

Avoiding Missteps When Fraud is Suspected

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Fraud can have a devastating impact on CPAs' clients and on CPAs as well if they aren't careful in defining the scope of their services and properly responding when fraud is identified or suspected.

But why? Audits are designed to provide *reasonable assurance* that misstatements will be detected that could have a *material* effect on the financial statements, whether from errors or fraud. And the objective of a review is to obtain *limited assurance* that there are no *material* modifications that should be made to financial statements. Neither engagement is intended to provide absolute assurance, and most traditional CPA services aren't intended to provide any assurance at all. Why then would CPAs be expected to detect fraud resulting from withheld information, misrepresentations or falsified documents?

The answer, along with the problem, is *expectation*. The public believes that CPAs, regardless of the services performed, are the *Fraud Police*. We're certainly not the *Fraud Police*—the most recent survey by the Association of Certified Fraud Examiners noted only 3.3 percent of occupational frauds were initially detected by external audits while tips and accidents led to the discovery of over half the frauds.¹

To contain this expectation and to comply with professional standards in many cases, CPAs should obtain written understandings (i.e., engagement letters) that clearly define the client's (or management's) and the CPA's responsibilities for fraud prevention, detection and the communication of related matters before performing services.

As many policyholders are aware, CAMICO has a large library of sample engagement letters and clauses. All letters relating to the issuance of financial statements require clients to acknowledge their responsibility for both fraud prevention and detection. Additionally, these letters indicate the CPA will inform the appropriate level of management of any evidence or information that comes to the CPA's attention, during the performance of their engagement, that fraud may have occurred. This language is not only good risk management, but also complies with the AICPA's Auditing Standard titled *Consideration of Fraud in a Financial Statement Audit*,ⁱⁱ and AR Sections 80 and 90, which address CPAs' and their clients' responsibilities for fraud prevention and detection in compilation and review engagements, respectively.

The client's responsibilities for fraud detection and prevention aren't limited to financial statement engagements. So why not specify these responsibilities in all engagement letters, and not just those mandated by professional standards? Sadly, CPAs and their clients all too often are fixated on limiting the content of their engagement letters to the least amount of text and pages as possible. Fight this urge and the "fraud police" perception. Whenever tolerable, add engagement letter language indicating it is the client's responsibility to prevent and detect fraud.

Our Achilles Heel

CPAs want to help. This is a great attribute, but it can also place CPAs at considerable risk. When faced with suspicion that their client may have suffered a fraud, CPAs often want to, and do, come to the rescue. But, do they have the *professional competence* to do so. In their eagerness to help, do they take *due professional care* or adequately *plan or supervise* their response to the fraud? And do CPAs obtain *sufficient relevant data* to

support statements made regarding the alleged fraud? In their eagerness to help, CPAs might not have considered these General Standards.ⁱⁱⁱ All too often, attorneys representing parties impacted by fraud successfully allege that CPAs' hurried responses to fraud violated these general standards as well as the independence and objectivity rules.^{iv}

Scope, Limits and Acceptance Considerations

When faced with this opportunity/dilemma, CPAs should answer the following five questions before taking on this assignment: Will I impair my independence? Am I conflicted out? Do I have the requisite competence? Do I have the necessary experience/qualifications? Will I be digging my own grave?

If you are not performing an attest engagement, it won't matter if the engagement impairs your independence, but if you are, then be sure to comply with the AICPA's nonattest services requirements.^v CPAs should consider whether their objectivity is impaired before accepting a fraud examination engagement. Can you be objective when evaluating potential fraud that you didn't discover when performing your previous services? To avoid repercussions, CPAs should take care to reduce the likelihood that stakeholders perceive their investigation was not independent, objective or incompetently performed. In order to maintain independence, CPAs performing attest services (e.g. audits or reviews) will normally not participate in investigations. Due to independence impairment issues, forensic accountants should not be the external CPA engaged to perform financial statement services other than compiled financial statements for which they indicate they are NOT independent.

Certified Fraud Examiners and CPAs Certified in Financial Forensics have obtained credentials that provide bona fides for operating in this arena. CPAs lacking either credential should seriously consider teaming with those who do, or decline to participate on the team conducting the investigation.

If persons performing the fraud investigation work lack the requisite objectivity and competence, their efforts could result in evidence spoliation and a waste of valuable time. CPAs considering this niche are often surprised by the requirements and attributes of particular interest and benefit.^{vi}

Initial Response and Recommendations

CPAs should take care to avoid allegations that their fraud response is unauthorized or libelous. To do so, they should first obtain sufficient fraud predication of fraud suspicions describing the nature, the background and the basis for the suspicions. They should also establish that fraud suspicions are alleged by others, and should obtain written approval before accessing records or interviewing personnel.

If sufficient predicate exists, then CPAs should encourage management to:

1. Remain calm so they can participate in making informed decisions in response,
2. Inform legal counsel (investigations led by counsel preserve available legal privileges),
3. If the allegations pertain to senior management or officers, promptly notify the board of directors,
4. Identify documentation and records to be preserved and protected,
5. Share information only with those having the responsibility and skills to respond to the issues (investigations can be hindered by loose lips),
6. Separate facts from concerns and assumptions,
7. Take steps to minimize further losses (e.g., consider changing locks, passwords, combinations, Internet access to financial records), and
8. Consider whether it is wise to restrict duties or place on administrative leave those under suspicion until cleared.

Suspected fraudsters often are tempted to destroy or alter evidence. Consequently, it is important to secure records, documentation and other evidence as soon as possible; be sure concerned clients take the requisite precautions to preserve the evidence.

Poor decisions made in response to the initial suggestion that a fraud may have occurred can have devastating consequences. A competent, considered approach in response to the justification for a fraud investigation avoids missteps that could compromise the investigation and prosecution.

The goals for the initial response should not include a determination of exactly what occurred, or a quantification of any losses. Instead, the response should establish a foundation to assist the entity's management in making effective, prompt decisions to protect the company's finances and reputation.

An external CPA's response and suggestions regarding suspicions of fraud should not be influenced by the level of service the CPA was providing before fraud was suspected.

Establish a Written Understanding (e.g., Engagement Letter)

Whenever the CPA elects to participate in a fraud investigation, the CPA should establish with the client a written understanding that:

- Defines the scope and limits of the engagement (consultant or expert witness)
- Indicates services will be performed under the AICPA's Statements on Standards for Consulting Services (which distinguishes the work from any attest service)
- Indicates services will be directed by client's attorney
- Requests a retainer
- Does not describe expected results

The Fraud Investigation

Properly conducted investigations demonstrate that personnel are treated fairly, but fraud and unethical behavior will not be tolerated by those who are "integrity challenged." Presume work will be submitted to a prosecutor; by doing so, you avoid taking shortcuts that could undermine a successful prosecution. Pay particular attention to maintaining the chain of custody of evidence.

Be organized. Consider what is to be done, reassess results and implications after performing each step; the ultimate goal is to be able to answer who, why, how, and when the fraud was committed.

Outline:

1. Obtain engagement letter
2. Plan and organize
3. Gather evidence and data
4. Communicate with stakeholders early and often
5. Assess results
6. Report results and recommendations
7. Consider notifying law enforcement officials, restricting access by suspected fraudsters.

Factors to consider:

1. What are the key issues?
2. Who is involved?

3. Who is aware?
4. How pervasive is the fraud?
5. Should outside experts be consulted?
6. Identify records to be collected, preserved and analyzed
7. Collect the data
8. Consider recalling and restating financial statements
9. Who should be informed?

Documentation

Accurately and timely document work performed – this will necessitate:

- Properly tag and mark documents
- Work with copies, not originals
- Be factual
- Be timely
- Be concise
- Omit opinions

Interviewing

This function should be left to the experts and is too specialized to address in this article. There are a number of books, courses and newsletters on the subject (e.g., see the Association of Certified Fraud Examiners and Hamlet's Mind, www.hamletsmind.com, for newsletters and books on the subject).

Computer/Technology Issues

- Use an expert
- Consider mirroring
- Don't turn on or off
- Don't access files — will change metadata
- Consider *all* data storage (computers, flash drives, backup tapes, smartphones, "the cloud," etc.)

Makeup of the fraud investigation team

Those participating in the investigation should be independent of the activities, transactions and individuals who could potentially be culpable. Although it is natural to focus suspicions on particular individuals, the CPA should encourage management to go into the investigation with an open mind and to consider more than the obvious.

Impact on management and management's responsibilities

An organization's willingness to pursue fraud suspicions and to permit thorough inquiries and investigations is a strong sign of management integrity. Also, a proper examination by a qualified independent forensic team will allow the owner and/or management to focus their attention on day-to-day operations.

Stakeholders to keep informed:

- Owners/ management
- Board of Directors
- In-house counsel
- External counsel
- Forensic investigators
- Law enforcement (only after obtaining sufficient evidence and consulting with legal counsel)

Once fraud suspicions are validated (determined to be founded), the client should be encouraged to notify the appropriate insurance companies in order to avoid compromising any future claims.

Fraud Investigation Common Mistakes

- Not properly documenting work throughout
- Not securing evidence
- Overlooking electronic evidence
- Not using/being an expert
- Not maintaining chain of custody of evidence
- Not documenting/communicating exculpatory evidence

Practical Fraud Loss Prevention Tips

- Warn of embezzlement risk
- Offer internal control assistance
- Offer two-tiered bank reconciliation services (CAMICO policyholders can visit the Fraud and Engagement Letter resource centers on the CAMICO Members-only Site, www.camico.com, for sample letters and articles pertaining to the three preceding bullet points.)
- Recognize potential independence and objectivity impairment
- Encourage clients to require vacations as well as job and task rotation (fraudsters can't take the chance that the evidence of their fraud will surface on someone else's watch)
- Suggest clients establish fraud/ethics hotlines
- Encourage clients perform fraud risk assessments (consider discussion leader role)

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ⁱThe ACFE's 2012 Report to the Nations on Occupational Fraud and Abuse is available for free at <http://www.acfe.com/rtnn.aspx>

ⁱⁱ AU Section 316 effective for periods ending through December 14, 2012, and AU-C Section 240, effective for periods ending after December 14, 2012

ⁱⁱⁱ ET Section 201- General Standards

^{iv} ET 101 - Independence and ET 102 - Integrity and Objectivity

^v Interpretation 101-3 Nonattest Services

^{vi}<http://www.aicpa.org/interestareas/forensicandvaluation/resources/practaidsguidance/downloadabledocuments/forensicaccountingresearchwhitepaper.pdf>