities and encompasses activities such as bribery, kickbacks, bid rigging, illegal gratuities, economic extortion, and purchase and sales schemes involving conflicts of interest.⁵ Finally, *fraudulent statements* are typically false representations of financial information and involve misstatements which inflate assets and revenues and understate liabilities and expenses.⁶

According to the 2004 Report, asset misappropriation is the most common form of occupational fraud, occurring in over 90% of the ACFE's case studies, with median losses at \$93,000 per scheme and cash being the primary target. Fraudulent statements comprised less than 8% of the reported occupational fraud, although they caused the most damage with median losses at \$1,000,000 per scheme.⁷ Corruption was reported in 30.1% of the case studies and caused average losses of \$250,000 per scheme. The 2004 Report also notes that the expense of occupational fraud rises as the perpetrator's level of authority increases. Thus, frauds committed by employees caused median losses of \$62,000, frauds committed by managers caused median losses of \$140,000, and frauds committed by executives or owners caused median losses of an astonishing \$900,000.⁸ When parties conspire to commit fraud, the median losses can triple.⁹

THE ROLE OF FRAUD EXAMINERS

Fraud examiners encompass a wide array of professions, including auditors, accountants, fraud investigators, loss prevention specialists, attorneys, educators and criminologists. While fraud examiners can work independently, many are also members of the ACFE, a professional organization formed in 1988 with the goal of advancing fraud detection and prevention. Fraud examiners provide a broad range of services to businesses and governmental agencies as either employees or independent consultants. In particular, a fraud examiner may assist in a fraud investigation by procuring evidence, taking statements, and writing reports.

Within the broad category of fraud examiners are forensic accountants who specialize in a unique brand of accounting that departs from the traditional methods employed in the accounting field. *The Accountant's Handbook of Fraud & Commercial Crime* by G. Jack Bologna, Robert J. Lindquist, and Joseph T. Wells (New York: John Wiley & Sons, 1993), defines forensic accounting as "the application of financial skills and an investigative mentality to unresolved issues, conducted within the context of the rules of evidence. As a discipline, it encompasses financial expertise, fraud knowledge and a strong knowledge and understanding of business reality and the working of the legal system." Simply put, forensic accountants turn traditional accounting principles on their head by questioning and investigating the accounting methods and financial practices of a company.

Unlike traditional accountants who assume honesty and integrity in the examination of a corporation's finances, a forensic accountant typically will question figures and numbers until they are validated. "For example, while the traditional accountant may examine a company's records to determine whether they are accurate, the forensic accountant will search for 'badges of fraud' in financial statements, balance sheets, and underlying corporate documents. Furthermore, as part of their investigations, forensic accountants may perform a variety of fieldwork from inspecting company facilities to participating in witness interviews."¹⁰ Accordingly, a forensic accountant may be useful not just in assisting an organization create a fraud prevention program, but may also detect and identify instances and responsible parties once the organization has determined that fraud has in fact occurred.

CONSIDERATIONS IN RETAINING A FRAUD EXAMINER

When hiring a fraud examiner, a company should seek an evaluation that is both disinterested and reliable. These objectives, however, can occasionally conflict. Where employees within the organization conduct the fraud investigation, the results of such an investigation may be considered suspect because they are obtained by parties who are, or at least appear to be, biased.¹¹ Thus, while the company may prefer to use examiners with historical knowledge and details about the company, personnel, and accounting systems, their retention may raise issues of credibility. On the other hand, while the investigation of a fraud examiner who has no prior connection with the company may be unbiased, the resulting evaluation may also exhibit the examiner's inexperience with the particular organization and its business practices.

In balancing the twin goals of disinterestedness and reliability, a company should consider the purpose of the investigation. Where the results are to be used in-house or where the company is simply establishing a fraud prevention system, there is less concern regarding credibility. Thus, a fraud examiner who has knowledge of the business may be a wiser choice in that instance because of such examiner's familiarity with the company. In contrast, where information from the fraud investigation may be subject to scrutiny by those outside the company, the appearance of disinterestedness becomes more critical and the company should consider hiring an independent fraud examiner.

FRAUD DETERRENCE

Incidents of fraud do not assail a company overnight; rather, fraud often takes its toll slowly and deliberately. ACFE reports that the average fraud scheme lasts approximately 18 months before it is detected.¹² The results can be exacerbated if management ignores or fails to recognize warning signs. While a fraud investigation can be quite time-consuming and costly depending on the extent of the fraud, there are also hidden costs, including damage to public reputation and organizational morale. For these reasons, organizations may wish to conduct fraud risk assessments.¹³

To deter fraud at its early stages, management should be alert to "badges of fraud." Forensic accountants may provide assistance to companies and managers by developing appropriate risk management techniques.¹⁴ Use of internal controls, audits, and investigations can reduce

the likelihood of fraud. Some informal methods that managers can use to identify potential fraud perpetrators include:

- routine walkabouts;
- spot checking of subordinates' work;
- reviewing assignments to confirm the quality of the work performed; and
- scrutinizing any documentation submitted for signature.¹⁵

While increasing internal controls can help to reduce the incidence of fraud, it is recommended that companies couple such internal controls with the elements of education and fraud-prevention training. If used alone, internal checks may be viewed as cumbersome by employees. Moreover, such a system will be subject to employee override if it is not user-friendly.¹⁶ Thus, the most effective fraud techniques should be easy to use and include ongoing educational programs which explain the purpose of the internal controls without negatively affecting employee morale. Furthermore, a company should consider developing a code of ethics, a code of conduct, and a whistleblower hotline to impress the workforce with the ethical significance of its anti-fraud program.¹⁷

Although these methods certainly do not guarantee the wholesale elimination of fraud, they can help lower a company's susceptibility to fraud. The 2004 Report cites that "[o]rganizations that did not have reporting mechanisms suffered median losses that were over twice as high as organizations where anonymous reporting mechanisms had been established."¹⁸ Clearly, an anti-fraud program can help limit the losses of an organization due to fraud.

FRAUD DETECTION

In certain cases, a fraud examiner may also provide support to legal counsel charged with the task of unearthing fraud. In the course of conducting internal corporate investigations, an attorney may require assistance in the fact-gathering process. Whether an internal investigation concerns embezzlement by a corporate officer, environmental mishaps, or allegations of bank, tax, or healthcare fraud, legal counsel may be aided by the investigative tools possessed by a fraud examiner in gathering all the relevant facts.¹⁹

In particular, fraud examiners, such as forensic accountants, can assist companies, with the guidance of counsel, in reviewing complicated financial transactions;

tracing funds and other assets that have been improperly diverted or concealed;²⁰ assembling financial information in an effective format;²¹ conducting an investigation to determine whether criminal acts such as embezzlement, misappropriation, securities, and insurance fraud, among others, have occurred;²² recommending courses of action to the company to prevent such fraud from recurring;²³ reviewing documents, devising questionnaires, and conducting witness interviews;²⁴ determining the extent and source of the fraud;²⁵ conducting a physical surveillance;²⁶ and using informants and other undercover techniques.²⁷

Certain "badges of fraud" that a fraud examiner may investigate include:

- evidence of false invoices for payments or loans;
- misuse of company assets or equipment;
- fraudulent use of company checks;
- charging personal expenses as business expenses;
- overstating revenues and assets;
- understating expenses and liabilities;
- *lapping*—misappropriating one customer's payment and substituting funds from a subsequent customer; and
- *kiting*—showing the same amount on deposit in two bank accounts at the same time; and
- pocketing cash sales.²⁸

One unique accounting tool that is gaining momentum with forensic accountants is *Benford's Law*. This mathematical theorem allows accountants to use digital frequency analysis to identify numbers (and digits within numbers) that appear in unnaturally high percentages in populations of financial data. The occurrence of unexpected patterns can help detect fraud. This tool can identify suspect invoices and other financial transactions and detect acts such as bogus vendor payments, expense account fraud, and check-kiting schemes.²⁹ Once the investigation is complete, a comprehensive report is prepared that may include a report on the nature of the assignment, scope of the investigation, and techniques employed, and will set forth the limitations of the findings or opinions. If applicable, the report may also include schedules and graphics to properly support and explain the findings.

FRAUD IN THE TIME OF BANKRUPTCY

Fraud may pose an especially acute risk to companies close to or in financial distress, as management's time and attention may be focused on crisis management rather

than on internal accounting practices. Thus, there is a possibility that management may overlook diligent book-keeping. Additionally, the company may reduce the workforce by eliminating, among others, accounting personnel. Before downsizing, management should consider whether such employees possess knowledge regarding the company's accounting practices which would otherwise be unavailable. Moreover, management should consider the impact of reducing accounting staff as it may become more difficult for the company to record and supervise financial transactions in an accurate, efficient, and timely manner.³⁰

Once a bankruptcy proceeding is initiated, a fraud examiner may, in certain instances, be able to assist legal counsel with the following services:

- review company financials for suspicious or unusual transactions;
- analyze potential fraudulent transfers;
- prepare analyses of pre- and post-petition financial statements;
- locate diverted funds or assets of the debtor;
- identify misappropriated assets;
- identify reversible insider transactions;
- evaluate the factors contributing to the debtor's current financial condition and future viability;
- analyze monthly operating reports to ascertain business trends and issues; and
- analyze questionable accounting practices.³¹

A fraud examiner, such as a forensic accountant, may also be able to detect and identify indicators of bankruptcy fraud, such as:

- failure to keep usual business records;
- incomplete or missing books and records;
- unusual depletion of assets shortly before filing;
- concealment of assets;
- conduct outside ordinary business or industry standard practices;
- commencement of a similar business near or after filing;
- failure to pay withholding or state sales taxes;
- complicated corporate structure and relationships;
- creditor confusion regarding corporate structure;
- a record of litigation involving breach of contract, misrepresentations, and fraud;
- recent departure of debtor's officers, directors, or general partners;

- frequent amendments to financial schedules, statement of financial affairs, and monthly operating reports;
- inability to contact principals of debtor at debtor's stated location;
- frequent dealings in cash;
- transfer of property to shareholders, insiders, and relatives shortly before filing;
- payoff of loans to directors, insiders, and relatives shortly before filing;
- absence of knowledgeable officers to testify at the initial meeting with creditors;
- unanswered questions or incomplete information of debtor's schedules;
- inconsistencies in recent financial statements, tax returns, and debtor's schedules and statements of financial affairs;
- sudden depletion of inventory after bankruptcy petition without a plausible explanation;
- inflated salaries, bonuses, or cash withdrawals made by directors, shareholders, insiders, or relatives; and
- transactions with non-debtor subsidiaries, parent companies, or affiliated companies owned by the same related persons or entities.³²

CONFIDENTIALITY OF INFORMATION AND MATERIALS DISCLOSED TO A FRAUD EXAMINER OR FORENSIC ACCOUNTANT EMPLOYED BY COUNSEL

Pursuant to the doctrine announced in *Kovel v. U.S.*, 296 F.2d 918 (2d Cir. 1961), an investigative accountant retained by an attorney to assist in providing legal services to a client is also protected by the attorney-client privilege. This privilege, however, does not extend to information gained prior to the accountant's retention by the lawyer.³³ Furthermore, once an investigative accountant testifies, it is unlikely that such accountant's work papers will be privileged. Therefore, at the start of the investigation, the company and its counsel should assess what role the investigative accountant will serve and the impact each role will have on the assertion of a privilege claim.³⁴

A more expansive protection for the work prepared by an accountant may be available in the form of the work product doctrine. The work product doctrine extends to documents prepared by consultants acting under the direction and supervision of counsel and in anticipation of litigation. Arguably, this latter requirement can be satisfied

by the fact that the report was prepared during the course of an internal investigation. To bolster the application of the work product doctrine, reports should do more than just recite facts (which do not constitute work product) and should reflect thoughts and mental impressions as well.³⁵

CONCLUSION

Statistics show that occupational fraud is becoming increasingly prevalent. The benefits of a proactive fraud prevention and detection program are manifold. Vigilance in uncovering fraud not only enables a company to avoid the devastating risks of financial as well as reputational damage, but it also helps instill investors, management, employees, and the general public with a sense of confidence in the company.³⁶

END NOTES

¹ASSOCIATION OF CERTIFIED FRAUD EXAMINERS (www.cfenet.com), *2004 Report to the Nation on Occupational Fraud and Abuse*, at 8.

²*Id.* at 6.

³*Id.*

⁴Laureen Ryan & Barry Monheit, AMERICAN LAW INSTITUTE, *Occupational Fraud: Bankers Beware*, SD71 ALI-ABA 253, 258 (May 1999).

⁵*Id.*

⁶*Id.*

⁷ASSOCIATION OF CERTIFIED FRAUD EXAMINERS (www.cfenet.com), *2004 Report to the Nation on Occupational Fraud and Abuse*, at 11-12.

⁸ *Id.* at 30.

⁹ *Id.* at 35.

¹⁰ Philip R. Stein & Sharon D. Stuart, PRACTISING LAW INST., CORP. L. AND PRACTICE COURSE HANDBOOK SERIES, *Making Sure It All Adds Up: Preventing, Identifying, and Litigating Financial Fraud Cases*, 1354 PLI/CORP 351, 375 (February 2003).

¹¹ Alfred J. Lechner, Jr., PRACTISING LAW INST., CORP. L. AND PRACTICE COURSE HANDBOOK SERIES, *Lessons from Sarbanes-Oxley: The Importance of "Independence" in Internal Corporate Investigations*, 1378 PLI/CORP 493, 510-11 (July 2003).

¹² WEBSITE OF ASSOCIATION OF CERTIFIED FRAUD EXAMINERS (www.cfenet.com), *Fraud Statistics*.

¹³ Lesley D. Hand, PRACTISING LAW INSTITUTE, *Fraud: What Every Practicing Attorney Needs to Know*, 1133 PLI/Corp. 417, 425-426 (Aug. 1999).

¹⁴ *Id.* at 419-20.

¹⁵ *Id.* at 427.

¹⁶ *Id.* at 426.

¹⁷ *Id.*

¹⁸ ASSOCIATION OF CERTIFIED FRAUD EXAMINERS (www.cfenet.com), *2004 Report to the Nation on Occupational Fraud and Abuse*, at 26.

¹⁹ Joe D. Whitley & Jason Klitenic, PRACTISING LAW INST., CORP. L. AND PRACTICE COURSE HANDBOOK SERIES, *Don't Go It Alone: Conducting Internal Investigations with the Help of Private Investigators, Forensic Accountants, and Other Consultants*, 1178 PLI/Corp. 761, 763 (May 2000).

²⁰ WEBSITE OF ASSOCIATION OF CERTIFIED FRAUD EXAMINERS (www.cfenet.com).

²¹ Bart M. Schwartz & Andrew B. Melnick, AMERICAN BAR ASSOC. SECTION OF LITIG., *Tools Available in an Investigation*, 1 Bus. & Com. Litig. Fed. Cas. § 4.13.

²² WEBSITE OF ASSOCIATION OF CERTIFIED FRAUD EXAMINERS (www.cfenet.com).

²³ WEBSITE OF ASSOCIATION OF CERTIFIED FRAUD EXAMINERS (www.cfenet.com).

²⁴ Philip R. Stein & Sharon D. Stuart, PRACTISING LAW INST., CORP. L. AND PRACTICE COURSE HANDBOOK SERIES, *Making Sure It All Adds Up: Preventing, Identifying, and Litigating Financial Fraud Cases*, 1354 PLI/CORP 351, 375 (February 2003).

²⁵ *Id.*

²⁶ David E. Nesbitt, LOS ANGELES LAWYER, *When the Economy Heads Down, Fraud Goes Up*, 24-AUG L.A. Law. 44 (Aug. 2001)

²⁷ *Id.*

²⁸ Hand, at 423-24.

²⁹ Dan K. Webb, Robert W. Tarun, & Steven F. Molo, CORP. INTERNAL INVESTIGATIONS, *Accountants, Auditors and Tax Experts*, § 10.04.

³⁰ Susan O'Connell & Jeffrey R. Bourassa, *Bankruptcy: Does Your Legal Team Include a Forensic Accountant?* 22-APR Am. Bankr. Inst. J. 38 (April 2003).

³¹ *Id.*

³² *Id.*

³³ Webb, § 10.04.

³⁴ *Id.*

³⁵ Joe D. Whitley & Jason Klitenic, PRACTISING LAW INST., CORP. L. AND PRACTICE COURSE HANDBOOK SERIES, *Don't Go It Alone: Conducting Internal Investigations with the Help of Private Investigators, Forensic Accountants, and Other Consultants*, 1178 PLI/Corp. 761, 771-72 (May 2000).

³⁶ The information provided herein does not represent legal advice from the authors. Companies interested in retaining a forensic examiner to conduct a fraud investigation are strongly urged to first consult with their management team and counsel.

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