



## Protect Finances: Practice What You Preach

Firms must take aggressive steps to prevent employee theft

By **STEPHEN A. PEDNEAULT**

As professionals, we are accustomed to delivering advice and recommendations to our clients on how things should be done. Attorneys advise clients on how transactions and activity should be documented and complied to minimize the risk of exposure and litigation. Physicians recommend both proactive and reactive medical advice on how to maintain health and fitness. Accountants suggest internal controls, financial policies and bookkeeping procedures to ensure transactions are properly authorized and documented to minimize the risk of theft and embezzlement. Engineers recommend how space should be designed and utilized to maximize usage and efficiency while minimizing energy and waste.

The irony is that when you look to the firms that provide well-advised recommendations, often they don't follow those same recommendations.

I can attest from my own experiences that we often get too busy focusing on the needs of our clients that we never spend the time ensuring we implemented the same recommendations we deliver to our clients.

Here's a typical example of just how dangerous that can be based on my experience: John has a small, well-established practice with a hectic day-to-day pace. To deal with the administrative tasks, he has relied for years on Sarah, a professional who runs most aspects of his office.

To John, Sarah was his savior; someone who just "took care of things." He thought of

her as family and was grateful she took the day-to-day details off his hands. As all too often happens, he delegated more and more to her over time, relying on his "trust" factor, until the dreaded day he learned Sarah had been stealing from the firm. Worse, he discovered she had also been stealing from the client funds that his firm managed on behalf of clients.

John had spent his career advising clients not to delegate too much responsibility to their employees, to check and oversee transactions and activity on a regular basis, and to review the documentation to ensure nothing ever happened. And yet a significant six-figure theft occurred right within his own firm.

### A Tempting Source

Today's challenging economy has contributed to the rise in employee thefts. Many individuals are under significant stress to solve personal financial issues, and too many of them look towards opportunities for access to funds available to them through their employment. Their goal (or rationalization) is to "borrow" the funds to solve their issues.

Law practices of any size are equally prone to employee theft and embezzlement as any other employer, but they have an added burden of managing client funds of various types. This creates another risk for a potential loss of other people's funds.

Client funds are a particularly tempting source of funds for unscrupulous employees. These funds are comprised of closing funds, settlement funds, insurance and settlement proceeds, trust funds, estate funds

and assets, and other money held in escrow on behalf of a client or matter. Statutes and standards require that all client funds be segregated from a firm's operating funds, be tracked by individual client, be regularly reconciled, and be reported in a timely manner to clients.

Unfortunately, these statutes and standards haven't prevented abuse. I know of several law firms throughout our state that have experienced first-hand what happens when a trusted employee looks towards these accounts to solve their personal financial issues. Several cases in recent history even made their way into the press. Others were quietly resolved, but at significant cost to the firm's checkbook and reputation. These thefts have enormous impact.

Firms involved must make financial restitution (often significant) to make the client funds whole. They also incur professional fees to obtain representation in dealing with the statewide grievance committee. And then there's the emotional toll of having to overcome the fact that a trusted employee stole coupled with the real possibility of disbarment.



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### Zero Tolerance

What can your firm do to prevent this? It all starts with the overall tone established by the partners. That should be one of control

and zero tolerance. Strategies should prevent potential issues from occurring as well as detecting potential problems as early as possible. That tone should be communicated to all employees throughout the firm, and should be incorporated into the orientation of new members upon hiring.

Firms must create and follow stringent internal accounting controls to safeguard operating funds, and also the funds entrusted to them. Then they must remain vigilant. The standard should not be established to trust no one, but rather "trust with verification."

Each financial process within the firm should be designed so that the same individual cannot initiate, authorize, transact, approve, record and report the transactions and activity. Too much control vested within one individual not only creates opportunity, but also could lead to an unforeseen financial disaster.

Your firm's policies and procedures must be anchored by participation from the partners and owners of the firm. They must be personally involved in overseeing, approving and reviewing transactions and activity. These include reviewing bank statements,

investment statements and payroll registers. These actions can create a deterrent effect, as well as provide for early detection of an issue.

In addition, partners and owners must be involved in reviewing reports covering the firm's accounts receivables, collections, disbursements, and potentially most important of all, the firm's client funds activity. These measures alone may not be sufficient to prevent all fraud and embezzlement from occurring, but they certainly go a long way towards helping a firm detect many of the fairly straight-forward schemes commonly perpetrated and minimally concealed day in and out.

Another important reason to implement these measures has to do with insurance claims. If a firm is the victim of embezzlement, the insurance company is going to want to see what controls were present to prevent it before paying the claim. Payment of a claim is not automatic. Recently insurance companies have begun to push back responsibility for the fraud to the victim. In recent cases, insurance companies have requested the perpetrator's personnel files. They were looking for any information to

see whether the firm knew, or should have known, that the individual was dishonest.

They are also asking for information on internal controls, policies and procedures. They want to determine if the victimized firm could have minimized their loss through their own efforts. The end result may be what has been referred to as "shared responsibility". In this case the insurance claim representative seeks to settle the claim for less than the amount reported as being lost. In one recent case, a firm had to go into litigation to get the full amount of the claim paid.

In summary, a firm's approach to employee fraud and embezzlement should incorporate three important measures. First, establish policies and procedures to minimize opportunities and prevent fraud from occurring. Second, design procedures to review transactions, reports and statements, to detect any possible schemes the preventive measures didn't prevent. Lastly, ensure the firm has adequate employee crime or employee dishonesty coverage to ensure some level of recovery in the event both preventive and detection measures failed. And, most importantly, remain vigilant. ■