

OPINION

Forensic accountants — The response team to financial 911 calls

By Stephen Pedneault

Mention forensic accounting, and most people will immediately think of Enron. Despite all the negative effects the Enron case has had on stock prices, employee retirement accounts and at least one major accounting firm, it has helped to introduce the specialized area of forensic accounting to the public.

So, what do forensic accountants actually do? Many work in litigation support, where an attorney engages a forensic accountant to assist with a client matter by analyzing financial transactions, providing a valuation of a business or quantifying different types of damages. Others work with the insurance industry in calculating and investigating claims for business interruption; catastrophic losses due to fires or thefts; lost earnings; injuries, disabilities, and deaths. Some assist business owners, financial institutions and law enforcement agencies with investigations of financial statement frauds and employee embezzlements.

Examples of financial statement fraud include a company intentionally misrepresenting its profitability and net worth by omitting key financial information from published financial reports; a company inflating accounts receivable amounts and inventory to enable more borrowing from their financial institution; or a non-profit organization including expenses incurred after the year has ended in their submitted financial reports to avoid having to give back unspent grant money to the granting agency.

Enron has been the most publicized alleged financial statement fraud in recent history, but the fact is these frauds occur regularly, and at the local level, more than one might expect. With the economy over the past 12 months experiencing decreased sales and increased layoffs, coupled with strict financial covenants, personal

guarantees and tight borrowing standards, the incentives to commit financial statement fraud have skyrocketed.

So, how can a forensic accountant help with financial statement fraud? By prevention and detection.

Forensic accountants can apply trending and financial analysis techniques to amounts and balances over periods of time to help identify patterns of financial abuse or intentional misstatement. Working with users of financial statements and reports, such as banks, credit unions, and granting agencies, forensic accountants can educate these organizations on not only how to determine trends and analyze reports, but also on how to interpret the results of such analysis to identify "red flags." A potential fraudster may think twice about committing the fraud for risk of being detected by alert financial analysts.

Forensic accountants can play a key role in detecting fraud that already has occurred by analyzing relationships between accounts and balances, identifying corroborating information, and comparing a company's published financial reports and net worth to others within the same industry.

According to the Association of Fraud Examiners' 2002 *Report to the Nation — Occupational Fraud And Abuse*, "companies lose on average six percent of revenues as a result of occupational fraud and abuse. Of that amount, 80 percent of the occupational frauds involve asset misappropriation, with cash targeted 90 percent of the time."

Employee embezzlements, once thought of as rare, isolated incidents, have become relatively commonplace. Why? Possible reasons include the fact white collar criminals often avoid prosecution and punishment; addictions to drugs or gambling may be on the rise; and organizations forced to "downsize" may be combining formerly segregated

financial duties into the hands of one employee, thus opening the door to fraud. In addition, computer technology has made it easier than ever before to embezzle funds.

Thefts of customer payments often are concealed by credit memos and adjustments posted against customer balances. Losses can accumulate into the hundreds of thousands, even millions. These adjustments remove unpaid balances from accounts receivable agings, thereby removing any possibility of detection through collection efforts. Procedures to ensure a review of adjustments posted during the period often do not exist.

As with sports, the best defense against employee fraud is a strong offense. Establishing a corporate culture based on honesty is by far the best solution. The tone should be set by management leading by example, educating employees that theft and abuse will not be tolerated and will be prosecuted, and that it is an employee's duty to report any signs of improprieties.

Combining this with sound internal controls, a system of checks and balances, and policies and procedures to ensure completeness and accuracy, builds a strong defense against fraud.

Forensic accountants can play a key role by aiding in the evaluation of a company's management structure, employee job responsibilities, and systems of internal controls and accounting procedures. These reviews, based on experience, can provide management feedback regarding design flaws, areas of opportunities for fraud, and other deficiencies within client systems. By proactively educating management about potential risk areas, and providing recommendations for design changes and improvements, employee fraud can be prevented before it

occurs.

Baskin Robbins ice cream outlets display signs above their registers stating that if they fail to provide a register sales receipt, the customer is entitled to a coupon for a free ice cream cone. The policy is designed to ensure the employees accurately record every sale.

Forensic accountants familiar with the criminal process, rules of evidence, law enforcement protocols, and techniques used in crime investigations can be instrumental in identifying, quantifying, documenting and reporting employee embezzlements or assisting federal, state, or local criminal justice agencies.

They can be especially helpful if a company has evidence that something fraudulent is happening, but have not identified the persons involved, how much was stolen, and whether to criminally prosecute the case.

While most forensic accountants are not lawyers, they can assist legal counsel in strategizing both prosecution and recovery options. Once fraud has been discovered, legal counsel needs to be contacted to determine how best to proceed.

Forensic accountants often are hired by attorneys to assist in the investigation by reviewing and compiling financial records in an attempt to identify the fraud activity, the perpetrator, and any losses or damages. Moreover, they can further help the victim of fraud by identifying the alternative federal and state tax treatments available for these losses, as well as recommending ways to avoid future fraud losses. ■

Stephen Pedneault is a CPA, certified fraud examiner and manager of forensic and litigation services with Haggett, Longobardi & Company, LLC, a certified public accounting and business advisory firm in Glastonbury.

editorial@hbjournal.com

Joseph Zwiebel
Publisher
jzwiebel@hbjournal.com

John Kilroy
Editor
jkilroy@hbjournal.com

Jesse Fable
Editorial Intern
Jfable@hbjournal.com

Steve Laschever
Nick Lacy
Photographers

Kim Davis
Accounts Manager
kdavis@hbjournal.com

Nancy Thody
Classifieds Manager
nthody@hbjournal.com

Tammy Stone
Martha Villani
Andrea Kelley
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Address
Please address all correspondence to:
Hartford Business Journal,
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