Today’s Agenda

✔ What is it that needs to be protected?
✔ Tips and techniques to effectively manage assets
✔ **Red Flags**: Examples of fraud and embezzlement within law firms
✔ Emerging issues in asset management

Housekeeping

- PowerPoint Slides
- Additional resources
- Questions & Answers
It is my normal practice to provide as much material as I can for the attendees. As a result I might not cover every slide included in the presentation. If the slides I do not cover raise questions in your mind, please feel free to either catch me after the presentation or send me an email and I will answer your question.
What is it that needs to be protected?

• Assets
  – Tangible
  – Intangible

• The firm’s reputation

• The practitioner’s reputation

• The practitioner’s professional licenses

The Four Corners of Fraud

• Incentive: I want to, or have a need to, commit fraud.

• Opportunity: There is a weakness in the system that the right person could exploit. Fraud is possible.

• Rationalization: I have convinced myself that this fraudulent behavior is worth the risks.

• Capability: I have the necessary traits and abilities to be the right person to pull it off. I have recognized this particular fraud opportunity and can turn it into reality.
Environment

- Integrity and ethical values;
- The commitment to competence;
- Leadership philosophy and operating style;
- The way management assigns authority and responsibility, and organizes and develops its people;
- The 3 Ps: Policies, protocols and procedures.
The Face of Fraud Today

• The average yearly loss of revenue to fraud is equal to 6% of GDP, which translates to about $660 billion dollars a year!
• $3.5 trillion of GWP!
Source: Association of Certified Fraud Examiners (ACFE), 2012

Internal Controls
Internal Controls

What are Internal Controls?
Mean different things to different people and organizations

**Definition:** Internal Controls are systems of policies that:
- protect the assets of an organization
- create reliable financial reporting
- promote compliance with laws and regulations
- achieve effective and efficient operations

What are internal controls?

- Internal controls are a set of policies and procedures to prevent deliberate or misguided use or diversion of enterprise assets and resources for unauthorized purposes.
Types of Controls

- **Preventive**: Designed to keep errors or irregularities from occurring in the first place.

- **Corrective**: Designed to correct errors or irregularities that have been detected.

- **Detective**: Designed to detect errors or irregularities that may have occurred.

Major Components

1. Control environment
2. Risk Assessment
3. Control Activities
4. Information and communication
5. Monitoring
Foundational Issues

Control Environment

• Risk Assessment
• Control Activities
• Information and Communication
• Monitoring

Concepts

• Continuous, built-in component of operations
• Affected by people
• Provides reasonable assurance, not absolute assurance

Understanding the Revenue and Expense Cycles

Best Practices

• Preparing accurate and timely financial reports
• Audit/review of firm financial statements
• Evaluating staff and systems
• Inventory of real and personal property
• Handling of funds received and disbursed
• Implementing personnel and conflict of interest policies
Key Take Away Point!

Segregation of duties may be the most important element of safeguarding assets

Understand the Limitations

- No matter how well internal controls are designed, they can only provide reasonable assurance that objectives have been achieved. Some limitations are inherent in all internal control systems. These include:
  
  - **Judgment**: The effectiveness of controls will be limited by decisions made with human judgment under pressures to conduct business based on the information at hand.
  
  - **Breakdowns**: Even well designed internal controls can break down. Employees sometimes misunderstand instructions or simply make mistakes. Errors may also result from new technology and the complexity of computerized information systems.
  
  - **Management Override**: High level personnel may be able to override prescribed policies and procedures for personal gain or advantage. This should not be confused with management intervention, which represents management actions to depart from prescribed policies and procedures for legitimate purposes.
  
  - **Collusion**: Control systems can be circumvented by employee collusion. Individuals acting collectively can alter financial data or other management information in a manner that cannot be identified by control systems.
Types of Assets and Related Control Mechanisms

What is it that needs to be protected?

- Cash
  - Firm accounts
    - Collections
    - Disbursements
  - Client funds
    - Receipts
    - Disbursements
  - Invested Excess
Disbursing and Receipt of Funds

Disbursement of funds
• Have a written policy
• Documentation
  – Requisitioning
  – Authorization
  – Verifying
  – Recording

Receipt of funds
• Handling mail (and the new era of electronic funds transfer!), A/R posting, deposits
  – Write-off review

Additional Cash Management Issues

• ED /Office Manager to receive bank statements directly from bank and review statements with checks (any qualified bank can provide electronic copies of checks)
• Keep trust accounts under G/L control
Key Take Away Point!

• The person who reconciles the bank statement should not be an authorized check signer.
  – Create a 2nd Imprest Account to allow for smaller disbursements to be authorized and executed by the person who reviews the primary account(s).
  • Similar to how the firm’s petty cash account should function

What is it that needs to be protected?

• Office equipment and supplies
  – Computers & peripheral equipment
  – Computer software
  – Office supplies
  – Postage, FedEx, messenger, etc.
  – Cellular usage
  – Travel related expenses
  – Soda pop, snacks, coffee, etc.

*Studies show over 70% of employees have embezzled at some level....*
Fixed Assets and Intangibles

- Tactics and Procedures for Fixed Asset Controls
  - Software options
  - Sequential numbering tags
  - Annual physical inventory
  - Control of key fixed assets (e.g. laptops)

- Intangible Assets
  - Trade names
  - Proprietary processes and information

Fixed assets create some additional issues and concerns:

- Book vs. tax basis
- Cleaning up records for property taxes
- Capitalization policy
- Cost segregations studies for build outs / large TI projects
What Related Aspects Need to be protected?

- Internet and Email considerations
- Disgruntled employees
- Terminations and new hires

Preventing Identity Theft

- Don't have open access to your data.
- Use passwords.
  - Protect your passwords
  - Use unique passwords
- Encrypt your files.
- Watch out for co-workers who regularly hang around your office chatting with you.
Key Take Away Point!

- When terminating any employee, regardless of the reason, follow stringent protocols:
  - Plan ahead for the proper timing in cutting off access to all firm resources, including email, client files, access cards and keys.
  - Cut off all server and computer access, including remote access, immediately.
  - Assign someone to be with the employee until the physically collect their personal belongings and vacate the property.

Preventing Identity Theft

- Erase old hard drives.
- Protect wallets and purses.
- Don’t reply to unsolicited email.
- Shred sensitive documents.
- Have a plan!
  - If the worst happens, have a list of phone numbers.
The 2012 Marquet Report on Embezzlement

• Perpetrators typically begin their embezzlement schemes in their early 40s;
• Major embezzlement schemes span nearly a 5 year period, on average;
• By a significant margin, embezzlers are most likely to be individuals who hold financial positions within organizations;
• The most common embezzlement scheme is the forgery or unauthorized issuance of company checks;
• Gambling is a clear motivating factor in driving some major embezzlement cases; and,
• Less than 5 percent of major embezzlers have a prior criminal history.

What other steps can a firm take to protect its interests?

• Policies and procedures
  – Understand what a good voucher system is and it’s benefits
  – Pre-set Re-order sheets
  – Who should be authorized to sign checks and what support should be included?
  – Protocols for electronic receipts, credit card receipts and payments and wire transfers?
What steps can a firm take to protect its interests?

• Segregation of duties
  – The person preparing checks should not reconcile the bank statement
  – The person receiving the mail should not be depositing client payments
  – The person preparing checks should not be a check signer
    • Tip: Keep a separate impress account to fund for small disbursements

• Independent audits and reviews of financial statements and internal controls
  – Use a third party accountant or bookkeeper to do year end work as a check over on-going daily and monthly bookkeeping
  – Have someone qualified assess your internal control weaknesses
  – Require Betty Bookkeeper to take a vacation
What steps can a firm take to protect its interests?

• Be involved and observant
  – Understand the signals that can indicate problems

• Eliminate opportunities
  – Lots of cash creates risk
  – Employee personal problems create risk
  – New and departing employees create risk

Embezzlement doesn’t have to be cash – if you have someone working in your billing department and they have a family member or close friend being represented by the law firm, do not let them do the billing. Embezzlement comes in many forms. They can write off time, write down bills, etc. This too is embezzlement.
Recordkeeping Issues

• Retention of records [anecdote: recently got a call from a former firm of mine, they moved offices and had large tax basis T1 w/off and were under audit looking for supporting records going wayyyy back]

• Our protocol is 7 years, which satisfies the 6 years for IRS audits, plus one to be safe.
  – Some records need to be kept longer
  – Protocols for storage and destruction of both hard copy and electronic records

Examples to Learn From
Examples of fraud and embezzlement within law firms

• Meyerson Kuhn
  – Bowie Kuhn, former commissioner of major league baseball
  – Alleged billing fraud by American Express in excess of $12,000,000!

• ABC, P.C.
  – Accountant notes unusual disbursements while reconciling client ledger in conjunction with tax return preparation
  – Inquires about costs for new computer equipment over two prior years
  – Forensic analysis uncovers 6 years of fraud by Betty Bookkeeper/Office Manager
Examples of fraud and embezzlement within law firms

• ABC, P.C.
  – Betty first bought lunch and dinner for friends and charged to firm as client development
  – Betty goes shopping at Cherry Creek....Neiman Marcus no less!...charged to office supplies
  – Betty goes to Circuit City....home stereo and big screen TV...charged to office computers

Examples of fraud and embezzlement within law firms

• ABC, P.C.
  – Betty convicted of felony embezzlement with full restitution over time to ABC, P.C.
  – Partners now pay attention to check signing, bank reconciliation, financial statement detail.....
Examples of fraud and embezzlement within law firms

• John Smith, P.C.
  – John Smith has major personal problems
    • Alcohol & Drugs
    • Troubled marriage/affairs with staff
  – John Smith dips into client trust funds for a small short-term loan

• John Smith, P.C.
  – John Smith ends up spending over $300,000 out of client trust account
    • Colludes with office paralegal (the mistress) to hide indiscretions from other office staff for more than 2 years
    • Associates blow the whistle and an intervention takes place for a very troubled person
    • John Smith is a convicted felon and no longer practices law
What does a thief look like?

Who knows who this is?
Red Flags

- A signal that something is out of the ordinary
  - may need to be investigated further
  - do not indicate guilt or innocence
  - possible warning signs in not right
Red Flags

• Do not ignore a red flag!!!!
  Studies of fraud cases consistently show that red flags were present, but were either not recognized or were recognized but not acted upon by anyone. Once a red flag has been noted, someone should take action to investigate the situation and determine if a fraud as been committed.

• Sometimes an error is just an error
  Red flags should lead to some kind of appropriate action, however, sometimes an error is just an error and no fraud has occurred. You need to be able to recognize the difference and remember that responsibility for follow-up investigation of a red flag should be placed in the hands of a measured and responsible person.

• The majority of fraud cases (41.2 percent) are committed by clerk level employees. However, the median loss for fraud committed by managers was $218,000, which is almost three times greater than the loss resulting from an employee scheme.

• Approximately 61 percent of the fraud cases were committed by men. The median loss resulting from fraud by males was $250,000, which is more than twice the median loss attributable to women.

• Most fraud perpetrators (87.9 percent) have never been charged or convicted of a crime.

• Nearly 40 percent of all fraud cases are committed by two or more individuals. The median loss in these cases is $485,000, which is almost five times greater than the median loss in fraud cases involving one person.

• The median loss attributable to fraud by older employees is greater than that of their younger counterparts. The median loss by employees over the age of 60 was $713,000. However, for employees 25 or younger, the median loss was $25,000.
Employee Red Flags

- Employee lifestyle changes: expensive cars, jewelry, homes, clothes
- Significant personal debt and credit problems
- Behavioral changes: these may be an indication of drugs, alcohol, gambling, or just fear of losing the job
- High employee turnover, especially in those areas which are more vulnerable to fraud
- Refusal to take vacation or sick leave
- Lack of segregation of duties in the vulnerable area

Management Red Flags

- Increase in purchasing inventory
- Abnormal inventory shrinkage
- Lack of physical security over assets/inventory
- Payments to vendors who aren’t on an approved vendor list
- High volume of purchases from new vendors
- Purchases that bypass the normal procedures
- Purchasing agents that pick up vendor payments rather than have it mailed
Red Flag Excuses

- Explanations of “new found” wealth may include:
  - “My husband/wife just got a great promotion.”
  - “I have a few little investments that have been doing really, REALLY well.”
  - “Great Aunt Ethel passed away and I was totally surprised – she left us quite a nice little nest egg.”
  - “I finally decided to get rid of some property that’s been in the family for years.”

Key Take Away Point!

- Red flags are warnings that something could be or is wrong.
- Auditors, employees, and management need to be aware of red flags in order to monitor the situation and then take corrective action as needed.
- Employees who notice that red flags are ignored may mistakenly believe that it is okay to game the system or that they won’t get caught.
- A little fraud soon becomes a large one if left to grow.
Do you want to be famous for infamous?
Confidence Scams

• Nigerian Letter
• Spanish Prisoner
• Black Money
• Fake Checks
• Employment
• Lottery
• Romance

– Advance payment scams

Why they work

• The perpetrator has the skill to win your confidence
• Play on your emotions:
  – Greed
  – Desire to help
  – Empathy
  – Compassion
  – Naiveté
Knock, Knock….Candy Gram!

- Western Union or Money Gram
- International Wire Transfer
- Other party must remain “anonymous”
- If it is too good to be true …

Bibliography

- Law Office Staff Manual for Solos & Small Firms, Demetrious Dimitriou, 1995, $49.95
- ABA Guide to Lawyer Trust Accounts, Jay G. Foonberg, $69.95
Useful Websites

Websites

• www.aicpa.org/antifraud  (American Institute of Certified Public Accountants)
• www.theiia.org  (Institute of Internal Auditors)
• www.thesource.alanet.org  (ALA’s Legal Management Resource Center)

Ronald L. Seigneur,
ASA CPA•ABV•CFF  CVA CGMA
Seigneur Gustafson LLP CPAs
Colorado Front Range:
– 940 Wadsworth Blvd., Suite 200
  Lakewood, Colorado  80214
– 5950 Main Street, Suite 201
  Parker, Colorado  80365

☎ 303.980.1111 voice
☎ 303.308.6969 fax

Ron.Seigneur@cpavalue.com
www.cpavalue.com
www.cannavaluation.com
?? Questions ??