SPECIAL FOCUS:

Computer

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Forensics

If there were one brief definition of the work that forensic accountants do, it may be this: looking beyond the numbers and seeing situations as they really are.

Grasping the truth of the matter is vital to lawyers as they weigh and value their cases. More so than ever before, that truth can be obscured by the sheer complexity of new technologies. But despite that—or perhaps because of it—courts demand more and more in the way of transparency and disclosure, in discovery and beyond.

This month, we feature two articles that address the issues that many lawyers deal with daily. Called forensic accounting or computer forensics, this is an area that requires skill and an attorney's full attention.

BY KATHLEEN BARNEY, CFE

This Thing Called Forensic Accounting

Forensic accounting is once again front-page news due to such frauds as Enron and WorldCom. It seems you cannot turn on CNN without hearing about another executive brought up on fraud charges. Forensic accountants' previous claim to fame was the capture and prosecution of Al Capone for tax evasion. Despite the press coverage over the last few years, many people are unaware of forensic accountants, nor do they have an understanding of what these people do.

When forensic accountants hear the inevitable question "What does you do?" they know a paragraph explanation will ensue. The questioner's initial expectation is excitement at what must be cloak-and-dagger work: "Oh, like *CSI*" or perhaps astonishment: "You count dead people's money."

It's our sorry lot to have to disappoint these individuals. That's right: Forensic accounting is not exactly like *CSI*. In fact, forensic accountants do not sit in a dark room with a small flashlight examining financial documents. And they don't go to the crime scene and count the money in the latest victim's wallet before the coroner hauls away the body.

Forensic accounting is a specialized field carved out of multiple disciplines. Auditing techniques, accounting skills and investigative procedures are all key components of the practice. The Association of Certified Fraud Examiners (ACFE) defines forensic accounting as the application of accounting skills to provide quantitative financial information about matters before the courts.

The ACFE distinguishes fraud examination from forensic accounting but overlaps the disciplines in fraud investigations. The field of fraud examination encompasses many subsets, such as prevention, deterrence, anti-fraud training, investigation, internal control assessments and fraud loss calculations. This differs from forensic accounting because not all findings will be used in court.

Like any expertise, there are specialists and generalists. Forensic accountants may specialize in financial or partnership disputes, construction or environmental claims, trust/estate valuations, damages calculations or fraud investigations.

Most attorneys who retain a forensic accountant are looking for an expert to confirm or resolve allegations of fraud. In order to assist attorneys with cases involving alleged fraud, a detailed fraud investigation must be conducted. The major components of fraud investigations include securing documentation related to the allegations, interviewing witnesses and suspects, seizing electronic information, analyzing financial statements and accounts, and reviewing accounting processes and procedures.

It is important to note the difference between forensic accounting and financial audits. The biggest misconception is that financial audits will uncover all frauds. An audit is designed to detect material financial statement fraud. But it is ill equipped to recognize many types of internal frauds, such as fictitious vendors or ghost employees. The purpose of an audit is to verify that the financial statements are true and fairly presented. The purpose of forensic examination, on the other hand, is to review possible exploitations of the internal controls over a company's assets. In other words, forensic exams determine where the loopholes are and who is taking advantage of them.

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The Need for Forensic Accountants

Is there really a need for forensic accounting? Is fraud so pervasive that it affects companies of all sizes?

Unfortunately, yes. The ACFE conducts a study every two years regarding fraud in the United States. In the 2006 Report to the Nation, the ACFE estimated that five percent of a company's revenue is lost to fraud annually. When applied to the nation's gross domestic product, the fraud loss equates to $652 billion annually.

Who is the hardest hit by fraud? Sadly, it's the groups that can least afford it—small businesses. The median loss per fraud instance in small business is $190,000, according to the ACFE study. Fraud affects all businesses. The question is to what extent is it affecting your clients.

How can attorneys use forensic accountants to their benefit? As in all cases, it's critical to have an expert on your side. The Certified Fraud Examiner designation is the most well known of the fraud credentials for forensic accountants. Forensic accountants can become experts in cases such as embezzlement, partnership disputes, marital dissolutions, insurance claims, securities fraud and bankruptcy.

Although forensic accountants are great assets as expert witnesses, they can also be a resource to your firm as a consultant. Take the case of a business dispute.

Your client, a partner, wishes to be bought out of the partnership. A business valuation is conducted and the value of the business is less than expected. Perhaps not all sales are being recorded on the books, negatively affecting the value of the company. A forensic accountant can be retained to investigate the possibility of unrecorded or underreported sales. If the forensic accountant determines the managing partner is skimming $100,000 a year, then the revenue figure used in the valuation is grossly understated.

A second example is a child support hearing in which the wife is looking to increase the support and the husband is refuting the wife's need for additional income. The husband's argument is that she moonlights as an exotic dancer and makes more money then he does. Considering her job is cash intensive and not conducive to a paper trail, how do you determine her earnings? A forensic accountant can conduct an analysis of her finances. By using the net worth or expenditure method, a forensic accountant could indirectly substantiate her income.

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Finally, a company may know who is stealing and how, but the police won't touch the case because of their lack of resources for financial crimes. Your client looks to you for civil remedies. Forensic accountants can document the case and quantify the total amount of loss the company has suffered. The forensic accountants can then issue their findings through written reports and/or oral presentations. Accountants' attention to detail will be reflected in the report documenting the fraud. The forensic accountants can later be called to testify to their findings in court.

Rule of thumb: If your client's case involves money, you should use a forensic accountant.

Five Common Mistakes

As in any other legal case, there are many ways a fraud investigation could be jeopardized. Some mistakes are made by the investigators or attorneys, but the majority of mistakes result from the actions of the business owner or executive.

Mistake 1: Mishandling Evidence

It is imperative that when fraud is discovered, the evidence related to the fraud is secured. If an employee has altered invoices as a means to embezzle from the company, those invoices must be collected, copied and the originals secured. The documents are the evidence of the case that links the suspect to the crime. If documentation is left in full access to other employees, the argument could be made that the

Characteristics of a Good Forensic Accountant

- Solid foundation of accounting knowledge
- Strong oral and written communication skills
- Detail oriented
- Effectively apply investigative techniques
- Past investigative experience
- CFE designation
- Satisfaction of past clients
- Independence

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documentation was altered after it left the possession of the suspect. If this was a murder case, you would not leave the suspect's gun in the open where other people could touch it and add fingerprints to it.

Mistake 2: Altering Originals

Copy, copy, copy. As attorneys, you are aware that you should always work from a copy and not the original, but do your clients know that? On more occasions then I can recall, clients have marked up and made notes on original documentation. Some notes are as blatant as writing "forgery" across a check. When making notes regarding documentation, it is best to use copies or post-it notes. If someone writes on the originals, it is more difficult to determine which employee altered the document.

Mistake 3: Lack of Predication

Predication is a necessary component of a fraud examination. Predication is a set of circumstances that would lead a reasonable and professionally trained person to believe a fraud has occurred, is occurring, or will occur. This must be present before the investigation. Predication could be a tip from an employee, unreasonable answers or missing documentation. Without predication, the investigation could be viewed as a witch hunt.

Mistake 4: Accusing or Altering the Suspect

Your client finds out an employee has been stealing from the company. The initial thought of your client may be to confront the employee. Unfortunately, this would be the wrong action to take. There is a reason investigators interview the suspect during the last phase of the investigation. If they interview the suspect in the early stages, they lose the element of surprise, and the suspect is now aware of the investigation.

One of three things can happen. The suspect denies the allegation and is now aware the company is investigating him or her. Moreover, the suspect now has the opportunity to destroy evidence or cease other frauds he or she might have been perpetrating before detection. Second, the suspect may be innocent and the company cannot prove the crime. This could result in either a lawsuit brought against the company by the accused or, at the very least, a lack of trust and goodwill by the accused toward the company. In the best-case scenario, the suspect admits to the crime and leaves the premises without incident. This is a one-in-three chance that your client should not risk.

Mistake 5: Failure To Obtain a Written Statement

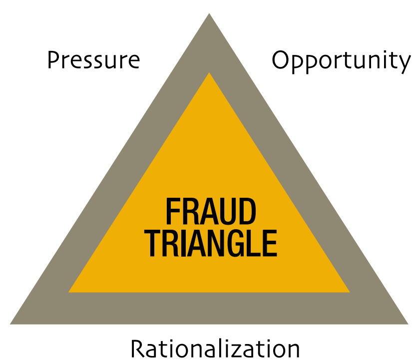
If your clients ignore the warning in Mistake 4 and confront the individual, this next problem usually occurs: The suspect admits to committing the fraud, is terminated and is escorted off the property. Yet, no written statement is obtained from the suspect. Now the supposed confession is a "he said/she said" argument. The suspect, aware of the ongoing investigation, usually then obtains legal representation and refuses future interviews with forensic accountants.

Protecting Your Own Practice

Attorneys see cases from their clients involving fraud often, yet they are unaware of how easily fraud can be perpetrated against them. Law offices fall victim to fraud every day. Due to the nature of the industry, attorneys are always focused on their clients' issues and not on those within their own firm. Firms need to put checks and balances in place to protect the firm's assets.

A local attorney once told me that three out of five of the law firms he was employed by had an office manager or other personnel steal from the firm. Let's face it: Lawyers are great at arguments, but not usually as savvy with accounting. Attorneys fall into the same pitfalls as doctors; they need to hire people to handle the billing and payments. Attorneys are focused on their discipline and trust others will be responsible with their job duties.

Recognizing the signs of fraud is simple if you know the fraud triangle. All three factors of the triangle must be present for a fraud to occur. The signs are pressure, opportunity and rationalization.



First, an employee feels the pressure of a financial burden such as divorce, a gambling problem, alcoholism or an excessive lifestyle. This becomes his or her motivation to steal. Second, opportunity exists in the loopholes of the internal controls, which allow the employee to exploit his or her position for personal gain. Finally, the fraudster must be able to rationalize the behavior. I have never met a perpetrator of fraud who considered himself a crook. The most common rationalizations are "I will pay it back," "The firm can afford it" and "I'm not hurting anyone."

The easiest way to mitigate fraud is by limiting the opportunity employees have to take advantage of their positions. If the opportunity for your employees to commit fraud is limited, then your employees will be less inclined to attempt fraudulent acts. Keep in mind: Internal controls are in place to keep honest people honest.