fraud alert

february/march 2004

Follow the money

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Follow the money

USING FINANCIAL RECORDS TO PROVE FRAUD

In a typical fraud case, financial and other records are the principal — and sometimes the sole — evidence. Whether needed to establish proof beyond a reasonable doubt for a criminal case, or by a preponderance of evidence for a civil case, these records are critical. With the right documents, even if no witnesses are available to testify, it may be possible to convince a court or obtain a confession from a fraud suspect.

Financial records often are complex. It requires a skilled practitioner to produce an analysis that will withstand cross-examination and other challenges. Forensic accountants can identify the best potential sources of evidence and synthesize them to help build a strong case.

ON THE DOLLAR TRAIL

When starting work on most fraud cases, the forensic accountant analyzes the immediately available documentary evidence for clues to what the fraud might entail, then researches more in-depth evidence sources. He or she seeks a complete list of:

- The subject's assets at the beginning and end of the period under review, including residences, bank accounts, rental property, investments, automobiles, home furnishings and life insurance cash value,
- His or her liabilities at the beginning and end of the period, including mortgages, loans, credit card balances, taxes due, other outstanding bills, alimony and child support,
- Income from all sources for the period including salaries, commissions, rental income, dividends, interest, insurance proceeds and inheritance, and
- Expenses for the period including mortgage and rental payments, utilities, food, transportation, insurance, clothing and health care.

What kinds of documents can deliver this kind of information? Besides relevant letters, faxes and e-mails, experts look at:

Financial statements. The forensic accountant performs both "horizontal analysis" of changes in given accounts from one period to the next, and "vertical analysis" of the relative size of a specific account to that of comparable entities. In each case, significant deviations from expected relationships and trends may highlight areas needing more detailed investigation.

Tax returns can be useful in identifying profits and losses from previously undisclosed businesses.

General ledgers, journals and payroll records. Forensic accountants scrutinize these either as a follow-up to an anomaly spotted during financial statement analysis, or to focus in on an insider's or witness's tip.

Accountants' work papers. These documents identify which areas accountants carefully reviewed as part of the audit process — and which ones they didn't. They highlight issues the auditors raised, along with the explanations offered by the company being audited. Remember, though, that accountants generally comment only on "material" items, but a fraud investigation focuses on uncovering the "needle in the haystack."

Tax returns. Forensic accountants use tax returns in fraud investigations, but because of the differences between generally accepted accounting principles (GAAP) and the tax code, financial statements are not directly comparable to tax returns. The differences include the timing in which certain elements of income and expense are recognized, and whether they're recognized at all. Tax returns, however, can be useful in identifying profits and losses from previously undisclosed businesses, interest and dividends on hidden bank accounts, and deductions and expenses (such as real estate taxes) that may lead to unknown funds or assets.

Mapping illicit income

When assembling fraud evidence, forensic accountants need to select the right method to prove income came from unknown sources. They often use the "net worth approach," which involves collecting a large variety of financial information and producing an analysis of whether the subject's combined expenditures and change in net assets during a given period exceed his or her income from known sources for that period.

The IRS routinely uses the net worth approach to prove tax fraud. But it can be equally useful in proving other types of fraud, including embezzlement and bribery. The net worth approach can take the form of the "asset method," used when the subject has invested illegal funds to accumulate wealth and acquire assets, or the "expenditures method," used when the subject spends illicit income on items he or she can't accumulate, such as travel and entertainment. For more information on these methods, please ask us about our special supplement, "Pinning down income from unknown sources."

Bank records. The subject's statements and canceled checks may reveal such irregularities as unusually high balances, abnormally large deposits, deposits unconnected to legitimate sources, and checks written that may identify other bank accounts, credit cards, loans or the purchase or location of major assets.

Brokerage records. These statements can help complete the subject's financial profile in terms of cash deposits and funds transfers, as well as the amounts used to purchase securities, and their earnings.

Property records. Public records of corporate filings, real estate ownership, mortgages, liens and judgments, and Uniform Commercial Code (UCC) filings may reveal previously undisclosed assets and liabilities.

Credit card records. These can help document the subject's lifestyle, travel and expenditures.

Telephone records. Knowing whom the subject called can identify contacts with real estate and securities brokers as well as extramarital relationships.

With evidence in hand, the forensic accountant chooses the clearest method to organize and present it. (See "Mapping illicit income" above.) Properly collecting and synthesizing this data, combined with gathering statements from insiders or other witnesses, should help prove how the fraud took place.

ONE STEP AT A TIME

Making optimal use of financial records calls for extensive fraud investigation experience and forensic accounting skill. To learn more about how you can build a case against a fraud suspect, please call us for a consultation.

Getting the goods on inventory theft

When a business suspects that a current or former employee may have stolen inventory, it can be hard to find out whether the suspicions are true, and if they are, to document and prove the theft.

Why so much difficulty? For starters, many companies give numerous employees access to inventory and tolerate ongoing poor record keeping. They may perform a complete inventory only once a year, or use haphazard methods if they count more often.

One person performing multiple duties can both commit and conceal fraud.

These businesses' owners don't know what they should have at a given time or, if inventory is missing, who might be responsible. So forensic accountants are often called on to examine company records and physical inventory and learn exactly what's been happening.

IDENTIFYING THE PROBLEM

In some cases, investigation proves there's been no inventory theft, even though items aren't where they should be. The problem is usually sloppy paperwork and procedures in one or more areas. So forensic accountants check the company's receiving and inspection procedures, for instance, before assuming a theft has taken place. (See "Theft vs. oversights" on page 5.)

If there's no other plausible explanation for the missing inventory, the experts look for signs that the environment is conducive to fraud. For instance, a company with poor controls over purchasing, receiving and cash disbursement runs a real risk of inventory theft. One person performing multiple duties can both commit and conceal fraud.

If they believe the inventory could have been stolen, the forensic accountants begin combing the records for clues. Anything that doesn't follow established inventory standards can raise a red flag. Some examples:

- Odd journal entries posted to inventory,
- Large gross margin decreases,
- Sudden problems with out-of-stock inventory, and
- Unusually large account adjustments after staff performs a physical count.

Having found one or more warning signs, the experts set to work to establish evidence and prove the fraud.

SEARCHING FOR EVIDENCE

Inventory fraud may leave a paper trail, so forensic accountants review journal entries for unusual patterns. For example, an entry recording a physical count adjustment made during a period when no count was taken obviously warrants suspicion. The accountants follow up by tracing all unusual entries to supporting documents.

Theft vs. oversights

Before assuming theft, forensic accountants check to see whether the items were really stolen — because they may have been on the premises all along. Or, they might have been shipped out to customers, or never delivered by vendors.

For instance, poor physical controls can cause mistakes in recording items taken from storage. A company without a location assignment for each item, an effective method of keeping tabs on overflow stock and a well-run returns system might have misplaced inventory.

Other conditions that can give the appearance of stolen inventory are short vendor shipments nobody notices because of lax receiving and inspection procedures, and unobserved vendor overcharges. Forensic accountants look for trouble in these areas if the company lacks proper transaction, approval, authorization and documentation procedures.

Finally, some companies fail to bill customers for shipments because the shipping and billing functions don't work in tandem. Obviously, this can cause inventory to disappear without explanation.

TAKING A COUNT

It's important to confirm the physical inventory as well. Although a count may disrupt normal business routines, it's an effective way to learn exactly what merchandise is missing. If done properly, it also may lead directly to the fraudster.

Forensic accountants sometimes recommend hiring an outside inventory firm to not only perform the count but also value the inventory. The outside experts can arrive quietly and unexpectedly, possibly taking a fraud perpetrator by surprise.

Financial records aren't the only "paper" evidence. Vendor lists may show suspicious patterns, such as post office box addresses substituting for street addresses, vendors with several addresses, and names closely resembling those of known vendors.

Even if they've found no evidence of nonexistent vendors, forensic accountants look at all vendor invoices and purchase orders for anomalies. One example: unusually large invoices or alleged purchases that don't involve delivery of goods.

Discrepancies between the amounts due per invoice, the purchase order, and the amount actually paid warrant investigation. The experts also familiarize themselves with the cost, timing and purpose of routine purchases and flag any that deviate from the norm.

Whether employees or an outside firm count inventory, experts carefully observe warehouse activity once employees realize a count is imminent. Fraudsters may make hurried attempts to shift inventory from another location to substitute for missing items they know will be discovered.

Inventory at remote locations also can disappear, so forensic accountants often will confirm quantities with the storage facility or go with the client to personally inspect them. In pinning down suspected theft, it's best to do the count in person rather than delegate the job to a possible fraudster.

PROVING THE THEFT

Even at a company where inventory confusion reigns, it's possible to build solid evidence of theft, but it takes expertise and hard work. In cases involving missing inventory, we can examine the paper trail and the physical inventory to learn what's happened and, if needed, help produce understandable and convincing courtroom presentations to prove the theft.

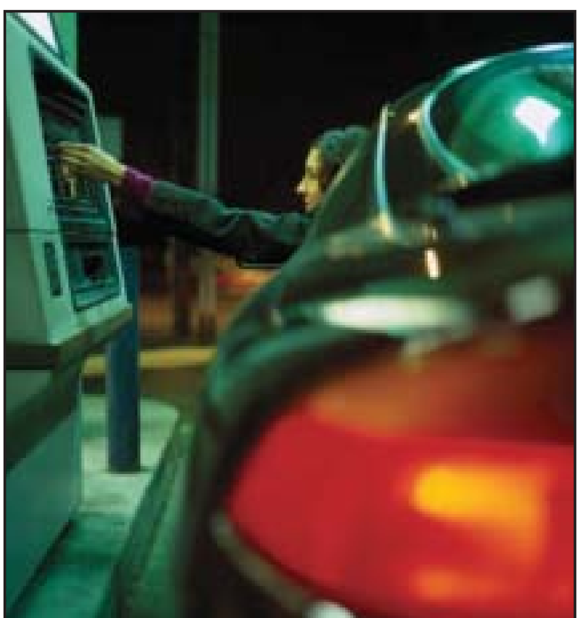
Fraud to watch for:

HIGH-TECH ATM, DEBIT CARD FRAUD SPARKS DISPUTES

ATM fraud is nothing new, but banks are giving customers a harder time if their ATM or debit cards incur unauthorized charges and they haven't reported the cards lost or stolen.

Federal Reserve regulations mandate that banks can't hold customers liable for more than $50 of losses if they report card or PIN theft within two business days. But this doesn't help people who have no idea their information has been stolen until funds start disappearing from their accounts.

The banks' view is that the customers must have shared the cards or PINs with others who then withdrew funds — making the customers responsible for the loss. Many individuals, however, are swearing this wasn't so, leading to lengthy disputes with financial institutions.



INVISIBLE THIEVES?

In fact, some of today's high-tech methods do allow total strangers to steal card information almost invisibly. Most ATM fraud starts not at banks, but at such locations as service stations and mini-marts where security isn't as tight and thieves find it easier to tamper with cash machines.

To steal PINs, thieves may use small electronic scanners or remote cameras. Some surreptitiously cover ATM keyboards with thin overlays containing computer chips that capture the customer's typed-in PIN. Partners in crime working at the bank then provide the rest of the information needed to steal funds from the account.

Thieves have been known to record debit card data using "wedges" similar to those customers swipe their cards through at supermarket checkout counters. Dishonest cashiers or waiters can hide the tiny devices in the palm of a hand. They then imprint the stolen information on blank cards with magnetic strips that are easily available over the Internet.

HELP IN SIGHT?

The good news is that banks and their customers are becoming more aware of high-tech theft and increasing their precautions. Also, federal regulators have warned financial institutions not to routinely brush off account holders who believe their data has been stolen. If you'd like further information about frauds affecting financial institutions, please contact us.

Document production headaches?

LET A FORENSIC ACCOUNTANT FIND A CURE

Discovery can be the most difficult and expensive part of a fraud case. And though documents are often the most useful evidence in litigation, obtaining them from the opposing party may pose problems. Fortunately, forensic accountants can often cure document production headaches.

PAINFUL TENSIONS

Of course, both sides should promptly turn over relevant requested documents, as long as they're not protected by some legally recognized privilege or confidentiality order. But the opposing party often wants to avoid disclosing materially incriminating evidence that will strengthen the other side's position.

By hindering discovery, one side can delay proceedings and make opponents pay extra costs. And it's hard to prove the other side is intentionally failing to cooperate, so requesting court intervention can only prolong the process.

STRESS RELEASE

How can forensic accountants help? These experts seek every document, including those in electronic form, generated during the period at issue that could affect the case. Even if the other side refuses to hand over incriminating documents, however, forensic accountants can use other investigative techniques to gather evidence. This may build a strong enough case to convince the opponent to stop hoarding.

For example, say a vendor is suspected of bribery in a procurement fraud case. The forensic accountant can usually determine via a background investigation if other customers have sued the vendor for overcharges or fraud.

If a business suspects an employee of receiving bribes or kickbacks, the forensic investigator can prepare a financial profile and a net worth analysis of the person. A sudden increase in wealth obviously raises a red flag.

Investigating the vendor's and employee's lifestyles can help, too. For instance, say the forensic accountant learns the employee has a drug or alcohol addiction, gambling habit, extravagant lifestyle or other personal financial problems. A party can gain significant leverage from this evidence.

Based on these and related techniques, a forensic accountant can help develop a case by identifying and evaluating the existing evidence that an economic crime has been committed. He or she may also formulate scenarios of what could have happened, and name the methods used to disguise irregularities. Last, a forensic expert can describe the crime's probable scope.

Once the plaintiff has established a solid framework of evidence against the defendant, the other side may realize that withholding documents will increase litigation costs but not prevent the inevitable if the case goes to trial. Even with no trial in sight, the sheer weight of evidence can bring about compliance. Also, the defendant's non-cooperation, coupled with the compelling evidence against him or her, can result in punitive damages.

THE DOCTOR IS IN

If you're having difficulties persuading the opposing party in a fraud case to produce documents, please give us a call. We can review the case with you and suggest ways to obtain the evidence you need.

Don't Let Fraud Ruin Your Business

Occupational fraud and abuse costs American businesses an estimated $600 billion annually — roughly $4,500 per employee. Small businesses are the most vulnerable to these crimes. But you don't just have to stand there and be victimized by them.

Let Rogers, Lynch & Associates LLC assist you in combating fraud and abuse. We offer a wide range of forensic accounting, and fraud-related services, including:

- Litigation Consulting and Support
- Expert (Witness) Services
- Fraud Detection and Deterrence
- Insurance Claim Analysis: Loss Profits, Business Interruption, Surety Bond Claims, Fidelity Bond Claims
- Divorce/Community property Partition
- Evaluation of Internal Control Systems
- Financial Statement Analysis and Interpretation
- Bankruptcy and Reorganization
- Asset Recovery
- Track and Locate Assets Misappropriated

Since our firm's founding in 1989, we have been committed to providing our clients professional service of the highest quality. Our clientele includes family and closely held businesses, public corporations, and commercial lenders throughout the United States.

We would welcome the opportunity to help you prevent, detect, or prosecute fraud. Please call us at 504-282-1441 or visit our Web site: www.rlastars.com, and let us know how we can be of assistance.

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Certified Forensic Accountants • Business Consultants
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